Corporate Darwinism: Disciplining Managers in a World with Weak Shareholder Litigation

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Abstract: Corporate Darwinism: Disciplining Managers in a World with Weak Shareholder Litigation

Corporate legal scholarship largely focuses on addressing managerial agency costs. As part of this paradigm, legal scholars examine how effectively representative litigation, whether class actions or derivative suits, control managerial agency costs. While most corporate law academics believe that there are benefits created by these suits, they are qualified by the litigation agency costs that surround them. In recent years, concerns about litigation agency costs has resulted in many legislative and judicial actions that restrict shareholder litigation.

In this article, we claim that recent corporate governance developments are a natural consequence of both the ineffectiveness and inefficiency of shareholder suits to address certain genres of managerial agency costs. As representative shareholder litigation has been constrained by numerous legal developments, our corporate governance system has developed new mechanisms as alternative means to address managerial agency costs. We further argue that these new governance responses are themselves becoming stronger because, in part, of the rising concentration of share ownership of public companies.

Activist hedge funds are among the most obvious manifestation of developments that have changed ownership of American public companies and reduced managerial agency costs. Private equity firms assist them in their efforts and act as strong managerial monitors as well by introducing strong risk management systems among other things.

But other forces are at work as well. For example, the passage of the Dodd-Frank Act further armed investors, both large and small, by mandating a non-binding Say on Pay vote. This new vote on executives’ pay fills a corporate governance hole created by the failure of derivative suits to regulate compensation as say-on-pay resolutions enable shareholders, especially small institutional shareholders, to engage in direct monitoring of executive compensation.

We next consider the rising role of the appraisal remedy that is moving to fill a monitoring gap created by the decline in the efficacy of shareholder litigation focused on acquisitions. As we will show, the appraisal proceeding, an old and previously largely defunct form of litigation, has been resuscitated by a few hedge fund investment groups, who have begun filing these actions in an effort to engage in what some have called “appraisal arbitrage.” They target underpriced acquisition transactions to recover substantial value which pressures bidders to improve prices.

Finally, we conclude by examining how managerial oversight failures may be addressed using securities fraud class actions after the Supreme Court’s most recent antifraud decision in *Omnicare Inc. v. Laborer’s Dist. Council Const. Indus. Pension Fund*. This monitoring gap is
also targeted by private equity firms and their superior risk management techniques and superior board structures for portfolio companies.
Corporate Darwinism: Disciplining Managers in a World with Weak Shareholder Litigation

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Corporate legal scholarship is riveted on addressing managerial agency costs. Berle and Means 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. Jensen and Meckling later showed that, within such dispersed ownership systems, shareholders engage in a variety of strategies so as to minimize these divergences. In pursuit of this goal, shareholders may deploy shareholder voting, the threat of a change of control transaction, or performance based-compensation, among other things, to punish managers should they be poor stewards and fail to create shareholder value and to encourage them to do a better job. 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.

As part of this paradigm, legal scholars examine how effectively representative litigation, whether class actions or derivative suits, control managerial agency costs. Many scholars argue

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2 ADOLE Berle & Gardner M. Means, *The Modern Corporation and Private Property* (1932) (describing 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 essential hire capital rather than capital retain managers).


that over the past seventy years shareholder representative litigation has acted as an important policing mechanism of managerial abuses at U.S. public companies. 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 created by these suits are qualified by the litigation agency costs that surround them. Litigation agency costs arise since the suits are often brought by a named plaintiff that has no substantial ownership interest in the corporation, so that their prosecution could be easily seen as lawyer-driven. 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 recent years, concerns about the combination of the Loser Pays Rule and litigation agency costs has resulted in legislative and judicial actions that restrict shareholder litigation in many ways.

In this article, our thesis is straightforward: we claim that the recent arrival of some significant governance developments is a natural consequence of both the ineffectiveness and inefficiency of shareholder suits to address certain genre of managerial agency costs. That is,

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11 For a fuller exploration of these differences in a multi-country setting, see generally Symposium, Shareholder Suits, 6 EUR. CO. & FIN. L. REV. 181 (August 2009).
just as one part of a balloon expands when another part contracts, we reason that governance responses evolve to fill voids caused by the decompression of shareholder monitoring in areas where it was once supplied by private suits. In other words, as representative shareholder litigation has been constrained by numerous legal developments, our corporate governance system has developed new mechanisms as alternative means to address managerial agency costs.

But we also take this argument one step further: we claim that these new governance responses are themselves becoming stronger 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 most public companies.12 This growing concentration of ownership in public companies has the twin effects of reducing the costs of collective action and increasing the likelihood that an owner exists who will have a sufficient economic interest to embrace improved governance as a wealth-increasing strategy. The increasing concentration of ownership of public companies has the consequential effect of governance responses being efficient and effective where the response would not have been observed were ownership not concentrated. We thus argue that not only does concentration increase activism among this growing group of blockholders, but concentrated ownership also ushers in new methods to address agency costs.

Activist hedge funds are among the most obvious manifestation of developments that have changed ownership of American public companies and reduced managerial agency costs. They have filled a gap left by the closing of the market for corporate control and the weakness of

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acquisition-oriented class actions.\textsuperscript{13} Hedge 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.\textsuperscript{14} Institutional investors 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 institutions have pushed and shoved to get reluctant managers to take shareholder value maximizing actions and to compensate for the slack left by weak representative litigation. Using their voting strength, activist hedge funds have gained board representation where they act as monitors of management, reduce executive compensation, force sales, spinoffs, or financial restructurings, or prompted other strategies to improve operating performance.\textsuperscript{15} Private equity firms assist them in their efforts and act as strong managerial monitors as well by introducing strong risk management systems among other things.\textsuperscript{16}

The passage of the Dodd-Frank Act further armed investors, both large and small, by mandating a non-binding Say on Pay vote. This new vote on executives’ pay fills a corporate governance hole created by the failure of derivative suits to regulate compensation as say-on-pay resolutions enable shareholders, especially small institutional shareholders, to engage in direct


\textsuperscript{16} Martin Lipton, \textit{Dealing with Activist Hedge Funds}, HARY. L. SCHOOL FORUM ON CORP. GOVERNANCE & FIN. REG. (Nov. 6, 2014), http://corpgov.law.harvard.edu/2014/11/06/dealing-with-activist-hedge-funds-3/.
monitoring of executive compensation. While its effectiveness as a check on executive pay is still being studied, it has undoubtedly triggered a greater level of engagement between corporate directors and shareholders on compensation issues.

We also consider the rising role of the appraisal remedy within the context of 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 resuscitated by a few hedge fund investment groups, who have begun filing these actions in an effort to engage in what some have called “appraisal arbitrage.” As discussed later, although shareholders seeking protection through the appraisal remedy must overcome many hurdles to employ appraisal as a meaningful alternative to merger litigation, it has the potential to become an important monitoring mechanism.

Though there are evolving multiple governance mechanisms to address managerial agency costs, we see a new litigation approach to address lapses in oversight as well. Managerial oversight failures may be addressed using securities fraud class actions after the Supreme Court’s most recent antifraud decision in Omnicare Inc. v. Laborer’s Dist. Council Const. Indus. Pension Fund. As developed below, private enforcement actions building on Omnicare have the potential to police executives reporting to investors about their management oversight efforts, as well as boards reporting on their systems to monitor management’s stewardship, should those actors make false representations of the strength of internal systems for assuring board oversight and systems for promoting wise stewardship of the firm.

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We conclude that each one of these new, or revived, monitoring techniques may be able to stand in for acquisition-oriented and derivative shareholder litigation to insure that managerial agency costs are kept low. This article proceeds as follows. Section I of the article focuses on the breakdown of acquisition-oriented class actions and their potential replacement as a shareholder monitoring device by activist hedge funds and appraisal arbitrage. Next, in section II, we expose the weakness of derivative suit litigation as a check on excessive executive compensation arrangements and the potential for Say on Pay votes and hedge fund activism to supplant them as shareholder monitoring devices. Finally, in section III, we develop how derivative litigation has done little to insure that managers and boards engage in appropriate levels of oversight activities. We then argue that after Omnicare this function may be taken over by the federal securities laws and to a smaller extent private equity firms acting as monitors of internal control systems. We conclude with a summary and some policy suggestions.

