

Addressing Agency Costs through Private Litigation in the U.S: Tensions, Disappointments, and
Substitutes

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Draft of September 2, 2015

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We would like to thank the participants of the Conference on Public and Private Enforcement of Company Law and Securities Regulation – China and the World, December 13-14, 2014 for their helpful comments.

Introduction

Attention in the typical American corporate law class is riveted on addressing managerial agency costs. Berle and Means¹ popularized the topic by documenting how in the 1930's the ownership of U.S. public companies was separated from their management resulting in a misalignment of utility curves between owners and managers. Within such systems, shareholders engage in a variety of strategies so as to minimize these costs.² For example, shareholders may use shareholder voting, the threat of a change of control transaction, performance based-compensation, and litigation, among other things, to discipline managers should they be poor stewards and fail to create shareholder value. Over time, the relative value of these different devices for disciplining managers has ebbed and flowed with the changes in patterns of share ownership and constant evolution in legal rules, both substantive and procedural.³

Against this paradigm, the corporate law class studies how private suits, whether class actions or derivative suits, are potential tools for controlling managerial agency costs.⁴ Many scholars argue that over the past seventy years, shareholder representative litigation has acted as

¹ Adolf Berle and Gardner M. Means, *The Modern Corporation and Private Property* (1932)(describing not only that the typical public corporate owners were dispersed so that owners' exercise of oversight was seriously limited by high coordination costs that enabled managers to essentially hire capital rather than capital retain managers).

² The classic work, Michael Jensen and William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. Fin. Econ.* 305 (1976), sets forth the framework for considering multiple efficient responses to agency costs.

³ Randall S. Thomas and Robert B. Thompson, *A Theory of Representative Shareholder Suits and its Application to Multijurisdictional Litigation*, 106 *Northwestern L. Rev.* 1753, 1758-1760 (2012).

⁴ For a positive view of the efficiency of shareholder suits in addressing agency costs, *See e.g.*, James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 *Geo. Wash. L. Rev.* 745 (1984). *But see* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 *Cornell L. Rev.* 261(1986); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 *J. L. Econ. & Org.* 55 (1991).

an important policing mechanism of managerial abuses at U.S. public companies.⁵ Different types of representative litigation have had their moment in the sun – derivative suits early on, followed by federal securities class actions, and most recently merger litigation—often producing benefits for shareholders, but posing difficult challenges as well. In particular, the benefits are qualified by another concern, the litigation agency costs that surround shareholder suits. This form of agency costs arises since the suits are invariably representative with no requirement that the named plaintiffs have a substantial ownership interest in the corporation, so that their prosecution could be easily seen as lawyer-driven.⁶ And that perception is further underscored in the U.S. where the “American Rule,” in contrast to the “Loser Pays Rule,” provides no governor on the suit’s initiation and prosecution.

In this article, we assess the interactions of shareholder suits and governance mechanisms. Our thesis is straightforward: we claim that the recent rise of some important governance developments is a natural consequence of both the ineffectiveness and inefficiency of private suits to address certain genre of managerial agency costs. That is, just as one part of a balloon expands when another part contracts, we find that governance responses evolve to fill voids caused by the decompression of shareholder monitoring once supplied by private suits. In other words, as representative shareholder litigation comes under increasing attack, greater attention needs to be devoted to governance and market mechanisms as alternative means to address managerial agency costs.

⁵ Robert B. Thompson and Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 *Vanderbilt L. Rev.* 133 (2004); C.N.V. Krishnan, et al., *Shareholder Litigation in Mergers and Acquisitions*, 18 *Journal of Corporate Finance* 1248 (2012); James D. Cox and Randall S. Thomas, *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law*, 6 *European Company and Financial Law Review* 164 (2009).

⁶ *See e.g.*, John C. Coffee, Jr. *Understanding the Plaintiff’s Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 *Colum. L. Rev.* 669 (1986); Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 *Duke L. J.* 945 (1993)

But we also take this argument one step further: these new governance responses are themselves more efficient because, in part, of the rising concentration of share ownership of public companies. Decades after Berle and Means aroused attention to the presence and ills of the separation of ownership from management, share ownership has steadily evolved so that there are now a significant number of large blockholders at many public companies. In fact, today there is growing activism among this growing group of blockholders.⁷

Activist hedge funds are its most obvious manifestation. Hedge fund activism is one of the new policing mechanisms for managerial agency costs have sprung up in the US. These funds control large pools of unregulated capital and aggressively invest in underperforming target companies seeking to bring about stock price increases. Hedge funds have assumed a role of “governance intermediaries” as they develop and present choices for more docile institutional holders who can become supporters but rarely initiators.⁸ Institutions are informed by their independent third party proxy advisors on initiatives teed up by the activist hedge fund. Hence in combination the hedge funds and institutional investors have pushed and shoved to get reluctant managers to take shareholder value maximizing actions.

The passage of the Dodd-Frank Act further armed institutional investors by mandating a non-binding Say-on-Pay vote. This new vote fills a corporate governance hole created by the failure of derivative suits by enabling shareholders to engage in direct monitoring of executive compensation. While its effectiveness as a check on executive pay is still being studied, it has

⁷ Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 *Rev. of Fin. Studies* 1377 (2009). This activism is further facilitated by private equity firms’ ownership consolidation. See pp. ___ below.

⁸ See Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 *Colum. L. Rev.* 863 (2013)(activist hedge funds are desirable complement to tendency of financial institutions to be “rationally reticent”); Paul H. Edelman, Randall S. Thomas and Robert B. Thompson, *Shareholder Voting in an Age of Intermediary Capitalism*, 87 *Southern California Law Review* 1359 (forthcoming 2014). A close review of the multiple effects of hedge fund activism, see Alon Brav, Wei Jiang, Frank Partnoy & Randall S. Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 *J. Fin.* 1729 (2008).

undoubtedly triggered a greater level of engagement between corporate directors and shareholders.

Finally, we consider the rising role of the appraisal remedy against the context developments in shareholder litigation focused on acquisitions. As we will see, the appraisal proceeding, an old and previously largely defunct, form of litigation, has been spruced up by a few intrepid investment groups, who have begun filing these actions in an effort to engage in what some have called “appraisal arbitrage.” This new monitoring technique must overcome many hurdles though before it can truly fulfill its promise. We conclude that each one of these new, or revived, monitoring techniques may be able to stand in for representative shareholder litigation during its hour of need to insure that managerial agency costs don’t rise too far.

I. The Shifting Landscape of Private Shareholder Litigation

During the past seventy years there have been many shifts among the multiple types of shareholder litigation. Close examination reveals both contraction and expansion with the former involving procedural developments whereas the latter invariably doctrinal innovations. Despite these ebbs and flows, the business community shares the common view that shareholder litigation is vexatious, robust and expanding. As we will see, their concern is partly justified, at least with respect to litigation spawned by acquisitions. In this section, we set forth the significant substantive and procedural developments we argue not only define the realm of shareholder litigation in the U.S. but invite governance to enter where litigation formerly was the sole mechanism for limiting managerial agency costs.

A. Shareholder Merger and Acquisition Class Actions

Delaware jurisprudence has for some time placed a bright bull's-eye on merger and acquisition transactions inviting shareholder initiated court challenges. Initially litigation was aimed at self-dealing acquisitions such as where a cash-out merger occurs with the controlling stockholder.⁹ Judicial review was later extended to multi-step transactions with the dominant stockholder.¹⁰ In such transactions, the burden of proving their entire fairness is on the dominant stockholder. Many sales of control to a third party under Delaware law also invite heightened scrutiny with the burden on management to prove they acted prudently to get the best offer.¹¹ And, should the target of another firm's ardor rebuff the bidder's overture, Delaware also subjects those defensive actions to heightened scrutiny.¹² Knitting each of these together is the Delaware belief that the significance of the transaction to the shareholders, and in some instances the serious risk of director self-interest, combine to present an appealing case to lift the otherwise strong presumption of independence and good faith so that a fulsome inquiry of the overall fairness of transaction can be judicially conducted.

The bull's eye that judicial doctrine has placed on these transactions has had its effect. Litigation against publicly held companies that under deals overwhelmingly arises in the form of class actions, as opposed to derivative suits.¹³ Generally, multiple suits are filed very quickly

⁹ The leading case is *Weinberger v. UOP, Inc.*, 457 A.2d 701 (1983).

¹⁰ *In re Pure Resources, Inc. Shareholder Litigation*, 808 A.2d 421 (Del. Ch. 2002)(controlling stockholder who raises ownership interest to level sufficient to carry out a short-form merger via a tender offer must establish entire fairness in the resulting merger, unless such merger is consummated at the same terms as the preceding tender offer, the overall transaction is conditioned on a non-waivable plebiscite of a majority of the independent shareholders, and there is no accompanying retributive threats).

¹¹ The principle was first established in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A. 2d 173 (Del. 1986), and was further clarified in *Paramount Comm. Inc. v. QVC Network*, 637 A.2d 34 (Del. 1994).

