CORPORATE DARWINISM: DISCIPLINING MANAGERS IN A WORLD WITH WEAK SHAREHOLDER LITIGATION*

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Because representative shareholder litigation has been constrained by numerous legal developments, the corporate governance system has developed new mechanisms as alternative means to address managerial agency costs. We posit that recent significant governance developments in the corporate world are the natural consequence of the ineffectiveness and inefficiency of shareholder suits to address certain genre of managerial agency costs. We thus argue that corporate governance responses evolve to fill voids caused by the inability of shareholder suits to monitor and discipline corporate managers.

We further claim that these new governance responses are themselves becoming stronger due in part to the rising concentration of share ownership of public companies. Share ownership has steadily evolved so that there are now a significant number of large blockholders at most public companies. 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.

Finally, the increasing concentration of ownership of public companies has the effect of making governance responses efficient and effective, a response that would not have been observed were ownership not concentrated. Thus, we not only argue that concentration increases activism among this growing group of blockholders but also that concentrated ownership

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ushers in new methods to address agency costs and makes those methods effective.

INTRODUCTION

Corporate legal scholarship is riveted on addressing managerial agency costs.[1] Adolf Berle and Gardner Means popularized the topic by documenting how in the 1930s the ownership of U.S. public companies was separated from management, resulting in a misalignment of utility curves between owners and managers.[2]

1. *See* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289 (1980) (explaining how the "separation of security ownership and control" functions as "an efficient form of economic organization"); Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 234 (1979) (affirming the centrality of transaction costs to economics and providing an in-depth analysis of them).

2. ADOLF A. BERLE & GARDNER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 66, 112–13 (1932) (explaining that the typical public corporate owners were dispersed so that owners' exercise of oversight was seriously limited by high

Michael Jensen and William Meckling later showed that within dispersed ownership systems, shareholders engage in a variety of strategies so as to minimize these divergences.[3] In pursuit of this goal, shareholders may deploy a variety of mechanisms—shareholder voting, the threat of a change-of-control transaction, or performance-based compensation—to encourage managers to succeed and punish managers who are poor stewards and fail to enhance shareholder value.[4] Over time, the relative value of these different devices for disciplining managers has ebbed and flowed with the changes in share ownership patterns and the constant evolution in legal rules, both substantive and procedural.[5]

As part of this paradigm, legal scholars regularly examine how effectively representative litigation, whether class actions or derivative suits, controls managerial agency costs.[6] Many scholars argue that over the past seventy years shareholder representative litigation has acted as an important policing mechanism of managerial abuses at U.S. public companies.[7] 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

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coordination costs, which enabled managers to essentially hire capital rather than capital to retain managers).

3. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 323–24 (1976). The article sets forth the classic framework for considering multiple efficient responses to agency costs. *See id.* at 305–06.

4. *See* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1531–32 (2007).

5. *See* Randall S. Thomas & Robert B. Thompson, *A Theory of Representative Shareholder Suits and Its Application to Multijurisdictional Litigation*, 106 NW. U. L. REV. 1753, 1758–60 (2012).

6. For an example of a positive view of the efficiency of shareholder suits in addressing agency costs, see James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745, 775–76 (1984). *But see* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 277–83 (1986) (concluding that derivative stockholder suits do not have a significant effect on shareholder wealth); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 84–85 (1991) (concluding that shareholder litigation is a weak and ineffective tool of corporate governance).

7. James D. Cox & Randall S. Thomas, *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law*, 6 EUR. COMPANY & FIN. L. REV. 164, 164–65 (2009); Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 134–35 (2004); *see* C.N.V. Krishnan et al., *Shareholder Litigation in Mergers and Acquisitions*, 18 J. CORP. FIN. 1248, 1249 (2012).

litigation—which often produce benefits for shareholders but pose difficult challenges as well.[8]

In particular, the benefits created by these suits are qualified by the litigation agency costs that surround them.[9] Litigation agency costs arise because suits are often brought by a named plaintiff that has no substantial ownership interest in the corporation. As a result, the initiation and maintenance of these suits could be easily seen as lawyer driven.[10] And that perception is further underscored in the United States where the "American rule," in contrast to the "English rule," provides no governor on the suit's initiation and prosecution.[11] In recent years, concerns about the combination of the English rule and litigation agency costs have resulted in legislative and judicial actions that restrict shareholder litigation in many ways.