I. Acquisition-Oriented Class Actions and New Governance Initiatives

During the past seventy years, there have been many shifts among the multiple types of shareholder litigation. Despite these ebbs and flows, the business community shares the common view that shareholder litigation is vexatious, robust and expanding.\(^{20}\) As we will see, this perspective is partly justified, at least with respect to litigation spawned by acquisitions. In this section, we set forth the significant substantive and procedural changes that have adversely affected shareholder acquisition-oriented class actions in the U.S. We then argue that these

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developments have prompted other governance techniques to move into areas where shareholder litigation formerly was the primary mechanism for limiting managerial agency costs.

A. Shareholder M&A Class Actions

Delaware jurisprudence has for some time placed a bright bull’s-eye on merger and acquisition transactions inviting shareholder-initiated court challenges. The initial development in this area facilitated shareholder suits aimed at self-dealing acquisitions such as where a cash-out merger occurs with the controlling stockholder.\textsuperscript{21} Close judicial review was later extended to multi-step acquisitions with a dominant stockholder.\textsuperscript{22} In such transactions, the Delaware courts often placed the burden of proving entire fairness of the transaction on the dominant stockholder. Moreover, under Delaware law, any sale of control to a third party invites heightened scrutiny with the burden on management to prove they acted prudently to get the best offer.\textsuperscript{23} And, should the target of another firm’s ardor take steps to rebuff the bidder’s overture, Delaware subjects those defensive actions to heightened scrutiny.\textsuperscript{24} Knitting each of these doctrines together is the Delaware courts’ belief that the significance of the transaction to the shareholders, and in some instances the serious risk of director self-interest, in combination present an appealing case to lift

\textsuperscript{21} The leading case is \textit{Weinberger v. UOP, Inc.}, 457 A.2d 701 (1983).
\textsuperscript{22} In re Pure Res., Inc. S’holder Litig., 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).
\textsuperscript{23} The principle was first established in \textit{Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.}, 506 A. 2d 173 (Del. 1986), and was further clarified in \textit{Paramount Commc’ns. Inc. v. QVC Network}, 637 A.2d 34 (Del. 1994).
\textsuperscript{24} At least in Delaware, such defensive measures are guided by \textit{Unitrin, Inc. v. Am. Gen. Corp.}, 651 A.2d 1361 (Del. 1995), modifying \textit{Unocal Corp. v. Mesa Petroleum Co.}, 493 A.2d 946 (Del. 1985).
the otherwise strong presumption of independence and director good faith so that a fulsome inquiry of the overall fairness of transaction can be judicially conducted.

The target that judicial doctrine has placed on these transactions has had its effect. Litigation against publicly held companies that undertake deals is now of epidemic proportions and overwhelmingly arises in the form of class actions, as opposed to derivative suits.25 Generally, multiple suits are filed very quickly after the announcement of a transaction; counsel in such suits are law firms with a rich history of engaging in such litigation.26 Data regarding such suits in an earlier time shows that those suits challenged primarily deals in which managers had a conflict of interest, that the suits tended to produce cash settlements, and that the cases did not exhibit the same degree of litigation agency costs that were commonly believed to accompany other representative suits.27 Thus, during 1999 – 2000, only 12% of deals were the subject of litigation, most of such litigation focused on Delaware companies and the suits were maintained in Delaware.28 Furthermore, this litigation decreased the likelihood of a deal closing, but also increased the returns on the deals that closed, so that overall it was associated with an increased return for the target firm shareholders.29

Much of this has since changed dramatically so that today almost all deals attract suits.30 Cain and Davidoff report that in 2012 there were 121 transactions over $1.00 million in value, and that 111 of these deals experienced deal litigation.31 Roughly 50% of these deals also

25 Thomas & Thompson, The New Look of Shareholder Litigation, supra note 5, at 137.
26 Id. at 138.
27 Id. at 172 tbl.4.
28 C.N.V. Krishnan et al., supra note 7, at 1249–1250.
29 Id.
resulted in litigation in more than one jurisdiction. While several commentators have opined on the underlying causes for these developments, we observe that it has occurred while the number of securities class actions and their lawyers has declined. While causation is always a difficult challenge, we surmise that the rapid rise in transaction oriented litigation may, at least in part, be reflective of many plaintiff-oriented law firms redirecting their focus.

Just as too much fudge can be a problem, too warm an invitation to challenge transactions creates its list of problems. There are multiple concerns that flow from multi-forum litigation focused on a single transaction. At a minimum, multiple suits challenging the same deal in multiple forums may visit non-trivial costs on the involved corporations. Even when all suits are within the same state, litigation costs might be magnified as there invariably will be the question of what impact the resolution of the dispute in one forum will have on another forum. To be sure, when suits are within a single jurisdiction, courts can, as is the case in Delaware, invoke the simplifying heuristics of the first-to-file rule to address the competing claims of different counsel. Such costs are magnified when litigation straddles two or more jurisdictions. When this occurs, comity among competing courts is possible, but such coordination involves costly and time consuming one-off discussions among the involved courts, for which the outcome is less than certain. Moreover, uncertainty regarding which suit among the various forums will be

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32 Id. at 2.
35 In a thoughtful analysis of the problems posed by such multi-forum litigation, Professor George Geis argues that the preferred solution is forum selection bylaws, discussed later in this section, and where the firm does not have such a provision he suggests the outcome be guided by the court’s assessment of the adequacy of counsel. George S. Geis, *Shareholder Derivative Litigation and the Preclusion Problem*, 100 VA. L. REV. 261 (2014). Professor Geis also recommends more vigorous application of statutory authority to assign costs for ill-conceived suits.
36 A sobering lesson to be drawn from the explosion of multi-forum litigation is illustrated in *Pyott v. Louisiana Municipal Police Employees’ Retirement System*, 74 A.3d 612 (Del. 2013), where 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. *Id.*
deemed the lead suit undercuts the incentives for plaintiffs’ counsel to invest heavily in the suit out of concern their efforts in developing the case will prove unrewarded by the likelihood that another counsel’s suit will be anointed as the lead suit. More troubling is recent evidence that

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, 2011 WL 1429626 (C.D. Cal., Apr. 12, 2011), 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. 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. Louisiana Municipal Police Employees Retirement System v. Pytt, 46 A.3d 313 (Del. Ch. 2012).

Vice-Chancellor Laster reasoned that privity 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 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. 46 A.3d at 336. That the action before him was being prosecuted by a firm that also fit this profile was not mentioned in the opinion. 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.” 46 A.3d at 350. The court thus concluded that privity was not in order since the earlier action failed to provide adequate representation for Allergan.

The Delaware Supreme Court reversed on both points. 74 A.3d at 614. 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.

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 an In re Caremark Int’l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996) 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. 46 A.3d at 357. Of note is that the difference is not with the judge but the quality of the derivative suit counsel. C. N. V. Krishnan, Steven Davidooff Solomon and Randall S. Thomas, Zealous Advocates of Self-Interested Actors? Assessing the Value of Plaintiffs’ Law Firms in Merger Litigation (Vand. Law and Econ. Research Paper No. 14-25, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2490098.

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. Ultimately, any difference in zealousness between plaintiff’s counsel in the federal court and the Delaware court was addressed with the Ninth Circuit reversing the district court’s dismissal, chastising the trial court for repeatedly drawing inferences in the board’s favor. Rosenbloom v. Pytt, 765 F.3d 1137 (9th Cir. 2014).

37 Thomas & Thompson, A Theory of Representative Suits, supra note 30.
non-cash settlements – whether in the form of changes in merger agreement terms or additional disclosure – do not have a significant impact on shareholder approval rates for completed deals.\(^{38}\)

Further eroding counsel’s incentive to invest heavily in an atmosphere of multi-forum litigation is the lurking fear of the reverse auction. With the reverse auction, unscrupulous plaintiffs’ (and defendants’) counsel advance their own financial interests by entering into a global settlement that greatly undervalues the injury suffered by the class shareholders.\(^{39}\) The reverse auction not only weakens the compensatory function of shareholder suits but by providing relief cheapened by the attorney’s self-interest weakens the deterrence value of the suit.