¹² At least in Delaware, such defensive measures are guided by *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995), modifying *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

¹³ Thompson and Thomas, *The New Look of Shareholder Litigation*, supra note 5, at 137.

after the announcement of a transaction, by law firms who are repeat players in such litigation.¹⁴ Early data indicated that suits challenging deals in which managers had a conflict of interest in the proposed deal were the most likely to produce cash settlements and that these suits did not exhibit the same degree of litigation agency costs as suggested for other representative suits.¹⁵ Thus, during 1999 – 2000, only 12% of deals had litigation and that most of the deal litigation related to Delaware firms was in Delaware.¹⁶ Furthermore, this litigation decreased the likelihood of a deal closing, but also increased return on the deals that closed, so that overall it was associated with an increased return for the deals.¹⁷

This has since changed dramatically so that today almost all deals attracting suits.¹⁸ Cain and Davidoff report that in 2012 there were 121 transactions over \$100 million in value, and that 111 of these deals experienced deal litigation.¹⁹ Roughly 50% of these deals also resulted in litigation in more than one jurisdiction.²⁰ While several commentators have opined on the underlying causes for these developments,²¹ we observe that it has occurred while, as seen later in Section II.C, the number of securities class actions and their lawyers has declined. While causation is always a difficult challenge, we do surmise that the rapid rise in transaction oriented litigation may, at least in part, be reflective of many plaintiff-oriented law firms redirecting their foci.

¹⁴ *Id.* at 138.

¹⁵ *Id.* at 172 tbl.4.

¹⁶ C.N.V. Krishnan et al., *Shareholder Litigation in Mergers and Acquisitions*, 18 J. Corp. Fin. 1248, 1249-1250 (2012).

¹⁷ *Id.*

¹⁸ Randall S. Thomas & Robert B. Thompson, *A Theory of Representative Suits and Its Application to Multijurisdictional Litigation*, 106 NW. U. L. REV. 1753 (2012).

¹⁹ Matthew D. Cain & Steven M. Davidoff, *Takeover Litigation in 2013* (Jan. 4, 2014) (unpublished working paper), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2377001, at 1–2.

²⁰ *Id.* at 2.

²¹ Thomas and Thompson, *A Theory of Representative Suits*, supra note ; John Armour, et al., *Is Delaware Losing its Cases?*, 9 J. Empirical Legal Stud. 605 (2012); Sean J. Griffith & Alexandra D. Lahav, *The Market for Preclusion in Merger Litigation*, 66 Vand. L. Rev. 1053 (2013).

Just as too much fudge can be a problem, too warm an invitation to challenge transactions also has its list of problems. Delaware has innovated, just as it did initially with creating the doctrine inviting suits. Among its substantive innovations was removing from close burden-shifted fairness inquiry freezeouts pursuant to state short-form merger statutes that allow parents to acquire a ninety percent owned subsidiary solely upon the approval of the parent board of directors.²² More recently, in *Kahn v. M & F Worldwide Corp.*,²³ the Delaware Supreme Court held that an acquisition involving the dominant stockholder would nonetheless enjoy a presumption of fairness if there is both impartial approval by a majority of the disinterested shareholders of the subsidiary *and* the subsidiary was represented in the negotiations by a truly independent negotiating committee. Where each of these conditions is met, the transaction enjoys the substantial protections of the Business Judgment Rule that is generally accorded arms-length transactions.

Delaware has also innovated procedurally. The most troubling aspect of acquisition litigation captured in the above statistics is not the rise in the rise over time in the percentage of acquisition transactions that are challenged but that the pattern today is that there are multiple suits in multiple forums. When the multiple suits are all in Delaware, this was a manageable problem. For example, simplifying rules such as “first to file,” while crude, had the benefit of allowing a court to quickly consolidate the nettlesome suits into one. Thus, while multiple suits have always something of an eyesore to the profession, and particularly the dignity of the litigation bar, it was a manageable one when the suits were in Delaware. However, when the same acquisition triggers multiple suits outside of Delaware, the problem is of a quite different magnitude because of the inherent limits on a single court’s jurisdiction to resolve disputes.

²² *Glassman v. Unocal Exploration*, 777 A.2d 242 (2001).

²³ 88 A.3d 635 (Del. 2014).

A sobering lesson to be drawn from the explosion of multi forum litigation is illustrated in *Pyott v. Louisiana Municipal Police Employees' Retirement System*.²⁴ Derivative suits were filed in California federal court and Delaware Chancery Court following Allergan's guilty plea accompanied by the payment of a \$600 million fine for having actively marketed off-label uses of its blockbuster drug, Botox. Despite the fact that the case was proceeding on an expedited discovery calendar in Delaware, the California federal court acted first. In *In re Allergan*, the federal district court dismissed with prejudice the derivative suit on the grounds the derivative suit plaintiff failed to allege sufficient facts to excuse a demand on the board of directors under governing Delaware precedents.²⁵ Thereupon the defendants moved to dismiss the Delaware suit, arguing that through the application of collateral estoppel the Delaware suit could not continue as dismissal was constitutionally required by the Full Faith and Credit Clause of the Constitution. In an extensive review of the governing law and the factual allegations set forth in the complaint, Vice-Chancellor Laster refused to dismiss the case.²⁶

Vice-Chancellor Laster reasoned that preclusion on the basis of collateral estoppel required privity between the litigants. While privity exists in contemporaneous derivative suits, even though different plaintiffs initiated the suits, Laster held that under Delaware precedents, because of the plaintiff's failure to show that demand was excused, whereby the plaintiff could be deemed the legal representative for the corporation's suit, that privity does not exist when the suit has been dismissed because demand was neither made nor excused. An independent basis for holding the Delaware suit was not collaterally estopped was his belief that the plaintiff in the California suit was not an adequate representative. The basis for this conclusion was that the

²⁴ 74 A.3d 612 (Del. 2013).

²⁵ *In re Allergan*, 2011 WL 1429626 (C.D. Cal., Apr. 12, 2011).

²⁶ *Louisiana Municipal Police Employees Retirement System v. Pyott*, 46 A.3d 313 (Del. Ch. 2012).

California suit's plaintiff was represented by what Vice-Chancellor Laster described as a "fast filing" "specialized plaintiff's firm" who customarily files suits on a contingency fee basis.²⁷ Much of the opinion on this issue is directed to reviewing the problems that flow from the first-to-file rule, most significantly prompting hasty filings of ill-conceived suits, concluding that "[b]y leaping to litigate without first conducting a meaningful investigation, the California plaintiffs' firms failed to fulfill the fiduciary duties they voluntarily assumed as derivative action plaintiffs."²⁸ The court thus concluded that preclusion was not in order since the earlier action failed to provide adequate representation for Allergan.

The Delaware Supreme Court reversed on both points. The court held that California, and not Delaware, law should determine whether privity is lacking due to the derivative suit's dismissal for the failure to excuse demand on the board of directors. It concluded that under California law, contrary to the approach in Delaware, privity is satisfied even though the suit is dismissed for failure to excuse a demand. The Supreme Court also held that the irrebuttable presumption that fast-filers are inadequate representatives was not justified and, hence, overruled this basis for holding the prior suit did not preclude the Delaware suit.

Central to understanding the significance of *Pyott* is that the Vice-Chancellor would have excused the demand and disagreed with the California federal court that did not excuse a demand. A close comparison of the complaints in each case support the ruling made by each court. For example, in *Allergan* the federal court found that the complaint baldly asserted the board's knowledge of off-label promotion solely because the board had knowledge of off-label sales. In contrast, this assertion was more fully developed by the plaintiff in *Pyott*. There the

²⁷ 46 A.3d at 336. The fact that the action before him was being prosecuted by a firm that also fit this profile was not mentioned in the opinion.

²⁸ 46 A.3d at 350.

complaint alleged, among other facts, that the board approved promoting off-label use as part of an overall strategic plan. Similarly, *Allergan* held the complaint's allegations were too conclusory with respect to the charge that the board ignored marketing wrongdoings; whereas the complaint in *Pyott* detailed that the board received warnings from the firm's general counsel that off-label use was due to misbehavior in the marketing department and that the board approved a series of strategic plans that involved off-label applications of Botox (as well that board was aware that Botox use was increasing at a far faster rate than on-label use).

A close review of the two opinions supports the view that the complaint before the Delaware court was far more detailed in supporting the central allegations of a *Caremark* oversight claim than was set forth in the complaint before the federal district court. As such, there was a substantial basis to support Vice-Chancellor Laster's conclusion that sufficient facts were alleged to support reasonable inferences that the directors and officers of Allergan expected to garner increased sales by active promotion of off-label uses of Botox.²⁹ Of note is that the difference is not with the judge but the quality of the derivative suit counsel.³⁰ The difference between the two courts is not a dispute over doctrine. It is a dispute over whether facts violate a doctrine, namely the fiduciary obligation of officers and directors not to knowingly violate a criminal statute. And there is no reason to believe that had the federal district judge had the Delaware complaint before him that his decision would have been different from that reached by Vice-Chancellor Laster. No doubt Delaware's four Chancery Court judges hear many cases and likely have developed a stronger sense of how the doctrine has been interpreted. But the close comparison of the two complaints reveal that the difference in result was not due to experience

²⁹ 46 A.3d at 357.

³⁰ C. N. V. Krishnan, Steven Davidoff Solomon and Randall S. Thomas, *Zealous Advocates of Self-Interested Actors? Assessing the Value of Plaintiffs' Law Firms in Merger Litigation*, Vanderbilt Law and Economics Research Paper No. 14-25 (2014), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2490098

of the two judges; instead, it appears that the attorneys pressing the case in California were not equal to those before the Delaware court. As a consequence, the cause of action appears to have been poorly prosecuted in California- a fate that Vice-Chancellor Laster sought to amend.