Our thesis is straightforward: we claim that the recent arrival of significant governance developments is a natural consequence of both the ineffectiveness and inefficiency of shareholder suits to address certain genres of managerial agency costs. That is, 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, the corporate governance system has developed new mechanisms as alternative means to address managerial agency costs.

In addition, we take this argument one step further: we claim that these new governance responses are themselves becoming stronger due in part to 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

8. *See generally* Jessica Erickson, *The New Professional Plaintiffs in Shareholder Litigation*, 65 FLA. L. REV. 1089 (2013) (examining professional plaintiffs in shareholder litigation and providing a proposed framework to address the problem professional plaintiffs bring to shareholder litigation).

9. There is robust literature on exploring how and why the representative suit counsel's incentives are poorly aligned with the interests of the corporation or its shareholders. *See, e.g.*, John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, L. & CONTEMP. PROBS., Summer 1985, at 5, 23.

10. *See, e.g.*, John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 679–81 (1986); Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 948–49 (1993).

11. For a more complete exploration of these differences in a multi-country setting, see generally Symposium, *Shareholder Suits*, 6 EUR. COMPANY & FIN. L. REV. 161 (2009).

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. Also, the increasing concentration of ownership of public companies has the consequential effect of making governance responses efficient and effective where the response would not have been observed were ownership not concentrated. Thus, we not only argue that concentration increases activism among this growing group of blockholders but also that concentrated ownership ushers in new methods to address agency costs.

Activist hedge funds are among the most obvious manifestation of developments that have changed ownership of U.S. 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 acquisition-oriented class actions.[13] Hedge funds control large pools of unregulated capital and aggressively invest in underperforming target companies seeking to bring about stock price increases.[14] 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 are rarely initiators.[15] 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 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

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12. Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377, 1379 (2009). This activism is further facilitated by private equity firms' ownership consolidation. *See infra* Section III.C.

13. *See* Paul Rose & Bernard S. Sharfman, *Shareholder Activism as a Corrective Mechanism in Corporate Governance*, 2014 B.Y.U. L. REV. 1015, 1018–19 (2014).

14. *See id.* at 1019, 1034.

15. *See* Paul H. Edelman, Randall S. Thomas & Robert B. Thompson, *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359, 1361 (2014); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 867 (2013) (demonstrating how activist hedge funds are desirable complements to the tendency of financial institutions to be "rationally reticent"). For a close review of the multiple effects of hedge fund activism, see Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1755–73 (2008).

management; reduce executive compensation; force sales, spinoffs, or financial restructurings; or prompt other strategies to improve operating performance.[16] Alongside these hedge funds, 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.[17]

The passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act further armed investors, both large and small, by mandating a non-binding say-on-pay vote ("Say on Pay").[18] This new vote on executives' pay fills a corporate governance hole created by the failure of derivative suits to regulate compensation; Say on Pay resolutions enable shareholders, especially small institutional shareholders, to engage in direct monitoring of executive compensation.[19] 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. It should not be overlooked that such engagements are facilitated by, if not the direct result of, the rising concentration of share ownership in the hands of institutional investors.

This Article also considers the rising role of the appraisal remedy within the context of developments in shareholder litigation focused on acquisitions. 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 efforts to engage in what some have called "appraisal arbitrage."[20] As

16. *See* Martin Lipton, *Dealing with Activist Hedge Funds*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 9, 2012), http://corpgov.law.harvard.edu/2012/08/09/dealing-with-activist-hedge-funds/ [https://perma.cc/6TX5-6NF7].

17. Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219, 220 (2009); *see also* Martin Lipton, *Dealing with Activist Hedge Funds*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 6, 2014), http://corpgov.law.harvard.edu/2014/11/06/dealing-with-activist-hedge-funds-3/ [https://perma.cc/49DG-DSE6].

18. Randall S. Thomas & Christoph Van der Elst, *Say on Pay Around the World*, 92 WASH. U. L. REV. 653, 659–60 (2015); *see* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899–1900 (2010) (codified as amended at 15 U.S.C. § 78n-1 (2012)).