In the face of the explosion of deal-focused litigation, and growing awareness of the negative social consequences that may be facilitated by multi-forum suits, 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 freezouts pursuant to state short-form merger statutes that allow parents to acquire a ninety percent owned subsidiary solely

\(^{38}\) See Jill E. Fisch, Sean J. Griffith & Steven Davidoff Solomon, *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and A Proposal for Reform*, 93 Tex. L. Rev. 557 (2013) (Study was of 453 firms in 2005–12 time period of which 319 experienced litigation and resulted in 191 settlements that settlements amending merger terms or that provide only additional disclosure do not have impact on ultimate shareholder vote and that there is only weak evidence that increase in consideration impacts shareholder vote).

\(^{39}\) See generally Thomas & Thompson, *A Theory of Representative Suits*, supra note 30. By way of illustration, consider *Matsushita Elec. Indus. Co. v. Epstein*, 516 U.S. 367 (1996), 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 Clause of the U.S. Constitution required upholding the global settlement, provided the shareholders’ interests were adequately represented. 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. 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 that those at play in the Delaware state action. Hence, precedent exists within which a reverse auction can occur, if not thrive.
upon the approval of the parent board of directors.\textsuperscript{40} More recently, in *Kahn v. M & F Worldwide Corp.*,\textsuperscript{41} 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 vigorously 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. The Delaware legislature has also entered this area by authorizing a “streamlined back-end merger” whereby two independent firms can merge upon their boards approving the merger and the acquirer through a tender offer obtaining shares of the other company to assure approval of the merger.\textsuperscript{42}

In the face of the explosion in multi-forum suits, corporate lawyers also innovated using the mechanisms at hand. Today the antidote for multi-forum suits is the now widely-adopted forum selection clause. The standard forum-selection clause is set forth in the bylaws and authorizes the board of directors to designate a favored forum which is customarily, but not always, the corporation’s state of incorporation. Forum-selection bylaws were embraced by now-Chief Justice Strine, in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*,\textsuperscript{43} where he 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’

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\textsuperscript{40} Glassman v. Unocal Exploration, 777 A.2d 242 (2001).
\textsuperscript{41} 88 A.3d 635 (Del. 2014).
\textsuperscript{42} DEL. CODE ANN. tit. 8, § 251(h) (2014). A similar provision was adopted in Maryland in 2014. See MD. CORPS. & ASS’NS. § 3-106.1 (2015).
\textsuperscript{43} 73 A.3d 934 (Del. Ch. 2013).
\end{flushright}
contractual rights to the corporation. In 2015, the Delaware legislature passed a statute formally authorizing the inclusion of forum selection provisions in corporate bylaws.44

Thus, we are likely to see dramatic contractions in the use of acquisition-oriented litigation in Delaware because of these changes. While the Delaware courts initially developed broad substantive doctrines that provided avenues for shareholders to head to court to challenge the conduct of the board of directors in mergers and acquisitions, they subsequently significantly narrowed the avenues for doing so. This combined with Delaware’s approval of boards adopting bylaws that channel those challenges to Delaware will restrict the scope of acquisition-oriented class actions. Moreover, other state courts and legislatures are beginning to weigh in with bylaw changes that would require fee shifting onto plaintiffs in these class actions.45 The 800 pound gorilla in the room that has yet to be addressed is whether any states will permit corporate bylaws that mandate sending shareholder-manager disputes to arbitration.46 What does seem clear though is that the combination of these new bylaws will most likely lead to less accountability to shareholders by managers and directors.

B. Appraisal Arbitrage: A Remedy for Control Shareholder Self-Dealing?

44 S.B. 75, 148th Gen. Assemb. (Del. 2015), amending Del. Code Ann. tit. 8, § 115 (2015) (authorizing forum-selection bylaws), was signed by Governor Jack Markell on June 24, 2015. The same legislation also added Del. Code Ann. tit. 8, §§ 102, 109 (2015) (prohibiting fee-shifting provisions in articles of incorporation or bylaws, respectively). Earlier, following a contract-focused approach whereby the articles of incorporation and bylaws are understood to define the shareholders’ relation with their corporation, the Delaware Supreme Court held that the grant in the articles of authority to the board of directors to amend the articles thus enables the board of directors to adopt a bylaw that would shift the corporation’s litigation costs to the shareholder suit’s plaintiff if unsuccessful. ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554, 557–58 (Del. 2014).

45 See, e.g., Okla. Stat. tit. 18, § 1126 (2015) (“In any derivative action instituted by a shareholder of a domestic or foreign corporation, the court having jurisdiction, upon final judgment, shall require the nonprevailing party or parties to pay the prevailing party or parties the reasonable expenses, including attorney fees, taxable as costs, incurred as a result of such action.”).

In the past, merger litigation played a significant monitoring role in addressing possible agency costs in corporate transactions, especially controlling shareholder squeezeouts of minority shareholders in cash out mergers. It was particularly valuable for small shareholders, who would otherwise be unable to bring cases to challenge managerial misconduct in an acquisition. Empirical research examining its role at the turn of the millennium found that class action lawsuits challenging the fairness of the consideration paid in M&A transactions had a positive impact on takeover premiums.\textsuperscript{47} However, as we discussed above, merger litigation's future has been placed in jeopardy by the explosion in its use, followed by the adoption of forum selection bylaws and, at least in some jurisdictions, the availability of fee shifting bylaws. If this is true, is there another form of shareholder monitoring 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 over when 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,\textsuperscript{48} whereas Delaware limits its appraisal statute to mergers and consolidations,\textsuperscript{49} and the Model Business Corporation Act follows a course between these two positions.\textsuperscript{50}

\textsuperscript{47} C.N.V. Krishnan, et al., \textit{supra} note 7, at 1262.
\textsuperscript{48} \textit{See e.g.}, \textsc{Cal. Corp. Code} §§ 181, 1200 et seq., 1300 (2015); \textsc{N.Y. Bus. Corp. Law} § 910 (2015).
\textsuperscript{49} \textit{See Del. Code Ann. tit. 8 § 262(b) (2014).}
\textsuperscript{50} \textit{See Model Bus. Corp. Act} § 13.02(a) (1984).
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: \textsuperscript{51} difficult procedural steps that must be followed in precise order to preserve one’s right to the remedy; \textsuperscript{52} 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 shared; \textsuperscript{53} and the narrow limits of the remedy. \textsuperscript{54} Small shareholders were stymied by these problems, while larger blockholders made sparing use of the statutory appraisal remedies. \textsuperscript{55} As a result, prior research has found that few appraisal actions are filed and even fewer are actively litigated. \textsuperscript{56}

Professors Kahan and Rock were the first scholars to notice that hedge funds that were dissatisfied with the terms of an acquisition were adapting appraisal litigation to a new role. \textsuperscript{57} They point out that activist hedge funds are engaging in appraisal arbitrage when they buy shares of a target company’s stock with the objective of filing an appraisal petition and seeking a higher

\textsuperscript{52} 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) (2014).
\textsuperscript{54} The market out provision eliminates appraisal rights for mergers and consolidations where there is a liquid market for their securities. DEL. CODE ANN. tit. 8 §262(b) (1) (2014). 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. Thomas, \textit{supra} note 53.
\textsuperscript{55} Cede & Co. v. Technicolor, Inc., 884 A.2d 26 (Del. 2005). This is the case that ultimately shows the costs of pursuing appraisal even to large shareholders. Here, after the minority shareholders of Technicolor, Inc. were cashed out, a beneficial owner sought appraisal. Unsatisfied with the result, the beneficial owners appealed. The result was an extensive sequence of litigations spanning almost 20 years, leading to numerous disputes over the amount of the discount rate, whether post-judgment interest was owed, and how much discretion was owed to chancery court’s initial analysis.
\textsuperscript{56} Thomas, \textit{supra} note 53 at 22–23 (finding an average of less than 14 appraisal actions filed per year from 1977 to 1997).
price for their stock. Appraisal arbitrage is another example of how the increasing concentration of stock ownership may be leading to changes in shareholder monitoring devices.\textsuperscript{58}

Professor Geis,\textsuperscript{59} and Professors Korismo and Myers,\textsuperscript{60} have picked up this idea and written substantial articles debating the appropriate role of appraisal litigation as a monitor of M&A deals. Professor Geis focused on a Delaware Chancery Court appraisal decision, \textit{In re Appraisal Transkaryotic Therapies, Inc.}\textsuperscript{61} This case resolved a technical question about which shareholders qualified to seek appraisal after the announcement of a merger. In particular, the court held that shareholders that purchased their stock in the target company after the record date for the stockholders’ meeting, but before the date of the stockholder vote, and therefore who did not have the right to vote the shares at the meeting, could nonetheless seek appraisal. The net effect of the decision was to facilitate hedge funds accumulating substantial stakes in target companies in order to file appraisal actions in the hopes of making large profits on their investments.\textsuperscript{62}