The inability to correct the error, nonetheless underscores that among the burdens of that multi-forum litigation is not just unevenness across the judiciary but more importantly unevenness across the suits' counsels. This may well reflect the reluctance of some counsel to invest heavily in investigating the facts of the case and devoting time to drafting a complaint if uncertain whether those efforts will be undercut by a swifter proceeding by a rival counsel. If this surmise is correct, it poses a larger concern: this is an arena in which diligence and reflection are ultimately not rewarded but nimbleness and timing.

A further concern that flows from multi-forum litigation is a fear that this could feed a reverse auction; this occurs when a cooperative plaintiff collaborate with the defendant corporation to bring all challenges to a swift resolution by a court-approved low-ball settlement that yields a quick return to the lawyers but fails to protect the interest of the shareholders.³¹ By way of illustration, consider *Matsushita Electric Industrial Co. v. Epstein*,³² where Matsushita was sued in two class actions, one in federal court alleging violations of the federal securities laws regulating tender offers and the other in the Delaware Chancery Court alleging various breaches of fiduciary duty by company officers. Matsushita prevailed in the federal district court, and while that decision was being appealed to the Ninth Circuit, Matsushita entered into a global settlement that was approved by the Delaware court on terms that released the claims that had been raised only in the federal court. Even though the state courts lack jurisdiction to entertain the federal securities law claims, the U.S. Supreme Court held that the Full Faith and Credit

³¹ Thomas and Thompson, A Theory of Representative Suits, supra note .

³² 516 U.S. 367 (1996).

Clause of the U.S. Constitution required upholding the global settlement, provided the shareholders' interests were adequately represented.³³ In the background of this matter is the important fact that the two suits were being prosecuted by two competing law firms and that the damages being pursued in the federal district court were of a significantly greater amount than those at play in the Delaware state action. Hence, precedent exists within which a reverse auction can occur, if not thrive.

Matsushita creates the potential for multi-jurisdictional litigation to cause harm in both federal and state court. While there are a variety of potential ways to address these problems, one private ordering antidote for the multiple concerns associated with multi-forum litigation is the forum selection bylaws.³⁴ These bylaws are adopted solely on the approval of the board of directors and mandate most forms of shareholder suits can only be maintained in a particular forum, generally Delaware.

In 2013, the Delaware Chancery Court upheld a unilaterally director adopted forum selection bylaw, reasoning the bylaws, including the board's authority to adopt bylaws, were an extension of the shareholders' contractual rights to the corporation.³⁵ More recently, the Delaware Supreme Court similarly reasoned that a bylaw by a non-profit corporation could impose a "loser pays" standard on shareholder litigation. The ultimate step in a board of directors' resort to the bylaws to address feared shareholder suits will be mandated arbitration; this step remains to be adjudicated in Delaware but is clearly at hand.

Thus, we see colliding developments in Delaware. On the one hand, the Delaware courts have developed broad substantive doctrines that provide avenues for shareholders to head to

³³ In *Epstein v. MCA, Inc.*, 179 F.3d 641 (9th Cir. 1999), the court held that the Delaware litigants and their attorney adequately represented the shareholders in prosecuting that suit.

³⁴ Thomas and Thompson, *A Theory of Representative Suits*, supra note .

³⁵ *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013).

court to challenge the conduct of the board of directors in mergers and acquisitions. On the other hand, the Delaware courts have approved boards adopting bylaws that channel those challenges to Delaware, that discourage such suits' maintenance by shifting costs to the losing party, and that portend sweeping all such disputes behind the veil of arbitration. These new bylaws will most likely lead to less accountability on the part of managers and their boards.

B. Derivative Suits

Traditional derivative cases raise state law breach of fiduciary duty claims against directors and officers. Typically, these claims allege breach of the duties of loyalty (including good faith) and care, as well as other state law issues. They are commonly used to attack directors or officers engaging in conflict of interest transactions with the corporation or taking a corporate opportunity belonging to the corporation. The options backdating scandal, in which a number of large corporations were found to have provided their executives with options to buy stock on dates and terms that were backdated, is a good example.³⁶ These cases arose after a scandal sparked by academic research and news stories led to government regulatory investigations that revealed wide-ranging misbehavior. In the aftermath of these events, shareholders filed many derivative suits to recover benefits that insiders unjustly obtained from the corporation.³⁷

³⁶ Quinn Curtis and Minor Myers, *Do The Merits Matter? Evidence from Options Backdating Derivative Litigations*, U. Penn. L. Rev (forthcoming 2015); John Armour, Bernard S. Black & Brian R. Cheffins, *Delaware's Balancing Act* (Univ. of Cambridge Faculty of law, Paper No. 37, 2011) available at <http://ssrn.com/abstract=1677400> [hereinafter *Delaware Balancing*], at 19 (discussing data relating to option backdating cases).

³⁷ See C. Forelle & J. Bandler, *the Perfect Payday- Some CEOs reap millions by landing stock options when they are most valuable; Luck or something else?* Wall St. J. A1 at c. 6 (March 18, 2006); *Ryan v. Gifford*, 918 A.2d 341, 360 n.60 (Del. Ch. 2007) (detailing scholarly research on the backdating controversy); Shannon German, *What They Don't Know Can Hurt Them: Corporate Officers' Duty of Candor to Directors*, 34 DEL. J. CORP. L. 221, 235 (2009) (explaining how a Wall Street Journal piece led to the investigation of 130 companies for backdating).

Derivative suit litigation among the broad group of shareholder suits is the most stable set of cases of all of the representative litigation groups. There has been little change in the underlying set of legal and procedural rules for derivative litigation in the past twenty years. In prior research, one of the authors studied all derivative litigation filed in Delaware during 1999 and 2000.³⁸ That article found that Delaware public companies were hit with about 30 cases per year with about 30% of them yielding relief to the corporation or its shareholders, and the remainder being quickly dismissed with little litigation activity.³⁹ Private Delaware firms were targeted with a dozen lawsuits annually, typically raising claims of minority oppression.⁴⁰

This research showed that a careful distinction must be made between public and private corporations when discussing the role of shareholder derivative suits. Derivative suits are very much alive and well in the private company setting; in this context they perform their historical function of remedying breaches of duty of loyalty, customarily in the form of acts in bad faith and more particularly self-dealing practices. In the close corporation context, they are better seen as remedying opportunistic behavior by those in control. While opportunistic grabs for assets and business are not foreign to public companies, in the public company context the malefactor is more likely to enjoy the insulation provided by the demand requirement. That is, a major feature of the derivative suit is the requirement that the suit plaintiff must either make a demand on the board of directors or establish a basis why such a demand would be futile. The ultimate outcome in either case depends on whether the board, or a subcommittee of the board, is believed to be sufficiently independent of the suit so that the board or committee's opinion that the suit fails to serve a corporate interest will be upheld by the reviewing court. As a consequence, the robust

³⁸ Robert B. Thompson and Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 *Vanderbilt L. Rev.* 1747 (2004).

³⁹ *Id.* at 1749-1750.

⁴⁰ *Id.*

derivative suit boneyard for public companies is predominantly the handiwork of the demand requirement. In the case of the private corporation, because those disputes are largely between the “ins” and the “outs,” the demand requirement is much less lethal because the alleged wrongdoing at the heart of the suit frequently can be more easily linked to a majority of the board. Also shaping the contours of such suits is the wide-adoption of immunity shields whereby a provision in the firm’s articles of incorporation insulates directors from liability for misconduct that is not a breach of the duty of loyalty, illegal, in bad faith or a knowing violation of the law.⁴¹ Immunity shields thus limit suits focused on alleged managerial failures to those involving knowing and systematic breaches on the part of the board.

While the derivative suit continues to be viable even within public companies, the vitality it enjoys depends very much on what form of managerial agency costs is the target of the suit. An area of distinct failure is that of executive compensation. In this area, both substantive doctrine and procedural requirements have eviscerated the derivative suit as an effective governor of executive compensation.⁴² This was not always the case. During the Great Depression, a good deal of litigation ensued, and with success, attacking bonus and incentive compensation policies of large public companies.⁴³ The leading case of the day, *Rogers v. Hill*,⁴⁴ held that compensation received by the firm’s president and directors was excessive, reasoning that stockholder approval of the compensation package “cannot . . . be used to justify payments of sums as salaries so large as in substance and effect to amount to spoliation or waste of corporate property. . . . If a bonus payment has no relation to the value of the services for which

⁴¹Del. Code Ann., tit. 8 §102(b) (7).

⁴²Randall S. Thomas and Harwell Wells, Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers’ Fiduciary Duties, 95 Minnesota L. Rev. 846 (2011).

⁴³ See Washington, A Corporate Executive’s Living Wage, 54 Harv. L. Rev. 733 (1941) (reviewing the case history of Depression Era compensation cases).

⁴⁴ 289 U.S. 582 (1933)

it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property. . . .⁴⁵ *Rogers* thus reflected the then contemporary approach to assess the overall reasonableness of the compensation package. In current times, the barest approval by a majority of the board of directors, insulates executive compensation. This bulwark is located in both substantive and procedural developments.