19. *See* Miriam Schwartz-Ziv & Russ Wermers, *Which Shareholders Benefit from Low-Cost Monitoring Opportunities? Evidence from Say on Pay* 1–2 (Robert H. Smith Sch. of Bus., Research Paper No. RHS 2510442, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2510442 [https://perma.cc/ZZ3U-4AU3 (staff-uploaded archive)].

20. *See Appraisal Arbitrage: Will It Become a New Hedge Fund Strategy?*, LATHAM & WATKINS LLP (May 2007), https://www.lw.com/upload/pubContent/_pdf/pub1883_1.pdf [https://perma.cc/W6GZ-UV4A].

discussed later, although shareholders seeking protection through the appraisal remedy must overcome many hurdles to employ appraisal as a meaningful alternative to merger litigation, as these suits are sometimes subject to abuse, appraisal has the potential to become an important monitoring mechanism.

Though multiple evolving governance mechanisms already address managerial agency costs, there nonetheless seems to be a new litigation approach to address lapses in managerial stewardship as well. Failures of managerial oversight with regard to product safety, operating risks, and compliance with the law may be addressed using securities fraud class actions after the Supreme Court's most recent antifraud decision in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund.*[21] As developed below, private enforcement actions building on *Omnicare* have the potential to police executives reporting to investors about their management oversight efforts. These instances will certainly occur when boards or senior officers provide optimistic assessments of their compliance systems that are materially incomplete in their reassurances. The resulting false representations respecting strength of internal systems and false images of board oversight can be disciplined based on the holding in *Omnicare.* Consequently, the possibility of such suits can be expected to promote greater attention to stewardship by managers who will take their oversight more seriously so as to avoid later charges that they falsely represented their oversight.

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 ensure that managerial agency costs are kept low. This Article proceeds as follows. Part I 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, Part II exposes 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 it as a shareholder-monitoring device. Finally, Part III discusses how derivative litigation has done little to ensure 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

21. 135 S. Ct. 1318 (2015).

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.[22] This perspective is partly justified, at least with respect to litigation spawned by acquisitions in light of the recent dramatic frequency of such deal-related litigation. This Part sets forth the significant substantive and procedural changes that have adversely affected shareholder acquisition-oriented class actions in the United States. We then argue that these 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 bullseye on M&A 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.[23] Close judicial review was later extended to multi-step acquisitions with a dominant stockholder.[24] In such transactions, the Delaware courts often placed the burden of proving entire fairness of the transaction on the dominant stockholder.[25] Moreover, heightened scrutiny is extended in situations of any sale of control to a third party, placing the burden on management to prove it acted reasonably to get the

22. *See* Trevor S. Norwitz, *Delaware Poised to Embrace Appraisal Arbitrage*, CLS BLUE SKY BLOG (Mar. 9, 2015), http://clsbluesky.law.columbia.edu/2015/03/09/delaware-poised-to-embrace-appraisal-arbitrage/ [https://perma.cc/34ZC-N2HF].

23. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983).

24. *See In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 424–25 (Del. Ch. 2002) (holding that a controlling stockholder who raises ownership interest to a level sufficient to carry out a short-form merger via a tender offer must establish (1) entire fairness in the resulting merger, unless such merger is consummated on the same terms as the preceding tender offer; (2) the overall transaction is conditioned on a non-waivable plebiscite of a majority of the independent shareholders; and (3) there are no accompanying retributive threats).

25. *See Weinberger*, 457 A.2d at 703.

best offer.[26] 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.[27] 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 prospect of director self-interest present an appealing case to lift the otherwise strong presumption of independence and director good faith so that a fulsome inquiry of the overall fairness of a transaction can be judicially conducted.

By targeting such transactions for closer scrutiny, judicial doctrine has had the natural effect of attracting litigation. Indeed, 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.[28] Generally, multiple suits are filed very quickly after the announcement of a transaction; counsel in such suits are usually law firms with a rich history of engaging in such litigation.[29] Data regarding such suits in an earlier time show that those suits challenged primarily deals in which managers had a conflict of interest, the suits tended to produce cash settlements, and the cases did not exhibit the same degree of litigation agency costs that were commonly believed to accompany other representative suits.[30] Thus, from 1999–2000 only 10.31% of deals were litigated; most of such litigation focused on Delaware companies, and the suits were maintained in Delaware.[31] Furthermore, this litigation decreased the likelihood of a deal closing but also increased the returns on the deals that did close. Overall, this litigation was associated with an increased return for target firm shareholders.[32]

Much of this has since changed dramatically so that today almost all deals attract suits.[33] Matthew Cain and Steven Davidoff report that in 2012 there were 121 transactions over $100 million in value and

26. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 185 (Del. 1986) (first case to extend heightened scrutiny); *see also* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 36 (Del. 1994) (clarifying the extension of heightened scrutiny).