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.” \textsuperscript{63} 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.”\textsuperscript{64} Yet, Geis equivocates about whether this is beneficial to target

\begin{footnotes}
\item[60] Korismo & Myers, supra note 51; see also Charles Korismo & Minor Myers, \textit{The Structure of Shareholder Litigation: When do the Merits Matter?}, 75 OHIO ST. L.J. (forthcoming 2015).
\item[61] 2007 WL 1378345 (Del. Ch. 2007).
\item[62] See supra note 58–59.
\item[63] Geis, supra note 59, at 1638.
\item[64] Id. at 1658.
\end{footnotes}
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.65

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 of dissenting shares in appraisal actions spiked sharply in 2013.66 They document the rise of a small, but growing, group of investors filing multiple appraisal actions arising out of different transactions.67 These repeat petitioners “target deals where the merger premium is low and where controlling shareholders are taking the company private.”68 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.”69

While this is certainly possible, we are 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 the 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 statutorily covered transactions have appraisal actions filed challenging the consideration paid in the deal.70 We may also expect this percentage to fall further if deal planners restructure the transaction so

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65 Id. at 1676.
66 Korsmo & Myers, Appraisal Arbitrage, supra note 51, at 17 fig. 3.
67 Id. at 18.
68 Id. at 28.
69 Id. at 42.
70 Id. at 16 fig. 2.
as to minimize or even avoid appraisal; one such strategy to remove any opportunity for appraisal is distribute stock, and not only cash, as consideration for the merger.\textsuperscript{71}

The biggest class of public company transactions where appraisal is currently available are cash out mergers. Of these, third party sales in arm’s length transactions in a well-shopped deal are likely to be fairly priced. In this class of deals, the Delaware courts have “suggested that a market test of a transaction will serve as a proxy for fair value in appraisal suits, so that arm’s-length deals with adequate market checks do not create appraisal risks for buyers”.\textsuperscript{72} If this is correct, we would not expect that shareholders would file such cases, as they are expensive to litigate and unlikely to result in a judicial determination that the plaintiffs are entitled to a price greater than the merger price. However, if such cases are being filed and settled for valuable consideration, that would suggest they are frivolous cases that have only nuisance value.

Amongst the remaining set of potential deals covered by appraisal, we would expect that appraisal would be most useful in control shareholder squeezeouts -- the transactions with the greatest potential for below market premiums being paid in sale of control transactions. In control shareholder squeezeouts, the transaction cannot be subject to a market check, and “…fiduciary duties and litigation may not be sufficient to ensure that the merger price reflects the fair value of the acquired shares.”\textsuperscript{73} Leveraged buyouts which are not adequately shopped to the market may also raise concerns about possible conflicts of interest as target firm managers may seek to preserve their jobs after the transaction closes and a private equity buyer may seek

\textsuperscript{71} \textsc{Del. Code Ann. tit. 8 \$262(b) (1) (2014). To the extent this creates a problem, the market out exception must be eliminated. As numerous critics have pointed out, shareholders who receive marketable securities for their shares in a merger may still need appraisal: if they sell those shares in the market after the merger, then they will suffer an uncompensated loss. Kor smo & Myers, \textit{Appraisal Arbitrage, supra} note 51.}

\textsuperscript{72} \textsc{Council of the Corporation Law Section of the Delaware State Bar Association, Section 262 Appraisal Amendments 2 (2015).}

\textsuperscript{73} \textit{Id.}
to hire them to run the firm. Appraisal arbitrage may act to protect shareholders from being
shortchanged in a sale of control in these circumstances.

Second, we would not expect to see appraisal as it is currently structured being used by
small shareholders with minimal stakes in the target firm. Given the great expense involved in
fully litigating an appraisal action, and the absence of a class action mechanism, small
shareholders will not find appraisal to be cost effective generally.\textsuperscript{74} If such cases are being filed
and settled, then it seems plausible that they are nuisance litigation. At least that seems to be the
conclusion reached by the Delaware Council of the Corporation Law Section (the “Corporate
Council”) when they proposed a de minimis exception to the appraisal statute that would impose
limits on the remedy unless “the total number of shares entitled to appraisal exceeds 1% of the
outstanding number of shares that could have sought appraisal; or (2) the value of the merger
consideration for the total number of shares entitled to appraisal exceeds $1 million…”\textsuperscript{75} But it
remains to be seen if the Delaware legislature will enact this proposal as it failed to act on the
Corporate Council’s proposed legislation this past year.

It is very unusual for the Delaware legislature not to follow the lead of the Corporate
Council in enacting corporate law.\textsuperscript{76} The legislature’s inaction, however, may not suggest
disagreement with the Corporate Council. The precipitating event for its inaction appears to have
been a letter from a group of seven major Wall Street law firms that raised several additional
issues about the appraisal statute.\textsuperscript{77} They were particularly concerned that the Delaware
legislature overrule the Transkaryotic decision in order to reduce the amount of appraisal

\textsuperscript{74} Indeed, small investors will benefit, if at all, from 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.
\textsuperscript{75} COUNCIL OF THE CORPORATION LAW SECTION OF THE DELAWARE STATE BAR ASSOCIATION, supra, note 72, at 4.
\textsuperscript{76} Marcel Kahan and Edward Rock, Symbiotic Federalism and the Structure of Corporate Law, 58 Vand. L. Rev. 1573, 1600 (2005).
\textsuperscript{77} Letter from Cravath, Swaine & Moore LLP, et al. to the Council of the Corporate Law Section of the Delaware State Bar Association (April 1, 2015) (on file with author).
arbitrage litigation filed by hedge funds. Thus, the legislature appears to be proceeding deliberately in considering a wide range of changes to Delaware’s appraisal statute. However sweeping the reform may be, appraisal cannot be expected to be robbed of its effect in the hands of a blockholder invoking appraisal as a vital check on ill-advised acquisitions.

This discussion raises an important empirical question: what type of appraisal cases are being filed and brought to trial, or if they are settled, what are the terms of those settlements? Korsmo and Myers publish data on cases that are tried in the Delaware Chancery Court but this constitutes a small subset of all appraisal cases filed. However, most of these cases are settled and the terms of these settlements are private. Without this information, the Delaware legislature’s decision about how to revise the statute will be a very difficult one. Until that occurs, we cannot predict what appraisal will look like in the future and whether it will grow into an important shareholder monitoring mechanism.

C. Hedge Fund Activism Reinvigorates the Market for Corporate Control and Replaces Acquisition-Oriented Class Actions As An Effective Monitoring Technique

The market for corporate control weakened substantially after the Delaware Supreme Court’s Time-Warner decision made it clear that it would not force target companies to redeem their poison pills in the face of a non-coercive fairly priced hostile tender offer. This was followed by that same court’s Unitrin decision that greatly reduced acquirer’s ability to win proxy contests for corporate control. Similarly, Delaware upholds the impregnable defensive combination of a

staggered board and poison pill.\textsuperscript{81} With the decline of the hostile takeover, managerial agency costs rose. When shareholder M&A litigation failed to fill the gap created, a space opened up for shareholder activists to attack these increasing levels of managerial agency costs. Beginning in earnest in the early 2000’s, a wave of hedge fund activism hit the U.S., leading to an increased level of M&A activity among targeted firms.\textsuperscript{82}

In recent years, hedge funds have actively engaged many companies in an effort to boost shareholder value.\textsuperscript{83} Empirical studies find that the filing of an activist hedge fund’s Schedule 13D filing creates positive average abnormal returns from 7% to 8%.\textsuperscript{84} 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.\textsuperscript{85} The combined effects of direct stock ownership and support from other investors have enabled top hedge funds to aggressively pursue the creation of shareholder value.\textsuperscript{86}

Where do the gains reflected in the stock market price increase come from? One line of research finds that much of the gains generated by hedge fund activism arise out of the increased likelihood that targeted firms will be sold or engage in spinoffs.\textsuperscript{87} For example, Greenwood and

\textsuperscript{83} Brav, Jiang, Partnoy and Thomas, supra note 14.
\textsuperscript{84} Id. at 1731.
\textsuperscript{85} Edelman, Thomas & Thompson, supra note 14; Gilson & Gordon, supra note 14.
\textsuperscript{87} While sales of the company generally result in a premium price being paid to the target company’s shareholders, the impact of spin-offs is more nuanced. Steven Davidoff Solomon, Does a Deal Have the Right Chemistry, or is it
Schor find that activist hedge funds returns are largely produced by takeover premiums.\textsuperscript{88} Another recent paper finds that in the second wave of activism, running from 2008 to the present, the largest and most successful hedge funds, using a variety of aggressive techniques such as proxy contests for board representation lawsuits, and media campaigns, force target companies to put themselves up for sale.\textsuperscript{89} Moreover, these most successful activists target firms with the greatest level of anti-takeover defenses, suggesting they are addressing the gap created by the closing of the market for corporate control. Thus, the weaknesses in corporate law in regulating effectively management antitakeover initiatives designed to thwart a change in control are being addressed through hedge fund activism.