In re Walt Disney Derivative Litigation,⁴⁶ is the most celebrated U.S. executive compensation decision. The facts are complicated, but at their core the complaint was that the Disney board hired Michael Ovitz under pressure from Disney CEO Michael Eisner with knowledge that Ovitz had no experience for the position, only to have that confirmed within an admittedly short period of time whereupon the board, without consulting outside experts regarding the corporation's ability to terminate Ovitz's without breaching the employment contract, quickly agreed to a \$140 million severance package. Even though both the trial and Supreme Court acknowledge grave departures from good corporate practices, each found that the misconduct did not rise to the level of bad faith and, hence, was protected under the firm's immunity shield.⁴⁷

Even more protective of director decisions is the more recent decision, *Freedman v. Ada*.⁴⁸ A derivative suit was initiated to recover more than \$130 million in bonuses approved by the board of XTO Energy. The plan lacked performance-based standards demanded by Internal Revenue Code section 162(m) for compensation in excess of \$1 million to deductible business expense on XTO Energy's tax return. After the plaintiff initiated a derivative suit, complaining

⁴⁵ *Id.* at 591-92 (quoting in part the intermediate court dissenting opinion by Judge Swan).

⁴⁶ 907 A.2d 693 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

⁴⁷ 906 A.2d at 67.

⁴⁸ 58 A.3d 414 (Del. 2013).

that that lack of any performance benchmarks caused had the consequence under section 162(m) of raising the corporation's taxes, the board prospectively modified the plan and the plaintiff dropped her derivative suit. In responding to the derivative suit plaintiff's request for fees incident the claim, XTO Energy's argued that the board was fully aware of section 162(m), but made a conscious decision not to avail itself of section 162(m) because it believed its approach to compensation decision should not "be constrained by such a plan." The court denied any award of fees to the plaintiff because a claim had not been stated; the court reasoned: "[e]ven if the decision were a poor one" as alleged by the plaintiff, "it was not unconscionable or irrational."⁴⁹

In addition to its' weak substantive standards in the regulation of executive compensation, the derivative suit plaintiff faces typically insurmountable procedural barriers. Derivative suits challenging an executive's compensation are regularly rejected on the ground of failure to make a demand on the board of directors. Under the orthodox view, demand is excused on grounds of futility, which require evidence that the compensation is so egregious as to be beyond the protection of the business judgment rule, or that the plaintiff has alleged with sufficient particularity that a majority of the board of directors lacks sufficient independence from the suit, or the suit's defendants, to render an impartial decision on whether the suit's continuance would be in the corporation's interest.⁵⁰ Moreover, even if a demand is excused on a ground of futility, the board of directors can resurrect its ability to interdict the derivative suit by creating a special litigation committee of independent directors who can thereby provide an

⁴⁹ XTO, *supra* at .

⁵⁰ *See e.g.*, Aronson v. Lewis, 473 A.2d 805 (Del. 1984)(no futility on allegation that defendant controlled more than 70 percent of the voting stock and would receive a six-figure annual compensation regardless of service to the company) ; Marx v. Akers, 88 N.Y.2d 189, 644 N.Y.S.2d 121, 666 N.E.2d 1034 (N.Y. Ct. App. 1996).

independent voice on whether the suit's continuance is in the best interests of the company.⁵¹ Nonetheless, some courts closely evaluate the committee's reasons supporting any such recommendation, so that the deference normally attendant director decisions is much reduced in the instance of their rejection of a derivative suit's continuation.⁵²

In contrast to the near zero impact on policing executive compensation, derivative suit litigation remains a viable medium within a narrow area within public companies involving self-dealing whether by executives or a dominant shareholder.⁵³ However, the expected recovery is likely smaller so that standard justifications – expected benefits of the suit are dwarfed by the tangible and intangible costs of its prosecution - in support of a board or committee recommendation that the suit be dismissed could more easily be justified. What remains for the public company derivative suit are so-called “failure to oversee” claims against the board.

Failure to oversee claims find their source in former Chancellor Allen's path breaking *Caremark* decision holding that the directors' duty of good faith was breached when there is evidence of a “sustained or systematic failure of a director to exercise reasonable oversight.” A dramatic instance of such a suit is *In re Massey Energy Company Derivative and Class Action Litigation*⁵⁴ where the complaint withstood defendants' motions to dismiss by alleging facts reflecting that the board repeatedly ignored reports and sanctions of mine safety violations in the years preceding the explosion in its Upper Big Branch mine killed 29 miners – the deadliest mine accident in 40 years. But, absent such dramatic pre-disaster warnings as occurred in *Massey*,

⁵¹ See *e.g.*, *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981)(setting forth procedures for evaluating a committee recommendation in a suit challenging board's decision to accelerate exercise date of options that greatly reduced the taxable income related to executive options while simultaneously reducing the deduction the corporation would enjoy in connection with the options).

⁵² See *e.g.*, *Boland v. Boland Trane Associates, Inc.*, 423 Md. 296, 31 A.3d 529 (Md. Ct. App. 2011).

⁵³ Mergers and acquisitions with a dominant stockholder or where some managers receive favorable treatment are not litigated as derivative suits but as class actions alleging unfairness to the shareholders.

⁵⁴ 2011 Del. Ch. LEXIS 83.

there is frequently insufficient evidence on which to conclude that the board has engaged in more than negligent oversight for which the ubiquitous immunity shield, discussed above, insulates the board from being accountable in the derivative suit. Indeed, the Delaware judiciary may well conclude that ignoring red flags may not even rise to the level of director negligence. To illustrate, consider *In re Citigroup Inc. Shareholder Derivative Litigation*,⁵⁵ holding that the business judgment rule insulated the directors against charges they failed to take precautions to avoid the ensuing financial losses arising from Citigroup's large exposure to the subprime lending markets. The suit alleged various red flags such as an economist's forecast that a speculative bubble was nearing its end, a leading subprime lender closing its 229 offices, another lender filing bankruptcy, analysts downgrading subprime mortgages, and a warning of increasing subprime delinquencies by another lender. The court reasoned:

. . . [The "red flags"] amount to little more than portions of public documents that reflected the worsening conditions in the subprime mortgage market and in the economy generally. Plaintiffs fail to plead particularized facts suggesting that the Board was presented with "red flags" alerting it to potential misconduct. . . . [The plaintiffs] repeatedly make the conclusory allegation that the defendants have breached their duty of oversight, but nowhere do [they] adequately explain what the director defendants actually did or failed to do that would constitute a violation. Even while admitting that Citigroup had a risk monitoring system in place, plaintiffs seem to conclude that, because the director defendants were charged with monitoring Citigroup's risk, then they must be found liable because Citigroup experienced losses as a result of exposure to the subprime mortgage market. The only factual support plaintiffs provide for this conclusion are "red flags" that actually amount to nothing more than signs of continuing deterioration in the subprime mortgage market. These types of conclusory allegations are exactly the kinds of allegation that do not state a claim for relief under *Caremark*.⁵⁶

⁵⁵ 964 A.2d 106 (Del. Ch. 2009).

⁵⁶ *Id.* at 128-130.

The above reasoning appears consistent with observation made in a widely noted Delaware Supreme Court decision that conduct that offends good corporate governance practices nonetheless is not inherently negligent conduct.⁵⁷ Thus, not only the immunity shield but more importantly the high standard of fault required to constitute negligence on the part of the directors severely restrict the scope of duty to monitor suits.

C. Federal Securities Class Actions

The story of few trials and many tribulations of federal securities class actions is well understood. Cornerstone, the litigation support group, reports that during 2011-2013 companies within the S&P 500 experienced the lowest number of securities class actions. More generally, the number of securities class action filings in 2013, although in line with the immediate two preceding years, were thirteen percent below the historical average number of annual filings. At least since 2005, the trend line in filings has been downward. With the decline in securities fraud class action filings there has been a concomitant decline in the number of settlements reached each year. While the average number of settlements 1996-2013 is 123 per year, in 2012 there were just 94. However, in 2013, there were 100 settlements, the first increase in total settlements to be experienced in years. While these downward declines were occurring, median settlement size has increased from \$3.7 million in 1996 to \$9.1 million in 2013. This supports the claim that plaintiffs are more discriminating in the cases they file, switching to suits likely to compensate for them for the costs and risks of securities class action litigation that are cataloged below.

⁵⁷ In re the Walt Disney Company Derivative Litigation, 906 A.2d 27, ___ (Del. 2006).

The high risk incident to the filing of a securities class action is embodied in a single data point: the pre-trial dismissal rate of filed suits. In 1996, after the year the PSLRA was enacted, there were 42 securities class actions dismissed; whereas, in 2013, in an era when many fewer securities class actions were being filed 79 suits were dismissed. Overall, approximately 42 percent of filed securities class actions are dismissed in response to defendant's motions to dismiss or summary judgment. At the core of these trend lines is the cost curve for the suits' maintenance and those costs have, not surprisingly, been impacted by several legal legislative and judicial developments.