27. *See* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1387–88 (Del. 1995), *modifying* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

28. Thompson & Thomas, *supra* note 7, at 137.

29. *Id.* at 138.

30. *See id.* at 172 tbl.4.

31. Krishnan et al., *supra* note 7, at 1253, 1254 tbl.1.

32. *Id.* at 1250.

33. *See* Thomas & Thompson, *supra* note 5, at 1781.

that 111 of these deals experienced deal litigation.[34] Roughly 50% of these 111 deals also resulted in litigation in more than one jurisdiction.[35] While several commentators have opined on the underlying causes for these developments,[36] we observe that these developments have occurred while the number of securities class actions and their lawyers have declined.[37] While causation is always difficult to prove, we surmise that the rapid rise in transaction-oriented litigation could, at least in part, reflect many plaintiff-oriented law firms redirecting their foci away from the once-booming securities fraud litigation that has now contracted.[38]

Just as too much fudge can be a problem, too warm an invitation to challenge transactions and an ensuing response to challenge common transactions creates its list of problems. One of the more apparent problems derives from a host of concerns that flow from multi-forum litigation focused on a single transaction. At a minimum, several suits challenging the same deal in various forums may levy 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 parties.[39] However, when litigation straddles two or more jurisdictions, such an easy-to-administer approach is not available. When a suit spans two or more

34. *See* Matthew D. Cain & Steven M. Davidoff, *Takeover Litigation in 2013*, at 1–2 (Ohio State Univ. Moritz Coll. of Law, Pub. Law Legal Theory Working Paper Series & Ctr. for Interdisciplinary Law & Policy Studies, Working Paper No. 236, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2377001 [https://perma.cc/MZS2-W3UQ (staff-uploaded archive)].

35. *See id.* at 2 tbl.A.

36. *See* John Armour, Bernard Black & Brian Cheffins, *Is Delaware Losing its Cases?*, 9 J. EMPIRICAL LEGAL STUD. 605, 634 (2012); Sean J. Griffith & Alexandra D. Lahav, *The Market for Preclusion in Merger Litigation*, 66 VAND. L. REV. 1053, 1069–70 (2013); Thomas & Thompson, *supra* note 5, at 1794–99.

37. For an extensive discussion of the differences between securities fraud class actions and M&A deal class actions, see Thomas & Thompson, *supra* note 5, at 1773–84.

38. *See id.* at 1776–78.

39. 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. *See* George S. Geis, *Shareholder Derivative Litigation and the Preclusion Problem*, 100 VA. L. REV. 261, 298–99 (2014). 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. *Id.* at 306. Professor Geis also recommends more vigorous application of statutory authority to assign costs for ill-conceived suits. *Id.* at 309.

sovereigns, 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.[40] Moreover, uncertainty regarding which suit will be deemed

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40. A sobering lesson to be drawn from the explosion of multi-forum litigation is illustrated by the Delaware Supreme Court in *Pyott v. Louisiana Municipal Police Employees' Retirement System*, 74 A.3d 612 (Del. 2013), where derivative suits were filed in the District Court for the Central District of California and Delaware Chancery Court following Allergan's guilty plea and payment of a $600 million fine for having actively marketed off-label uses of its blockbuster drug, Botox. *Id.* at 615. 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, Inc., Shareholder Derivative Litigation*, No. SACV 10-01352 DOC (MLGx), 2011 WL 1429626 (C.D. Cal. Apr. 12, 2011), the federal district court dismissed the derivative suit on the grounds that the plaintiffs failed to allege sufficient facts to excuse a demand on the board of directors under governing Delaware precedents. *Id.* at *5. Thereupon, the defendants moved to dismiss the Delaware suit, arguing that through the application of collateral estoppel, the Delaware suit could not continue because the full faith and credit clause of the Constitution required a dismissal. La. Mun. Police Emps.' Ret. Sys. v. Pyott, 46 A.3d 313, 316, 324 n.2 (Del. Ch. 2012). 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. *Id.* at 316.