Poor management is another reason why target firms are generally undervalued by the market. Hedge funds often are able to improve operating performance. For example, one set of researchers found that firms targeted by activists see a 1.22% increase in operating efficiency one year after acquisition.\textsuperscript{90} Another recent paper finds that the most successful hedge funds generate substantial improvements in operating performance at target firms with one year post-intervention ROA growth of 9.24%, sales growth of 2.54% and R&D investment growth of 3.42%.\textsuperscript{91} This suggests an additional path by which hedge fund activism combats managerial slack.

\textit{Just Financial Engineering?}, N.Y. TIMES, Dec. 16, 2015, at B5 ("a spinoff has become the transaction de jour," whose benefits are disproportionately realized by short term investors while long term performance is weak).
\textsuperscript{88} Greenwood & Schor, \textit{supra} note 80. Those authors find that activist targets, which do not result in a takeover have abnormal returns statistically indistinguishable from zero.
\textsuperscript{89} C.N.V. Krishnan et al., \textit{supra} note 84.
\textsuperscript{90} Christopher Clifford, \textit{Value Creation or Destruction? Hedge Funds as Shareholder Activists}, 14 J. OF CORP. FIN. 323, 324 (2008); see also Brav, Jiang, Partnoy and Thomas, \textit{supra} note 14.
\textsuperscript{91} C.N.V. Krishnan et al., \textit{supra} note 84, at tbl. 7. Finally, 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.” However, these capital structure changes do not appear to be the source of the market gains associated with hedge fund activism. Brav, Jiang, Partnoy and Thomas, \textit{supra} note 14; Greenwood & Schor, \textit{supra} note 80. Rather, just as the Miller and Modigliani theorem predicts, they are just a reshuffling of firm’s capital structure that does little to affect firm value. Franco Modigliani & Merton Miller, \textit{The Cost of Capital, Corporation Finance, & the Theory of Investment}, 48 AM. ECON. REV. 261 (1958).
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. Some advocates of this position have gone so far as to argue that hedge fund shareholders ought to have fiduciary duties to other shareholders as a check on their allegedly opportunistic conduct. Yet, the data reviewed above is inconsistent with the view that hedge fund short-termism is a problem.

There are several other reasons to question this claim. For one thing, hedge funds seem to have little trouble recruiting institutional investors to support their activist goals. If hedge fund’s plans only produced a short term gain at the expense of long term profitability, these long term investors would be reluctant to support them. Second, activist hedge fund holding periods average approximately 31 months, which is substantially longer than almost all other investors. 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

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92 Martin Lipton, Deconstructing American Business II and Some thoughts for Boards of Directors in 2007, 10 NAT’L LEGAL CTR. FOR THE PUB. INTEREST 1 (2006), 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.”); see also Lucian 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); Mark Roe, Corporate Short Termism – In the Boardroom and in the Courtroom, 68 BUS. LAWYER 977 (2013) (reporting that managerial and boardroom autonomy have been justified recently by claims that activist hedge funds shareholders are focused on short term gains); 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).


94 See also Lucian Bebchuk, et al., Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy, 39 J. CORP. LAW 1 (2013). See also Roe, supra note 92, containing an extensive discussion of the evidence, both pro and con of claims that investors with a short-term perspective are harming corporations before ultimately rejecting these arguments.


96 Kahan & Rock, supra note 95, at 1088.

97 William Bratton, Hedge Funds and Governance Targets: Long-Term Results, 95 GEO. L.J. 1375 (2007).
over a five-year period as were improvements in other measures of returns. 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.

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. 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 (potentially targeted) firms to aggressively maximize shareholder value.

Overall, activist hedge funds, sometimes working with private equity firms, have been able to fill the shareholder monitoring function of the market for corporate control. Here is a second example of how increasingly concentrated share ownership makes for more efficient shareholder monitoring of managerial agency costs. In combination with a slightly increased role for the appraisal remedy in the hands of appraisal arbitrageurs, these changes have largely offset the decline in the monitoring value of acquisition-oriented shareholder class actions and the decline of the hostile takeover.

II. Working around the Weaknesses of Derivative Suits as Monitors of Executive Pay


99 Davidoff, supra note 92; see also Dionysia Katelouzou, Myths and Realities of Hedge Fund Activism: Some Empirical Evidence, 7 VA. L. & BUS. REV. 459 (2013) (finding that hedge funds are not short term in their focus).

100 Greenwood & Schor, supra note 80, at 362.
Derivative suits are another type of representative litigation that can be used by shareholders as a monitoring device. 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. Small shareholders can bring these actions on behalf of the corporation in a representative capacity.

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. 101 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. 102 Private Delaware firms were targeted with a dozen lawsuits annually, typically raising claims of minority oppression. 103

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 public company setting; in this context they perform their historical function of remediin 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.

102 Id. at 1749–50.
103 Id.
A. The Derivative Suit’s Impotence to Address Excessive Compensation

One troubling area for the derivative suit as a governor for self-interested conduct is executive compensation. Whether one views executive pay as an endemic problem with American corporate governance,\textsuperscript{104} or a more isolated problem involving a few bad apples,\textsuperscript{105} most experts agree that the derivative suit has been a weak tool to address executive compensation concerns. As developed below, the derivative suit is hobbled both procedurally and substantively in the executive compensation suits.\textsuperscript{106}

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 outcome in either case ultimately depends on whether the derivative suit court believes the board, or a subcommittee of the board, is 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 of the demand requirement, there exists a very large boneyard comprised of derivative suits challenging executive compensation in public companies.

In the case of the private corporation, the disputes are largely between the “ins” and the “outs,” making the demand requirement 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. In contrast, the


public company’s board is dominated by outside directors so that there is a healthy presumption of independence with respect to both whether the suit furthers the corporate interest as well as the substantive appropriateness of the compensation package. The board itself is further protected from claims of overpaying executives by the widespread 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.\textsuperscript{107} Immunity shields thus limit suits against directors that allege such a managerial failure to claims that the directors had engaged in a knowing and systematic breaches on the part of the board. It is unimaginable that such a claim can be successful in an environment in which executive compensation packages arise from a multistep process that involves external consultants, human resource professionals, and a deliberative process of at least a committee of the board, all of which is guided by counsel who will assure steps consistent with the desired image of due deliberation in setting the compensation.

The derivative suit has not always been impotent in confronting executive compensation.\textsuperscript{108} During the Great Depression, a good deal of litigation ensued, and with success, attacking bonus and incentive compensation policies of large public companies.\textsuperscript{109} The leading case of the day, Rogers v. Hill,\textsuperscript{110} 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


\textsuperscript{108} Shareholders may also be successful in some stage of derivative lawsuits filed challenging aspects of executive compensation even though this may not lead to a final judgment in their favor. Kenneth J. Martin & Randall S. Thomas, Litigating Challenges to Executive Pay: An Exercise in Futility?, 79 Wash. U. L. Q. 569, 571 (2001).

\textsuperscript{109} See George T. Washington, A Corporate Executive’s Living Wage, 54 Harv. L. Rev. 733 (1941) (reviewing the case history of Depression Era compensation cases).

\textsuperscript{110} 289 U.S. 582 (1933).
amount to spoliation or waste of corporate property. . . . If a bonus payment has no relation to the value of the services for which it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property. . . . "Rogers thus reflected the then contemporary approach to assess the overall reasonableness of the compensation package.