The plaintiffs' bar underwent a substantial face lift with the passage of the Private Securities Litigation Reform Act of 1995. A central provision of the PSLRA was establishing a procedure for the court to select a "lead plaintiff". Before the PSLRA, courts confronted with multiple class action filings for the same disclosure violation invariably followed the protocol of the "first to file" in deciding which filed action would proceed. The PSLRA's lead plaintiff provision provides a procedure for the court to select the "most adequate" shareholder representative to serve as the lead plaintiff from among those petitioning to be selected. The act establishes a rebuttable presumption that the investor with the largest loss is the most adequate plaintiff; as consequence the plaintiff in large post PSLRA securities class actions often is a large financial institution.⁵⁸ Because the PSLRA tasks the lead plaintiff with selecting the suit's counsel, a correlative effect of the lead plaintiff provision has been concentration of securities class actions among a few plaintiff firms who have the resources to nurture on-going

⁵⁸ See generally James D. Cox, Randall S. Thomas & Lynn Bai, There Are Plaintiffs and ... There Are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements, 61 Vanderbilt. L. Rev. 355, 377 (2008) (provable losses, asset size of defendant, and existence SEC enforcement action statistically correlated with presence of institution as lead plaintiff); James D. Cox and Randall S. Thomas, Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions, 106 Colum. L. Rev. 1587, 1619 (2006) (data reflects courts' preference for institution contrasted with individual, to be lead plaintiff).

relationships with many such financial institutions. Less well-connected law firms are now relegated to suits against companies whose market capitalization is less conducive to any institutional presence. Nonetheless, the overall objective of the lead plaintiff provision appears to be largely achieved, namely providing the securities class action lawyer with a real client. Evidence supports the view that institutional lead plaintiffs address the earlier referenced litigation agency costs of representative suits. Institutions serving as lead plaintiffs are associated with larger settlements, larger percentage recovery relative to provable losses, and pre-suit agreements that yield lower relative fees to the suit's counsel.⁵⁹

But the PSLRA did more, much more, than burnish the image of the class action lawyer. It burdened maintenance of the suit with a heightened pleading requirement as well as barring discovery until all motions to dismiss had been resolved. The Federal Rules of Civil Procedure have long required that a complaint must allege with "particularity" facts supporting an allegation of fraud. The PSLRA added to this the requirement that the alleged facts must establish more likely than not a "strong inference" of fraud. Moreover, until all pretrial motions were resolved, including motions to dismiss in which the "strong inference" standard is applied, no discovery is granted to the plaintiff. Thus, post-PSLRA, the plaintiff no longer could by the mere fiat of filing a complaint gain access to the defendant's records to "fish" for facts that would support with particularity an allegation of fraud. The PSLRA's discovery bar effectively required plaintiff firms to be more resourceful prior to filing suit so that the complaint's factually allegations met the "strong inference" of fraud demanded by the PSLRA. Such resourcefulness in turn demanded plaintiff firms to invest non-trivial sums to investigate possible cases so as to marshal the facts to meet the pleading requirement. Failure to do so met with swift dismissal;

⁵⁹ Cox and Thomas, Mapping the American Experience, *supra* note (survey article on securities fraud class actions).

dismissal rates nearly doubled once the heightened pleading standard took effect. The effects were two-fold: the number of filings (and hence settlements) necessarily decline and the smaller plaintiff firms reduced their presence in securities class action suits (moving over into merger litigation oftentimes).

The Supreme Court also worked its transformative magic. The most dramatic effects on the conduct of securities class actions has been the Supreme Court's sweeping limitations on who is subject to liability under the antifraud provision. Three decades ago, the Supreme Court in *Central Bank v. Denver v. First Interstate Bank of Denver*⁶⁰ startled the legal community by holding there was no aiding and abetting liability for violations of the antifraud provision of the federal securities laws. More recently, in *Janus Capital Group, Inc. v. First Derivative Traders*,⁶¹ the Court further restricted violators in private actions. *Janus Capital Group* held that liability extended only to individuals who had "ultimate authority over the statement, including its content and whether and how to communicate it." Thus, the outside lawyer who schemes with managers to fabricate a series of transactions to conceal the firm's financial position would escape liability if the medium for the release of the false information depended on the approval of a board of directors whose members were unaware of the falsity of the information. It remains to be seen whether the auditing firm whose fraudulent certification of a firm's financial statements will similarly escape liability. In any event, the judicially narrowed scope of the antifraud provision removes many classic fraudsters (and their employers and their employer's insurance carrier) from being accountable in private antifraud suits.

By far the most significant impact on the costs related to initiating a securities class action flows from Supreme Court decisions related to various features of causation in securities

⁶⁰ 511 U.S. 164 (1994).

⁶¹ 131 S. Ct. 2296 (2011).

fraud class actions. Causality in securities litigation has two distinct components. There is a requirement that the misrepresentation induced the plaintiff to purchase or sell the security. This is generally referred to as transaction causation. As we will see below, the Supreme Court's activity in this realm of causation has been within the procedural context of what guides the decision whether a class action should be certified. Quite distinct from transaction causation is evidence set forth in the complaint that, even though a misrepresentation occurred and transaction causation has been established, the plaintiff must set forth facts supporting the claim the misrepresentation caused the plaintiff to suffer an economic loss. This is commonly referred to as loss causation.

In orthodox settings of fraud where plaintiff and defendant deal directly with one another, transaction causation is addressed by requiring evidence that the plaintiff *relied* upon the misrepresentation when purchasing or selling the security.⁶² Requiring positive proof of reliance by all members in securities class actions, where the alleged material misrepresentation invariably appeared in a public document, would be inconsistent with the central requirement for class action certification: that common questions of law and fact predominate over issues that are *sui generis* to individual class members.⁶³ The fraud on the market approach to addressing transaction causation has mightily facilitated securities class actions. Enshrined in the murky reasoning of *Basic Inv. v. Levinson*,⁶⁴ fraud on the market holds that investor reliance is reputedly presumed when the security is traded in a well-developed market. Justice Blackmun anchored the presumption on both the belief that facilitating class actions was consistent with overall congressional objectives of discouraging the dissemination of misleading information in

⁶² See *e.g.*, *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1988).

⁶³ FRCP Rule 23

⁶⁴ 485 U.S. 224 (1988).

public markets and by the then emerging efficient market hypothesis.⁶⁵ During the ensuing twenty-five years since *Basic*, courts restricted the scope of fraud on the market to securities traded in a market established to be efficient.⁶⁶

In 2013, four Supreme Court justices indicated they believed it was time to reevaluate fraud on the market; their reasoning was not only was this important decision only by a narrow plurality of the court but also that research in the years following *Basic* substantially qualifies, if not rejects, tenets of market efficiency that are central to presuming investor reliance.

Nevertheless, in 2014, in *Erica P. John Fund, Inc. v. Halliburton*,⁶⁷ a clear majority of the court affirmed the continued use of fraud on the market. Had the Court in *Halliburton* reversed this position, it would have meant the death of securities class actions as all members of the class would be required to establish individual reliance on the alleged misrepresentation; at a minimum, this would render aggregation of their claims in the class procedure inappropriate since individual inquiries into each member's reliance would overwhelm the efficiencies otherwise presented by the class action. The *Halliburton* decision, however, offers something to each litigation camp. The investors' victory lay not only in the preservation of fraud on the market as the doctrinal path to satisfying transaction causation, but also the court's reasoning clearly embraced the view that fraud on the market does not depend on evidence that the affected security consistently traded in an efficient market but instead that the alleged misrepresentation was of a type that for that security would or did affect the security in a way hypothesized for an

⁶⁵ 485 U.S. at ___.

⁶⁶ See *Cammer v. Bloom*, 711 F. Supp. 1264 (D. N.J. 1989)(listing among factors supporting such efficiency 1) weekly trading volume, 2) analyst following, 3) presence of market makers, 4) eligibility to use SEC integrated disclosure system and 5) responsiveness of security's price to new information). Other courts invoke a wider range of considerations so that a good deal of variance has existed among the courts with the reach of the fraud on the market doctrine. See generally Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 *Emory L. Rev.* 843 (2005).

⁶⁷ 134 S. Ct. 2398 (2014).

efficient market. Thus, plaintiffs can secure class certification on allegations that the material misrepresentation was of the type that more likely than not under the circumstances affected the security's price. Defendants, however, obtained a modest victory by being able to rebut class certification with evidence, such as costly econometric studies, that the alleged misrepresentation did not affect the security's price. It remains too early to determine the overall impact *Halliburton* will have in the lower courts.

The Supreme Court has been equally restrictive in the realm of loss causation. *Dura Pharmaceuticals Inc. v. Broudo*⁶⁸ held that the plaintiff's complaint must set forth facts supporting the claim that the alleged material misrepresentation caused the plaintiff to suffer a material loss. This requirement is typically satisfied by a factually-supported allegation that once the truthful information was released the stock price underwent a noticeable correction. All too frequently plaintiffs fail to make this showing because either the announcement the plaintiff asserts to be the correction is viewed by the court as not sufficiently aligned with the alleged misrepresentation to be deemed their correction, or the defendant, perhaps artfully, bundles many other items with the corrective statement so that it is not possible to disentangle the correction from other market-moving information contained in the same announcement. In either case, not only do the costs to litigate the case rise as suits customarily devolve into a battle of costly econometric experts but the risks of pursuing the suits rise as well. The result is that much more cherry picking of suits occurs, with the end result that the frequency of survival goes down but the outcome for cases that proceed is likely a greater settlement value. The data above supports each of these beliefs.