Vice Chancellor Laster reasoned that preclusion on the basis of collateral estoppel required privity between the litigants. *Id.* at 324. While privity exists in contemporaneous derivative suits, even though different plaintiffs initiated the suits, Vice Chancellor Laster held that under Delaware precedent, because of the plaintiffs' failure to show that demand was excused whereby the plaintiffs could be deemed the legal representatives for the corporation's suit, privity does not exist when the suit has been dismissed because demand was neither made nor excused. *Id.* at 334–35. An independent basis for holding that the Delaware suit was not collaterally estopped was his belief that the plaintiffs in the California suit were not adequate representatives. *Id.* at 335. The basis for this conclusion was that the California suit's plaintiffs were represented by what Vice Chancellor Laster described as a fast-filing "specialized plaintiff's firm" that customarily files suits on a contingency fee basis. *Id.* at 336. The opinion did not mention that the action before him was being prosecuted by a firm that also fit this profile. 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." *Id.* at 350. The court thus concluded that preclusion was not in order since the earlier action failed to provide adequate representation for Allergan. *Id.*

The Delaware Supreme Court reversed on both points. *See Pyott*, 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. *Id.* at 616. 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. *Id.* at 616–17. The court also held that the irrebuttable presumption that fast-filers are inadequate representatives was not justified, which led to the court's conclusion that the prior suit did not preclude the Delaware suit. *Id.* at 618.

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 oversight claim, like the one in *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), than was set forth in the complaint before the federal district the lead one undercuts plaintiffs' counsels' incentive to be heavily invested in it. This is due in part to the concern that their efforts in developing the case will prove unrewarded if their suit does not become the lead suit.[41]

Further eroding counsels' 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.[42] The reverse auction not only weakens the compensatory function of shareholder suits but also, by providing relief cheapened by the attorney's self-interest, weakens the deterrence value of the suit.

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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. *Pyott*, 46 A.3d at 357. Of note is that the difference is not with the judge but the quality of the derivative suit counsel. *See* C.N.V. Krishnan, Steven Davidoff Solomon & Randall S. Thomas, *Who Are the Top Law Firms? Assessing the Value of Plaintiffs' Law Firms in Merger Litigation*, 18 AM. L. & ECON. REV. 122, 148–49 (2016).

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 if the federal district judge had the Delaware complaint before him, his decision would have been different from that reached by Vice Chancellor Laster. Ultimately, any difference in zealousness between plaintiffs' counsel in the California federal court and the Delaware court was addressed by the Ninth Circuit reversing the district court's dismissal, chastising the trial court for repeatedly drawing inferences in the board's favor. *See* Rosenbloom v. Pyott, 765 F.3d 1137, 1159 (9th Cir. 2014).

41. Thomas & Thompson, *supra* note 5, at 1769.

42. *See id.* at 1770. By way of illustration, consider *Matsushita Electric Industrial 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. *Id.* at 370. Matsushita prevailed in federal district court, and while that decision was being appealed to the Ninth Circuit, Matsushita entered into a global settlement approved by the Delaware court on terms that released the claims that were raised only in federal court. *Id.* at 370–71. Even though the state court lacked 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. *Id.* at 386–87. 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. *Id.* at 650. In the background of this matter is the important fact that the two suits were being prosecuted by two competing law firms and that the damages being pursued in the federal district court were of a significantly greater amount than those at play in the Delaware state action. Hence, precedent exists under which a reverse auction can occur, if not thrive.

In addition to the frequency of deal-focused litigation, further disquiet arises from recent evidence that 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.[43] The fear is that regardless of whether the suits assert meritorious claims, the settlements reached will not produce observable benefits. The consequence of this being true is that judicial doctrines intended to protect shareholders are instead yielding a dead weight loss in the form of costly litigation.