In current times, given the requirement of a majority of independent directors at listed public companies, the barest approval by a majority of the board of directors insulates executive compensation. 112

Illustrative of the high substantive protection executive compensation enjoys from challenges by shareholders is the recent decision, Freedman v. Adams. 113 A shareholder 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 be a deductible business expense on XTO Energy’s tax return. After the plaintiff initiated the derivative suit, complaining that the lack of any performance benchmarks 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 an award of attorneys’ fees incident to the claim, XTO Energy 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 decisions should not be constrained by such a plan. 114 The court denied any award of fees to the plaintiff because it found that a claim had not been stated.

111 Id. at 591–92 (quoting in part the intermediate court dissenting opinion by Judge Swan).
112 NYSE Listed Company Manual Sections 303A.00, 303A.11; Nasdaq Equity Rule 5615(a) (3); see also 17 C.F.R. § 240.10A-3 (2015).
113 58 A.3d 414 (Del. 2013).
114 Id. at
The court reasoned that: "[e]ven if the decision were a poor one" as alleged by the plaintiff, "it was not unconscionable or irrational."\(^{115}\) In other words, the court found that the plaintiff had not established waste, even when a board of directors gave up an easily available tax deduction with no apparent benefit to the corporation.

In addition to the weak substantive standards in the regulation of executive compensation, the derivative suit plaintiff typically faces insurmountable procedural barriers.\(^{116}\) 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 requires 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 best interest.\(^{117}\) Moreover, even if a demand is excused on the grounds that it is futile, the board of directors can resurrect its ability to interdict the derivative suit by creating a special litigation committee of independent directors who can

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\(^{115}\) Id. at 417.

\(^{116}\) A typical example is In re Walt Disney Derivative Litigation, 907 A.2d 693 (Del. Ch. 2005), aff'd, 906 A.2d 27 (Del. 2006), one of 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. 906 A.2d at 67.

\(^{117}\) 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, 666 N.E.2d 1034 (N.Y. 1996).
thereby provide an independent voice on whether the suit’s continuance is in the best interest of the company.\textsuperscript{118}

Thus, litigation through the derivative suit is not, and for some time has not been, a credible check on executive compensation in public companies. To the extent directors feel constrained in their executive pay decisions they act out of concerns other than a fear of litigation. In this space, the Say on Pay mechanism assumes great importance.

B. Say on Pay

Excessive compensation payments to top corporate executives are a sign of managerial agency costs. Good corporate governance argues in favor of effective shareholder monitoring of these payments. As we have just seen, shareholder derivative suits have proven largely impotent to either redress or retard executive compensation abuses. 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 procedural and substantive derivative suit requirements.\textsuperscript{119}

\textsuperscript{118} 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). 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 continuance. See e.g., Boland v. Boland Trane Associates, Inc., 31 A.3d 529 (Md. 2011).

\textsuperscript{119} See e.g., Aronson, 473 A.2d at 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, 666 N.E.2d at 1034 (1996) (dismissing suit challenging CEO compensation for failure to excuse a demand where board not shown to have egregiously).
The federally mandated Say on Pay vote by shareholders is a recent regulatory initiative designed to bolster shareholder monitoring of executive compensation practices.\(^\text{120}\) 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.\(^\text{121}\) 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.\(^\text{122}\) The 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.\(^\text{123}\) At the other end of the spectrum, only 1 to 2% of firms (40 to 60 firms of the Russell 3000) received less than 50% shareholder support during these same years.\(^\text{124}\)

Small institutional shareholders tend to be more likely than larger ones to vote against management’s Say on Pay proposals,\(^\text{125}\) perhaps because of their lack of alternative methods for


\(^{122}\) Inst’l S’holder Servs., Preliminary 2011 U.S. Postseason Report 2 (updated Aug. 8, 2011); *see also* Say-on-Pay Support Runs High in 2013, With Few Exceptions, Reports Show, Corp. L. Daily (BNA), 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); cf. James F. Cotter, et al., *The First Year of Say-On-Pay Under Dodd-Frank: An Empirical Analysis and Look Forward*, 81 Geo. Wash. L. Rev. 967 (2013) (reporting results from early 2012 proxy season that show that 2012 was a more difficult season for issuers for Say on Pay proposals).

\(^{123}\) Supra note 116–20.


\(^{125}\) See Schwartz-Ziv & Wermers, supra note 17, at 3.
confronting management with their opinions. Furthermore, when ownership is more dispersed, the Say on Pay vote “provides an opportunity of many small institutional shareholders to coordinate, and to voice a unified opinion” about management’s pay. However, upon occasion, large shareholders have joined them in expressing their displeasure with unjustifiable pay.

Say on Pay’s introduction has had a significant effect on American corporate governance. Dodd-Frank’s mandated shareholder votes focuses directors on shareholders’ concerns about executive pay, increases shareholder participation in corporate governance, and opens lines of communication between management and shareholders (and proxy advisory firms) regarding executive compensation. 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. Many companies revised the content of the CD&A filed with the annual meeting proxy materials. At companies whose pay programs received negative say-on-pay recommendations by proxy advisory firms, most boards took a variety of steps to engage shareholders following an “against” recommendation.

One interesting new line of research on Say on Pay’s monitoring effects finds that “companies that have a non-insider blockholder and receive low support rates for the SOP vote are significantly more likely to: (1) pick more reasonable (modest) peer-companies for

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126 Id. at 2.
127 See Thomas et al., supra note 122, at 1227.
130 Thomas et al., supra note 122.
131 Cotter et al., supra note 123.
determining executive compensation; (2) decrease the growth rate of excess compensation; and (3) experience CEO turnover within 12 months of the SOP vote, relative to companies that do not have a non-insider blockholder." This suggests that Say on Pay is most effective when a large blockholder serves as a "reluctant watchdog." Yet, in the United States, existing studies suggest that Say on Pay has not led to lower executive pay levels or to changes in its composition. 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 votes. However, internationally, Correa and Lel find that pay growth rates are lower in their comparative study of countries that have adopted Say on Pay legislation. 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."

In sum, Say on Pay acts as a low cost monitoring measure for shareholder groups that has some impact on executive compensation abuses. While it does not have a dramatic effect on pay

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132 See Schwartz-Ziv & Wermers, supra note 17, at 5.
133 Id.
134 Cuiffat et al., Say Pays! Shareholder Voice and Firm Performance (ECGI-Finance Working Paper No. 373, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2240410; Peter Iliev & Svetla Vitanova, The Effect of Say-on-Pay in the U.S. 3 (Feb. 1, 2015) (unpublished manuscript) (on file at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2235064). 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.
137 Id. at 14. Figure 1 illustrates the gap between the two groups of countries. Id. at 35.
levels or composition, it has shifted corporate governance patterns, leading to more interaction between management and shareholders over compensation issues. Smaller institutional investors have been more willing to vote against management pay packages but Say on Pay’s biggest effects come when large outside blockholders join smaller institutional investors in voting no on excessive compensation packages. Finally, the data to date supports the intuition that a periodic Say on Pay vote and the dialogue it prompts with proxy advisors and large blockholders retard the scale of pay from what would be the case were there no Say on Pay resolution.

C. Hedge Fund Activism and Executive Compensation

Say on Pay is a low cost shareholder monitoring technique that has had relatively limited, though important, effects. Shareholder monitoring of excess executive compensation can also come in higher impact forms, such as through the market for corporate control. During the 1980s, many bust-up takeovers were motivated, at least in part, by claims that target company managers were entrenched in power and helping themselves to overly generous amounts of compensation. While undoubtedly this was not the most important motive for hostile acquisitions, it did become a rallying cry for many shareholders.138

While the traditional hostile takeover that occurred in the 1980’s has largely disappeared, in recent years, hedge fund activists have targeted firms with high levels of executive pay.139

138 Henry G. Manne, Mergers and the Market for Corporate Control, 73 J. POL. ECON. 110 (1965) (noting that executive compensation leads to lower share prices which makes companies into attractive targets, but stating that “it is extremely doubtful that the full compensation recoverable by executives for managing their corporations explains more than a small fraction of outsider attempts to take over control.”).