⁶⁸ 544 U.S. 336 (2005).

The seeds of eviscerating the antifraud provision potential to address managerial agency costs were sewn much earlier. The mantra invoked in the 1960s and 1970s to justify curbing the then ever-expanding scope of Rule 10b-5 was that it could not address “acts of corporate mismanagement.” This phrase arose from *Birnbaum v. Newport Steel Corp.*⁶⁹ where the gravamen of the complaint was that the controlling stockholder thwarted an on-going acquisition of the company at a premium so that the controlling stockholder could garner the entire control premium for himself. The defendant’s misconduct in *Birnbaum* was ultimately addressed under state law doctrine as a breach of the controlling stockholder’s fiduciary duty;⁷⁰ in contrast, *Birnbaum* reasoned that the antifraud provision reached on fraud in connection with a plaintiff’s own purchase or sale and not to breaches of fiduciary duty by managers or controlling stockholders absent such a connection with the plaintiff’s actual purchase or sale. Later, the Supreme Court in *Santa Fe Industries, Inc. v. Green*⁷¹ would take a similar position in holding that alleged unfairness, absent deception, in connection with a forced sale of securities held by minority holders was outside the scope of the antifraud provision. Thus, the sine qua non for a violation of the securities laws is a material deception; an egregious breach of fiduciary obligation absent deception is not within the reach of antifraud provisions.

Despite the significant narrowing of the antifraud provision that has occurred, it indicts the comparative weakness of state law that a rapidly growing area of antifraud private suits are suits that at the core are complaints regarding management stewardship. As seen earlier, state fiduciary duty claims that the directors and officers were poor stewards must confront not only the Business Judgment Rule’s strong presumption of propriety but more importantly that at least

⁶⁹ 193 F.2d 461 (1952).

⁷⁰ *Perlman v. Feldman*, 219 F.2d 173 (1955).

⁷¹ 430 U.S. 462 (1977).

with respect to directors the claim is likely insulated by the immunity shield that limits damage actions against directors to breaches of duty of loyalty. Illustrative of how such oversight suits fall within the antifraud provision is the *Omnicare* where the Second Circuit held a cause of action was stated by allegations that the directors, in connection with several optimistic statements made regarding the firm's likely continued growth in revenues, failed to disclose that its revenue growth was dependent on illegal arrangements with numerous healthcare providers. A purely state fiduciary suit on such a claim would not only confront the problems described above, but also would be a derivative claim for which the necessity of a demand on the board or a committee of the board greatly weakens the suit's possibilities. Those problems are currently bypassed in contemporary monitoring suits disguised as failure to disclose cases.

We therefore find that disclosure-oriented federal securities suits can address errant stewardship provided the managers proffer bold claims of their compliance with the law, that their business strategies are yielding great returns, or that existing contracts will add immensely to future profits, when behind each assertion is an on-going violation of federal or state law that upon detection and compliance will prove immensely unrewarding to the firm. However, outside this realm, the most significant contribution of private and public enforcement of the securities laws is the culture of compliance they compel. Complaints abound that suits, or most suits, are frivolous and drive up the cost of business transactions. Regardless of the accuracy of this claim, it nonetheless supports a healthy awareness of the perils of nondisclosure of material information in securities transactions, which includes periodic reports and other announcements that reach investors. Enforcement, public and private, of the securities laws shines a bright light on managers with not only the therapeutic effect of warding some from misbehavior, but also by alerting investors and regulators of facts warranting inquiry and perhaps enforcement.

II. Evolving Non-Litigation Monitoring Substitutes

The preceding material supports the conclusion that shareholder litigation has a lessening role in addressing certain types of agency cost. Managerial underperformance is insulated by the business judgment rule, the demand requirement in derivative suits and the immunity shield. Independent of these bulwarks against the disciplining lash of shareholder suit is the withdrawal courts have taken from regulating executive pay. Finally, although it remains early in the life-cycle of forum selection and arbitration bylaws, they each portend weakening whatever force shareholder suits have had in protecting shareholders in acquisitions.

Coterminous with the before-described constrictions of shareholder litigation, a number of alternative monitoring techniques have developed that address, to some extent, the voids created by the contraction of shareholder suits. We review below these monitoring developments. While each of these methods has its advocates and critics, collectively they have brought about significant changes in the relationship between management and shareholders at American public corporations. In this section, we explore each one of these areas to explain how they are affecting corporate governance today as well as their limits as monitoring devices.

A. Activist Hedge Funds

In recent years, hedge funds have actively engaged many companies in an effort to boost shareholder value.⁷² Empirical studies finding that the filing of an activist hedge fund's Schedule

⁷² Brav, Jiang, Partnoy and Thomas, *supra* note .

13D filing creates positive average abnormal returns from 7% to 8%.⁷³ These benefits appear to last: firms targeted by activists see a 1.22% increase in operating efficiency one year after acquisition.⁷⁴ Where do these gains come from?

Target firms are generally undervalued by the market, often because of poor management. In these interventions, hedge funds frequently seek to force companies to pay out dividends or buy back shares as a means of distributing to shareholders “excess cash.” In other situation, a hedge fund may seek to persuade target firms to spin off less inefficient divisions or assets, or even force the sale of an entire company. The lead hedge fund will often accumulate 6 to 8% of the target company’s stock, which by itself is not enough to give them a strong negotiating position if target management resists their efforts. However, other hedge funds and many less active institutional investors, including some who have direct investments in the lead hedge fund, will vote their shares in the target company in support of the lead hedge fund.⁷⁵

Corporate management and their supporters have a less rosy view of hedge fund activism: they argue that hedge funds are pursuing short term profits at the expense of the long term investors in targeted companies.⁷⁶ Some advocates of this position have gone so far as to argue that hedge

⁷³ Brav et al., *supra* note, at 1731. In contrast, Greenwood and Schor find that while activist hedge funds do produce these abnormal returns, the returns are produced by takeover premiums, not improvements in management. Robin Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. OF FIN. ECON. 362, 363 (2009). The authors find that activist targets which do not result in a takeover have abnormal returns statistically indistinguishable from zero.

⁷⁴ Christopher Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. OF CORP. FIN. 323, 324 (2008). See also, Brav et al., *supra* note at .

⁷⁵ Gilson and Gordon, *supra* note ; Edelman, Thomas and Thompson, *supra* note .

⁷⁶ Martin Lipton, *Deconstructing American Business II and Some thoughts for Boards of Directors in 2007*, 10 National Legal Center for the Public Interest (March 2012), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2017116 (The most important problem that causes concern about American business in the future is “[p]ressure on boards from activist investors to manage for short-term share price performance rather than long-term value creation.”); Steven M. Davidoff, *A Standard Criticism of Activist Investors That No Longer Holds Up*, N.Y. TIMES, July 10, 2013, at B5 (describing and rejecting claim that hedge funds are short term shareholders); Mark Roe, *Corporate Short Termism – In the Boardroom and in the Courtroom*, 68 Business Lawyer (August 2013) (reporting that managerial and boardroom autonomy have been justified recently by claims that activist hedge funds shareholders are focused on short term gains); Lucian

fund shareholders ought to have fiduciary duties to other shareholders as a check on their allegedly opportunistic conduct.⁷⁷ Recent empirical work is inconsistent with the view that hedge fund short-termism is a problem.⁷⁸

Moreover, the argument that hedge funds are systematically ripping off long term investors is hard to reconcile with those investors' actions. For one thing, hedge funds seem to have little trouble recruiting institutional investors to support their activist goals.⁷⁹ If hedge fund's plans actually only produced a short term gain at the expense of long term profitability, these long term investors would be reluctant to support them.⁸⁰ Second, activist hedge fund holding periods average approximately 31 months, which is substantially longer than almost all other investors.⁸¹ Finally, one study of hedge fund interventions from 1994 to 2007 found that the initial stock price gains resulting from the initial announcement of a hedge fund's activism were sustained over a five year period as were improvements in other measures of returns.⁸² All of this evidence supports the claim that hedge fund activism is not dominated by short term considerations, but rather generates valuable monitoring of corporate management.⁸³

Bebchuk, *The Myth that Insulating Boards Serves Long Term Value*, 113 Colum. L. Rev. 1637 (2013) (arguing against claims that activist investors take profitable short term actions that are long term value decreasing).

⁷⁷ Iman Anabtawi and Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 Stanford Law Review 1255 (2008).

⁷⁸ Lucian Bebchuk, et al., *Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy*, 39 J. Corp. Law 1 (2013). See also, Roe, *supra* note contains an extensive discussion of the evidence pro and con claims that investors have a short-term perspective that is harming corporations and ultimately rejects these arguments.

⁷⁹ Marcel Kahan and Edward B. Rock, *Hedge funds in Corporate Governance and Corporate Control*, 155 U. Penn L. Rev. 1021 (2007), at 1089; see also Briggs, *supra* note , at 702.

⁸⁰ Kahan & Rock, *supra* note , at 1088.

⁸¹ William Bratton, *Hedge Funds and Governance Targets: Long-Term Results*, 95 Georgetown L. J. 1375 (2007).