139 Brav, Jiang, Partnoy and Thomas, supra note 14, at 1742 tbl. 1.
Although this targeting may be largely done to attract the support of other investors for other initiatives, it has increased the level of management turnover and reduced significantly the level of executive compensation at targeted firms.\textsuperscript{140} Brav et al. find that in the year that firms were targeted by hedge funds, “the CEO compensation in the target companies is on average $914,000 higher than the equivalent measure at peer companies in the same industry that are of similar size and stock valuation” but that “one year after hedge fund intervention, CEO pay at targeted firms is not distinguishable from peer levels.”\textsuperscript{141} Compensation form also changed with increases in pay-for-performance sensitivity levels.\textsuperscript{142}

Thus, we see that derivative litigation’s weaknesses in monitoring excess managerial pay have been compensated for by the introduction of low cost Say on Pay monitoring and by the rapid expansion of higher impact hedge fund activism. This leads us to ask: are there other areas where derivative litigation is failing and if so, what monitoring techniques may be taking its place?

III. The Derivative Suit and Stewardship of the Firm

In contrast to its’ low impact in policing executive compensation, derivative suit litigation remains a viable medium within a narrow area at public companies, the 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

\textsuperscript{140} \textit{Id.} at tbl. 7, p. A.
\textsuperscript{141} \textit{Id.} at 1767.
\textsuperscript{142} \textit{Id.}
faith was breached when there is evidence of a “sustained or systematic failure of a director to exercise reasonable oversight.”

A. Failure to Oversee Claims in Derivative Suits

A dramatic instance of such a suit is In re Massey Energy Company Derivative and Class Action Litigation. In that case, 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 that killed 29 miners – the deadliest mine accident in the U.S. in 40 years.

But, absent such dramatic pre-disaster warnings as occurred in Massey, failure of oversight claims confront two important bulwarks that protect directors – the ubiquitous immunity shield provision and the demand requirement. Unless the claims of lack of oversight rise to the level of a purposeful abandonment, as contrasted with a breach sounding in negligence, the standard immunity shield insulates the offending directors from liability. There is frequently insufficient evidence on which to conclude that the board has engaged in more than negligent oversight for which the immunity shield insulates the board from being held accountable in the derivative suit.

Indeed, the Delaware judiciary appears to have concluded that ignoring red flags may not even rise to the level of director negligence. To illustrate, consider In re Citigroup Inc. Shareholder Derivative Litigation, 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

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144 964 A.2d 106 (Del. Ch. 2009).
seemingly ample red flags that should have caught the board’s eye, 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. Nevertheless, 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.\footnote{Id at 128–30. See also, Central Laborers v. Dimon, C. A., 2016 U.S. App. LEXIS 48 (2d Cir. Jan. 6, 2016) (affirming the dismissal of a shareholder derivative suit bringing a Caremark claim under Delaware law against JPMorganChase for its failure to institute internal controls sufficient to detect Bernie Madoff’s Ponzi scheme).}

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.\footnote{In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 55–58 (Del. 2006).} 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 derivative duty to monitor suits. Indeed, the division between *Massey* and *Citigroup* may be that *Citigroup* involved a challenge to legitimate business practices whereas *Massey* is riveted, as was *Caremark*, on the directors’ conscious disregard to the corporation’s adherence with the law when implementing business strategies. After all, Chancellor Allen’s opinion emphasized the important role that compliance programs had assumed for American corporations when he justified departing from the earlier Delaware precedent that expressly relieved directors of the need to superintend the corporation’s systems to assure compliance with the law. Even if this is the means to distinguish: the conflicting results reached in *Massey* and *Citigroup*, the facts required to satisfy even *Massey* reflect such an abandonment of the directors’ monitoring role as to suggest outright complicity in the lawless acts rather than a want of oversight. As such, *Caremark* appears cabined to the extremes of corporate misbehavior.\textsuperscript{147}

B. Where Federal Securities Class Actions Do Not Wither: Management Stewardship

Another potential avenue for shareholder monitoring of failures in management stewardship is through securities fraud class actions. The story of few trials and many tribulations of federal securities class actions is well understood. At first glance, these suits appear poorly placed to assume a greater role in providing shareholder monitoring of managerial oversight. For one thing, the number of such suits has been declining in recent years. Cornerstone Research, the litigation support group, reports that during 2011-2013 companies within the S&P 500

experienced the lowest number of securities class actions in recent history.\textsuperscript{148} 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.\textsuperscript{149} 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 124 per year, in 2012 there were just 94.\textsuperscript{150}

However, in 2013, there were 102 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.\textsuperscript{151} 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.

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, a year after Congress introduced a variety of procedural changes intended to reduce the frequency of securities suit, there were 43 securities class actions dismissed; whereas, in 2013, in an era when many fewer securities class actions were being filed, 80 suits were dismissed.\textsuperscript{152} Overall, approximately 42 percent of filed securities class actions are dismissed in response to defendant’s motions to dismiss or summary

\textsuperscript{149} Id. at 30.
\textsuperscript{151} Id.
\textsuperscript{152} Id.
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.

However, securities fraud class actions are also ill-suited for monitoring managerial agency costs for other reasons as well. Doctrinally, the seeds of eviscerating the antifraud provision’s potential to address managerial agency costs were sown in the 1960s and 1970s to justify curbing the then ever-expanding scope of Rule 10b-5 when the Supreme Court ruled that it could not address “acts of corporate mismanagement.” This phrase arose from Birnbaum v. Newport Steel Corp., where the gravamen of the complaint was that the controlling stockholder thwarted an on-going acquisition of the company at a premium so that he could garner the entire control premium for himself. The defendant’s misconduct in Birnbaum was ultimately addressed under state law as a breach of the controlling stockholder’s fiduciary duty. In contrast, Birnbaum reasoned that the antifraud provision reached only fraud in connection with a plaintiff’s own purchase or sale, and not 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 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

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153 Id.
155 193 F.2d 461 (1952).
157 Birnbaum, 193 F.2d at 464.
fiduciary obligation absent deception is not within the reach of antifraud provisions. Thus, with the one exception discussed below, the antifraud provision has not just been relegated to a rear seat for claims of fiduciary misconduct, it has not even been in the vehicle carrying these shareholder complaints to settlement or judgment.

Despite the significant narrowing of the antifraud provision that has occurred, there has been a growing use of the antifraud provision to redress lapses in management’s oversight.\(^{159}\) Given all of the obstacles that shareholders face in bringing these cases, their use in oversight situations is an indictment of the comparative weakness of state law mechanisms to curb this variety of managerial agency cost. 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, the additional protection provided the board’s decision by the immunity shield provision. The effect of the immunity shield is to force the suit’s focus toward the responsible officers, rather than the outside directors.\(^{160}\) So focused, the derivative suit plaintiff confronts an even greater obstacle, the demand requirement whereby a decision by the independent directors that the suit is not in the corporation’s best interest scuttles the suit. In combination, failure of oversight and harmful stewardship escape scrutiny under state law except in the extreme instances of conscious abandonment of compliance with the law illustrated as occurred in *Massey*. The vacuum thereby created by the state derivative suit’s withdrawal has drawn the federal securities law antifraud provision into this space.

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At first, the path for securities fraud class actions challenging managerial oversight lapses was unclear. After *Santa Fe Industries*, absent a materially misleading statement the antifraud provision is not violated. However, investors could identify misrepresentations anchored in management’s failed stewardship and the accompanying lapses in board oversight. Many of the actionable statements are the consequence of the SEC’s Management Discussion and Analysis (MD&A) provision that mandates SEC filings, among other MD&A requirements, to set forth “any known trends or uncertainties . . . the registrant reasonably expects will have a material . . . impact.” The demands of this requirement were recently strengthened by a federal circuit court decision holding that failure to comply with the requirement is a material omission as the natural implication of making a disclosure of a known trend or uncertainty is that the trend or uncertain does not exist. More generally, management, certainly within regulated industries, proffer statements of the firm’s compliance with prevailing legal requirements, or offer opinions about the firm’s business strategies and operations meeting the on-going regulatory and competitive challenges that confront the firm. These statements are attuned to well-understood investor concerns with the importance of regulation and competition. Management’s reassurance on these points is appreciated by investors but is likely tainted by over-optimism that appears to abound among managers. It is into this informational environment that the Supreme Court’s

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161 ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co., 553 F.3d 187, 196 (2d Cir. 2009) (citing 15 U.S.C. § 78u-4(b)(1), (2); Tellabs Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 320 (2007)) (“[T]he complaint must ‘specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading,’ and ‘state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.’”).