⁸² Lucian Bebchuk, Alon Brav & Wei Jiang, *The Long Term Effects of Hedge Fund Activism*, 115 Colum. L. Rev. 1085 (2015); see also, Nicole M. Boyson & Robert M. Mooradian, *Experienced Hedge Fund Activists* (Working Paper, Apr. 3, 2012) (finding that hedge fund activism "can lead to superior long-term target firm and hedge fund performance").

⁸³ Steven Davidoff, *A Standard Criticism of Activist Investors That No Longer Holds Up*, N.Y. TIMES, July 10, 2013, at B5; see also, Dionysia Katelouzou, *Myths and Realities of Hedge Fund Activism: Some Empirical Evidence*, __ VA. L. & Bus. REV. __ (2012) (finding that hedge funds are not short term in their focus).

Private equity firms interact in important ways with hedge funds and facilitate their activism. One hedge fund strategy that generates substantial shareholder value is persuading targeted firms to put themselves up for sale, often to private equity firms.⁸⁴ These sales are generally at a substantial premium over the prior market price and act to discipline management of underperforming companies as well as create ongoing pressure on managers at other firms to aggressively maximize shareholder value.

Private equity firms are also important shareholder monitors in their own right as well.⁸⁵ The formation of this control blockholder at newly privatized firms acts to monitor corporate managers to focus their efforts on increasing stock price. The private equity firm can do this in a variety of ways including increased levels of pay for performance, smaller and more focused boards and the threat of dismissal for nonperforming executives.⁸⁶

B. Say on Pay

Excessive compensation payments to top corporate executives are a sign of managerial agency costs. While reasonable people can differ over whether this is a systemic problem with American corporate governance,⁸⁷ or a more isolated problem involving a few bad apples,⁸⁸ most experts agreed until recently that shareholders did not have an effective mechanism for monitoring executive pay. For example, shareholder derivative suits have proven largely

⁸⁴ Michael Schor and Robin Greenwood, *Investor Activism and Takeovers*, 92 *J. Fin. Econ.* 362 (2009).

⁸⁵ Masulis and Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 *U. Chicago L. Rev.* 219 (2009).

⁸⁶ *Id.*

⁸⁷ Lucian Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press 2004).

⁸⁸ John E. Core, Wayne R. Guay and Randall S. Thomas, *Is U.S. CEO Compensation Inefficient Pay Without Performance*, 103 *Michigan L. Rev.* 1142 (2005).

impotent to either redress or retard excessive executive compensation. Executive pay challenges, even when coupled with suggestions of influence by a dominant controlling stockholder, are crushed by the deference accorded boards of directors under the derivative suit demand requirement.⁸⁹

The Say on Pay vote by shareholders is a recent regulatory initiative designed to bolster shareholder monitoring of executive compensation practices.⁹⁰ In the U.S., Say on Pay was adopted when the American Congress passed the Dodd-Frank Act of 2010. Dodd-Frank required, among other things, that U.S. public companies hold an advisory shareholder vote on the compensation of their top executives.⁹¹ In the first set of such votes, held during the 2011 proxy season, shareholders strongly supported existing pay practices at most firms with Say on Pay votes getting on average of 91.2% support.⁹² These average support levels continued to be high in subsequent years with more than three quarters of companies in the Russell 3000 receiving at least 90% shareholder support in 2012 and 2013.⁹³ At the other end of the spectrum, only 1 to

⁸⁹ See e.g., *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984)(dismissing suit for failure to excuse demand where six-figure annual compensation was payable to 70 percent stockholder regardless of his ability to serve as executive); *Marx v. Akers*, 88 N.Y.2d 189, 644 N.Y.S.2d 121, 666 N.E.2d 1034 (1996)(dismissing suit challenging CEO compensation for failure to excuse a demand where board not shown to have egregiously)

⁹⁰Randall S. Thomas and Christoph Van Der Elst, *Say on Pay Around the World*, 92 Wash. U. L. Rev. 653 (2015).

⁹¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-

203, § 951, 124 Stat. 1375, 1899 (2010) (adding new section 14A to the Securities Exchange

Act of 1934). See Randall Thomas et al., *Dodd-Frank's Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?*, 97 Cornell L. Rev. 1213, **Error! Bookmark not defined.** at 1225 (discussing the phase-in of the requirement based on the size of the company).

⁹² ISS, PRELIMINARY 2011 U.S. POSTSEASON REPORT 2 (updated Aug. 8, 2011). Equilar, a leading provider of data on executive pay, counted 2,252 from the Russell 3000 as of June 30, 2011. Equilar, *An Analysis of Voting Results and Performance at Russell 3000 Companies* (July 2011), available at <http://www.equilar.com/knowledge-network/research-articles/2011/pdf/Equilar-Voting-Analytics-July2011.pdf>. ;*Say-on-Pay Support Runs High in 2013, With Few Exceptions, Reports Show*, BLOOMBERG BNA CORP. L. DAILY, June 6, 2013 (reporting on study by Meridian Compensation Partners that found on average that 90.3% of shareholders voted in favor of company Say on Pay proposals with only 2% receiving less than 50% support); see also James F. Cotter, et al., 81 George Wash. L. Rev. 967 (reporting results from early 2012 proxy season that show that 2012 was a more difficult season for issuers for Say on Pay proposals).

⁹³ *Id.*

2% of firms (40 to 60 firms of the Russell 3000) received less than 50% shareholder support during these same years.⁹⁴

Nevertheless, Say on Pay's introduction had a significant effect on American corporate governance.⁹⁵ Dodd-Frank's mandated shareholder votes focused directors on shareholders' concerns about executive pay, increased shareholder participation in corporate governance, and opened lines of communication between management and shareholders (and proxy advisory firms) regarding executive compensation.⁹⁶ Beginning with the U.S. experience, management at many companies made changes to the substance and disclosure of their pay programs in an attempt to more clearly align pay to performance.⁹⁷ Many companies revised the content of the CD&A filed with the annual meeting proxy materials.⁹⁸ At companies whose pay programs received negative say-on-pay recommendations by proxy advisory firms, management at some firms connected with shareholders following an "against" recommendation.⁹⁹

⁹⁴ Cotter, et al., *supra* note, at 979–80. Some commentators claim that 67% support is a more important threshold because "ballots that fail to garner a two-thirds majority are an indication of potential problems, especially since more than 90 percent of the votes analyzed passed with a supermajority..." Ryan Krause, Kimberly A. Whitler & Matthew Semadeni, *When Do Shareholders Care About CEO Pay?*, Director Notes, Conference Board 2 (Aug. 2013); GEORGESON REPORT, FACTS BEHIND 2013 FAILED SAY ON PAY VOTES, June 11, 2013, *available at* http://www.computershare-na.com/sharedweb/georgeson/georgeson_report/GeorgesonReport_061113.pdf#1; Mary Hughes, *Pay-for-Performance is Still No.1 Issue in Say-on-Pay Success*, 16 CORP. GOV. REPORT 85 (Aug. 5, 2013) at 1..

⁹⁵ See Thomas et al., *supra* note, at 1227.

⁹⁶ Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Speech to Social Investment Forum (June 10, 2011).

⁹⁷ Michael Littenberg, Farzad Damania & Justin Neidig, *A Closer Look at Negative Say-on-Pay Votes During the 2011 Proxy Season*, DIRECTOR NOTES (Conference Bd.) 2 (July 2011), *available at* <http://www.srz.com/A-Closer-Look-at-Negative-Say-on-Pay-Votes-During-the-2011-Proxy-Season-07-26-2011/>.

⁹⁸ Thomas, et al., *supra* note .

⁹⁹ Cotter, et al., *supra* note .

Yet, in the United States, Say on Pay has not led to lower executive pay levels or changes in its composition.¹⁰⁰ Research on the U.K. has also found that overall CEO pay levels do not seem to have changed as a result of Say on Pay vote.¹⁰¹ However, internationally, Correa and Lel find that pay growth rates are lower in their comparative study of twelve countries that have adopted Say on Pay legislation.¹⁰² Their cross-country study of 39 nations – 12 that have adopted Say on Pay and 27 that have not done so— finds that although, “CEO compensation has increased in several SoP [Say on Pay] countries including the U.S. and U.K., the growth in CEO pay is higher in countries without SoP [Say on Pay] laws.”¹⁰³ Given this split in results, it seems fair to say that the precise effects of Say on Pay on executive compensation levels are still being determined.

C. Appraisal Arbitrage

As discussed earlier, merger litigation has played a significant monitoring role in addressing possible agency costs in corporate transactions. Empirical research examining its role at the turn of the millennium found that class action lawsuits challenging the fairness of the consideration

¹⁰⁰ Cunat et al., *Say Pays! Shareholder Voice and Firm Performance*, Working Paper (2013), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2240410 ; Iliev & Vitanova, *The Effect of Say-on-Pay in the U.S.*, Working Paper (2015), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2235064 , at 3. Iliev and Vitanova state: “We find that the Say-on-Pay vote had no effect on the level or the composition of CEO pay. We document no change in the ratio of equity and cash compensation as a fraction of total CEO pay, indicating that the vote had no detectable effect on the CEO compensation contract. We also find that firms changed the level or composition of pay in the year preceding the vote.” Iliev & Vitanova, *supra*, at 3.