162 Oran v. Stafford, 226 F.3d 275, 287 (3rd Cir. 2000) (citing 17 C.F.R. §229.303(a) (3) (ii) (2000)).


most recent antifraud decision arms Rule 10b-5 to have an even stronger role in addressing failures of stewardship.

In *Omnicare Inc. v. Laborer’s District Council Construction Industry Pension Fund*, the Supreme Court establishes the template for how management opinion statements regarding its policies, practices, and oversight are actionable under the antifraud provision. In its registration statement for a public offering of its securities, Omnicare stated management “believed” its various contracts were “in compliance with applicable federal and state laws” and “legally and economically valid arrangements.” The belief appears misplaced as subsequent to the public offering, several federal enforcement suits were initiated against Omnicare alleging multiple aspects of its contractual relationships and business arrangements violated federal health care laws. The class action suit was thereafter initiated by purchasers of the registered securities, alleging they had been duped by the false opinion of legal compliance.

The premise of *Omnicare* is that “a reasonable investor may, depending on the circumstances, understand an opinion statement to convey facts about how the speaker has formed the opinion. . . . [I]f the real facts are otherwise, but not provided, the opinion statement will mislead its audience.” *Omnicare*’s template assesses management’s opinions regarding its performance, policies and practices through the lens of whether the opinion expressed is a half-truth, meaning the opinion is actionable because in light of the total circumstances management omitted facts necessary to prevent what was said from being materially misleading. This formulation is captured by the Court’s illustration:

Consider an unadorned statement of opinion about legal compliance: “We

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166 *Omnicare*, 135 S. Ct. at 1323.
167 *Id.* at 1324.
168 *Id.* at 1328–29.
believe our conduct is lawful.” If the issuer makes that statement without having consulted a lawyer, it could be misleadingly incomplete. . . . [A]n investor, although recognizing that legal opinions can prove wrong in the end, still likely expects such an assertion to rest on some meaningful legal inquiry . . . Similarly, if the issuer made the statement in the face of its lawyers’ contrary advice, or with knowledge that the Federal Government was taking the opposite view, the investor again has cause to complain: He expects not just that the issuer believes the opinion . . . but that it fairly aligns with the information in the issuer’s possession at the time.169

Before Omnicare, generalized statements of optimism, such as “our conduct is lawful,” were perfunctorily viewed as harmless puffery. The ultimate significance of Omnicare is inviting inquiry whether management’s professed optimism was nonetheless a half truth.

Henceforth, whether mandated or volunteered, when executives report on their management oversight, and boards report on their efforts and systems to monitor management’s stewardship, Omnicare will police their professed achievements. While bad stewardship and poor monitoring will not give rise to disciplining of such underperformance by the antifraud provision, false representations of the strength of internal systems for assuring board oversight and systems for promoting wise stewardship of the firm are very much the subject today of the securities laws. Because Omnicare promotes greater transparency around the firm’s information and compliance systems, we should expect greater effort within the firm to assure they are fulfilling their objective of reducing managerial agency costs.

169 Id.
At a minimum, we therefore find that disclosure-oriented federal securities suits can address errant stewardship where 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.\textsuperscript{170} 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. And, it is a light beamed into an area largely vacated by state corporate law.

C. Hedge Funds and Private Equity Firms Monitor Managerial Oversight Failures

Hedge funds are constantly on the lookout for undervalued target firms. Firms that suffer from significant managerial oversight failures are likely to experience poor performance and stock price declines that will make them targets for activist shareholders. Activist hedge funds are more likely to seek to gain board representation at these firms, and those that succeed in

obtaining board seats will have strong incentives to monitor target firm boards and overall firm risk levels. 
Furthermore, as noted in section I.C above, hedge funds seek to force a sale of the target firm in many instances. The threat of hedge fund activism is therefore likely to keep corporate management sharply focused on paying attention to any red flags that might signal systemic weaknesses with their operations.

Private equity firms are another important monitor of managerial oversight failures. For one thing, they stand ready to purchase firms which have previously been targeted by hedge funds because of large losses from poor managerial oversight. Should that occur, corporate management at the newly privatized firm will be under the strict scrutiny of a strong board of directors appointed by the new controlling shareholder that seeks to insure shareholder value is maximized so that the private equity firm realizes substantial gains on its investment. The newly appointed private equity directors are highly motivated to perform in this role because they have increased levels of pay for performance, work in smaller and more focused groups, and can credibly threaten dismissal of nonperforming executives. As a result, we would expect that they would exercise strong managerial oversight with all cost-justified internal control systems deployed by the board in an effort to insure firm value was maximized. Derivative suits will be unnecessary as monitoring devices when private equity firms take on the oversight function.

\footnote{We note that some hedge funds have nominated director candidates with “golden leash” special compensation arrangements in which the hedge fund “privately offers to compensate its nominee directors in connection with their service as a director of the target corporation.” JASON D. SCHLOETZER, CONFERENCE BOARD ACTIVIST HEDGE FUNDS, “GOLDEN LEASH” SPECIAL COMPENSATION AGREEMENTS, AND ADVANCE NOTICE BYLAWS 6 (2015). The use of these arrangements is controversial, and no one has fully measured how often they are employed, but it appears that they are “rather limited in practice.” \textit{Id.}}


\footnote{\textit{Id.} at 251 (noting that directors at private equity controlled firms have stronger incentives to engage in active monitoring of managers and that “the private equity firms typically have a dominant position on the board of directors, providing them with the power to discipline management as well.”).}
Private equity firms are better risk monitors than public company boards for other reasons as well. ¹⁷⁴ First, management team members will have greater equity interest in their firms than their public company counterparts, especially at the more junior levels. This gives them stronger incentives to care about firm value and therefore to more accurately assess the impact on the firm of increased risk levels at the firm. Second, private equity managers’ equity interests are much more sensitive to changes in firm value because of the magnifying effects of the relatively high debt burden shouldered by their companies. This again gives them stronger incentives to monitor risk levels. Finally, the more experienced directors that are employed by private equity firms will have better information and greater ability to control risk levels because they have the backing of the control shareholder in doing so. In short, hedge funds and private equity firms are filling a monitoring gap created by derivative litigation’s shortcomings.

Conclusions

Derivative suits and M&A class actions have enjoyed periods of great repute as well as tough times where they have been vilified. Their usefulness as managerial agency cost monitoring devices has lately been called into question. Courts and legislatures have cut back on their scope and long term viability. However, even as the strength of these forms of litigation has waned, new forms of monitoring techniques have emerged. Hedge fund activism, Say on Pay votes, securities fraud class actions, private equity firms and appraisal arbitrage, have come forth to fill the gaps as potential alternative monitoring tools for disgruntled shareholders.

¹⁷⁴ Id. at 253–54.
In this paper, we argue that these two sets of developments are related to malfunctions in the market for corporate control, abuses in executive compensation practices and managerial oversight breakdowns. In each case, as managerial agency costs begin to spiral upward, investors sought ways to reduce them. Hedge fund activism is the strongest of these methods at the moment with many well-documented successes in opening up the market for corporate control, curbing executive compensation and attacking a lack of managerial oversight. Say on Pay voting requirements have served 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. Securities fraud class actions have shown promise as a tool for addressing managerial oversight failures as have private equity controlled boards of directors. Finally, appraisal arbitrage 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 arbitrage 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.

We believe that many of the new governance responses are influenced by, or created out of, the rising concentration of share ownership of public companies. It is now well-documented that share ownership has steadily evolved so that there are now a significant number of large blockholders at many public companies. This reduces the costs of collective action and increases the likelihood that an owner exists who will have a sufficient economic interest to embrace governance as a wealth-increasing strategy. Hedge fund activism, appraisal arbitrage,

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private equity boards of directors, and even Say on Pay, are directly or indirectly all the product of greater concentration of equity ownership.

Looking to the future, we see some evidence that these trends will continue. Hedge fund activism seems to rising to new levels in our economy. Private equity buyouts, while they are cyclical in nature, rising to higher levels with good economic times, but dropping off in times of recession, reflect the strong benefits of control shareholders over dispersed ownership systems. Furthermore, current market trends in the IPO markets are that increasing numbers of high profile firms are using dual class stock structures to preserve the benefits of concentrated ownership for the newly public companies. All of these forces should lead to higher levels of ownership concentration and managerial agency cost reductions by new forms of shareholder monitoring.
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