¹⁰¹ Martin Conyon & G. Sadler, *Shareholders Voting and Directors’ Remuneration Report legislation: Say on Pay in the U.K.*, 18 CORP. GOV.: AN INT’L REV. 296 (2010) (finding no change in the overall level of executive pay or its rate of growth subsequent to Say on Pay votes); *see also* Fabrizio Ferri & David A. Maber, *Say on Pay Votes and CEO Compensation: Evidence from the U.K.*, Review of Finance (2013) (finding that firms did adjust contractual features and increase sensitivity to pay for performance in response to negative vote outcomes).

¹⁰² Ricardo Correa and Ugur Lel, *Say on Pay Laws, Executive Compensation, Pay slice, and Firm Value Around the World*, Working Paper (2014), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2430465 .

¹⁰³ *Id.* at 14. Figure 1 illustrates the gap between the two groups of countries. *Id.* at 35.

paid in M&A transactions had a positive impact on takeover premiums.¹⁰⁴ However, as we discussed in section __ above, merger litigation's future has been placed in jeopardy by the adoption of forum selection bylaws and fee shifting bylaws. If this is true, is there another form of litigation that could take its place?

One possible candidate is appraisal litigation. In an appraisal proceeding, a shareholder can ask a court to determine the fair market value of their shares if they dissent from, or do not vote in favor of, a pending corporate transaction. States vary widely how widely appraisal is available: states that are more solicitous of shareholders provide appraisal for amendments to the articles of incorporation that adversely affect the rights of stockholders, the sale of all or substantially all the firm's assets, and mergers and consolidations,¹⁰⁵ whereas Delaware limits its appraisal statute to mergers and consolidations,¹⁰⁶ and the Model Business Corporation Act follows a course between these two positions.¹⁰⁷

Traditionally, appraisal has been viewed as an ineffective remedy for shareholders that is cumbersome and very limited in its scope. It has three types of disadvantages that commentators have focused on:¹⁰⁸ difficult procedural steps that must be followed in precise order to preserve one's right to the remedy;¹⁰⁹ the lack of a class action procedure that would permit easy joinder of all dissenting shareholders so that the costs of bringing an action could be more widely

¹⁰⁴ C.N.V. Krishnan, et al., Shareholder Litigation in Mergers and Acquisitions, 18 J. Corp. Fin. 1248, 1262 (2012).

¹⁰⁵ See e.g., Cal. Corp. Code §§ 181, 1200 et seq., 1300; N.Y. Bus. Corp. L. § 910.

¹⁰⁶ See Del. Code Ann., tit. 8 § 262(b).

¹⁰⁷ See MBCA § 13.02(a).

¹⁰⁸ Charles Korsmo and Minor Myers, Appraisal Arbitrage and the Future of Public Company M&A, 92 Washington University Law Review (forthcoming 2015), at 8.

¹⁰⁹ For example, under the Model Business Corporation Act, if a shareholder vote is required for the fundamental change, the shareholders must give written notice of their intent to dissent prior to the vote and then must refrain from voting in favor of the plan. Model Bus. Corp. Act § 13.21 (1984). Under the Delaware Act, after the vote the corporation must within 10 days give notice of the right to dissent, and thereafter the shareholders have 20 days within which they must make a written demand. Del. Code Ann. tit. 8, § 262(d) (2) (2001).

shared;¹¹⁰ and the narrow limits of the remedy.¹¹¹ As a result, prior research has found that few appraisal actions are filed and even fewer are actively litigated.¹¹²

Recently, however, Kahan and Rock have noticed that hedge funds that are dissatisfied with the terms of an acquisition may be adapting appraisal litigation to a new role.¹¹³ Professor Geis,¹¹⁴ and Professors Korsmo and Myers,¹¹⁵ have picked up this idea and written substantial articles debating the appropriate role of appraisal litigation as a monitor of M&A deals.

Based on some hedge fund litigation over the scope of their appraisal rights, Geis argues that, “it is certainly possible that a robust after-market for appraisal rights will develop, analogous to the market for corporate control that allegedly disciplines otherwise entrenched managers with the threat of an external takeover.”¹¹⁶ If so, Geis concludes that “corporate law might play a meaningful role in enhancing firm value by policing freezeout mergers in a more nuanced and creative manner.”¹¹⁷ Yet, Geis equivocates about whether this is beneficial to target company shareholders because of concerns that opening up the appraisal remedy will lead to more strike suits, and therefore suggests further restrictions on shareholders’ (already quite limited) ability to bring these cases.¹¹⁸

¹¹⁰ Randall S. Thomas, *Revising the Delaware Appraisal Statute*, 3 *Delaware Law Review* 1, 27-29 (2000).

¹¹¹ The market out provision eliminates appraisal rights for mergers and consolidations where there is a liquid market for their securities. 8 Del. C. §262(b) (1). The right to appraisal is restored if the target company’s shareholders are required to take consideration different from the shares they formerly held, such as cash. Randall S. Thomas, *Revising the Delaware Appraisal Statute*, 3 *Delaware Law Review* 1, 11-12 (2000).

¹¹² *Id.* at 22-23 (finding an average of less than 14 appraisal actions filed per year from 1977 to 1997).

¹¹³ Marcel Kahan and Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 *University of Pennsylvania Law Review* 1021, 1038-1039 (2007).

¹¹⁴ George Geis, *An Appraisal Puzzle*, 105 *Northwestern Law Review* 1635 (2011)

¹¹⁵ Charles Korsmo and Minor Myers, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 *Washington University Law Review* (forthcoming 2015). See also, Charles Korsmo and Minor Myers, *The Structure of Shareholder Litigation: When do the Merits Matter?*, 75 *Ohio State Law Journal* (forthcoming 2015).

¹¹⁶ Geis, *supra* note , at 1638.

¹¹⁷ *Id.* at 1658.

¹¹⁸ *Id.* at 1676.

Professors Korsmo and Myers generate some empirical data on this phenomenon. Using a data set on appraisal cases from 2004 to 2013, they find that the dollar value dissenting shares in appraisal actions spiked sharply in 2013.¹¹⁹ They document the rise of a small, but growing, group of investors filing multiple appraisal actions arising out of different transactions.¹²⁰ These repeat petitioners “target deals where the merger premium is low and where controlling shareholders are taking the company private.”¹²¹ Considering these findings, Korsmo and Myers argue that a robust appraisal remedy could be working in a socially responsible way as a “back-end check on abuses by corporate managers, controlling shareholders, or other insiders in merger transactions.”¹²²

While this is certainly possible, we are much more cautious about the effects of this potential trend. First, any monitoring effects on M&A activity that will arise out of appraisal litigation will be limited to small set of deals where appraisal is available. For example, even at the peak of this trend, Korsmo and Myers find that only slightly more than 15% of covered transactions have appraisal actions filed challenging the consideration paid in the deal.¹²³

To the extent that appraisal is effective within this narrow class of deals, we would expect to see controlling shareholders and other acquirers revising existing deal structures to avoid appraisal’s reach. This suggests it will be necessary to expand the class of transactions covered by appraisal rights if it is to be truly useful as a monitoring device.

Moreover, appraisal is of value only to large shareholders; small shareholders will not find appraisal to be cost effective generally. Indeed, small investors will benefit, if at all, from

¹¹⁹ Korsmo and Myers, *Appraisal Arbitrage*, supra note, at 17, Figure 3.

¹²⁰ *Id.* at 18.

¹²¹ *Id.* at 28.

¹²² *Id.* at 42.

¹²³ *Id.* at 16, Figure 2.

this appraisal litigation only if there is an ex ante effect from the potential for appraisal litigation on an acquirers' original pricing of the deal.

Finally, if appraisal litigation is to play a role as a monitor of managerial agency costs in mergers, the market out exception must be eliminated.¹²⁴ As numerous critics have pointed out, it makes no sense to say that shareholders who receive marketable securities for their shares in a merger do not need appraisal: if they sell those shares in the market after the merger, then they will suffer an uncompensated loss.

Conclusions

Representative shareholder litigation has enjoyed periods of great repute as well as tough times where it has been vilified. Its usefulness as a managerial agency cost monitoring device has lately been called into question. Courts and legislatures have cut back on its scope and long term viability. However, even as litigation's strength has waned, new forms of monitoring techniques have emerged. Hedge fund activism, Say on Pay votes, and appraisal arbitrage, have come forth as potential alternative monitoring tools for disgruntled shareholders.

In this paper, we show that these two sets of developments are related. If managerial agency costs begin to spiral upward, investors will seek ways to reduce them. Hedge fund activism is the strongest of these methods at the moment with many well-documented successes, although it is not without its failures. Activism has filled the gap left by the weakening of the market for corporate control after the Delaware courts effectively stopped policing management's use of defensive tactics in hostile takeovers. Say on Pay voting has served

¹²⁴ Id. at 50.

primarily as a tool to nudge managers to engage with their shareholders over issues related to executive compensation, a function that derivative litigation has shown itself unable to perform. Finally, appraisal arbitration holds out the hope of a better remedy for shareholders that are forced to sell their stock in control shareholder squeezeouts. If the Delaware legislature permits these appraisal actions to survive, then appraisal arbitration would provide shareholders with a means of redress when they are forced to sell their shares too cheaply, a remedy that was largely lost after the Delaware courts decided to apply business judgment standard review in many such transactions.