Delaware has innovated 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, and suits generally, just as it did initially by creating the doctrine inviting these cases. Among the state's substantive innovations was excepting from close burden-shifted fairness inquiry freezeouts pursuant to state short-form merger statutes that allow parents to acquire a ninety percent owned subsidiary solely upon the approval of the parent board of directors.[44] More recently in *Kahn v. M&F Worldwide Corp.*,[45] 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.[46] Where both of these conditions are met, the transaction enjoys the substantial protections of the business judgment rule, which is generally accorded to arm's-length transactions.[47] The Delaware legislature has also entered this area by authorizing a "streamlined back-end merger" whereby two independent firms can merge upon (1) their boards approving the

43. *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, 580–81, 585 (2015) (finding that of 453 firms in the 2005–2012 time period, 319 experienced litigation, of which 191 resulted in settlements that either amended merger terms or provided only additional disclosure, which did not impact the ultimate shareholder vote and was weak evidence that an increase in consideration impacts shareholder vote).

44. *See* Glassman v. Unocal Expl. Corp., 777 A.2d 242, 247 (Del. 2001).

45. 88 A.3d 635 (Del. 2014).

46. *Id.* at 645–46.

47. *Id.* at 646.

merger and (2) the acquirer, through a tender offer, obtaining enough shares of the other company to assure approval of the merger.[48]

Further innovations have been made to confront the explosion of multi-forum suits. Using mechanisms provided within corporate statutes, corporate lawyers have developed a powerful antidote to multi-forum suits through the now widely-adopted forum selection clause. The standard forum selection clause is set forth in the corporate 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 of Delaware Leo Strine Jr. in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*,[49] where the court upheld a unilaterally director-adopted forum selection bylaw, reasoning that the bylaws, including the board's authority to adopt bylaws, were an extension of the shareholders' contractual rights to the corporation.[50] In 2015, the Delaware legislature passed a statute formally authorizing the inclusion of forum selection provisions in corporate bylaws.[51]

Thus, it is likely that there will be 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 challenge the conduct of boards of directors in mergers and acquisitions, they subsequently significantly narrowed the avenues for doing so. This change, 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

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48. DEL. CODE ANN. tit. 8, § 251(h) (2015). A similar provision was adopted in Maryland in 2014. *See* MD. CODE ANN., CORPS. & ASS'NS § 3-106.1 (West 2015).

49. 73 A.3d 934 (Del. Ch. 2013).

50. *Id.* at 954, 958.

51. Act of June 24, 2015, ch. 40, § 5, 80 Del. Laws __, __ (codified at DEL. CODE ANN. tit. 8, § 115). Governor Jack Markell signed the bill on June 24, 2015. Michael Greene, *Delaware Fee-Shifting Bill Signed into Law; Also Endorses Exclusive Forum Clauses*, BLOOMBERG BNA (June 26, 2015), http://www.bna.com/delaware-feeshifting-bill-n17179928834/ [https://perma.cc/5UGS-BVM5]. The same legislation also added sections 102 and 109, prohibiting fee-shifting provisions in articles of incorporation or bylaws, respectively. *See* § 1, 3 (codified at DEL. CODE ANN. tit. 8, §§ 102, 109). 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, in the articles, the grant 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).

bylaw changes that would require fee shifting onto plaintiffs in these class actions.[52] 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.[53] What does seem clear though is that the combination of these new bylaws will most likely lead to less manager and director accountability to shareholders.

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

In the past, merger litigation played a significant monitoring role in addressing possible agency costs in corporate transactions, especially by 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 deal-focused litigation's 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.[54] However, as discussed above,[55] the future of merger litigation has been placed in jeopardy by the explosion of its use, 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, shareholders 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.[56] State laws vary widely with respect to

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52. *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.").

53. *See generally* James D. Cox, *Corporate Law and the Limits of Private Ordering*, 93 WASH. U. L. REV. 257 (2015) (arguing that boards of directors should not have the authority to amend bylaws that affect the procedural and substantive relationship between shareholders and the corporation); Ann M. Lipton, *Manufactured Consent: The Problem of Arbitration Clauses in Corporate Charters and Bylaws*, 104 GEO. L.J. 583 (2016) (arguing that recent Delaware cases are blurring the lines between contract law and those laws that govern corporate formation and modification).

54. Krishnan et al., *supra* note 7, at 1262.

55. *See supra* Section I.A.

56. *See* DEL. CODE ANN. tit. 8, § 262(a) (2015).

the availability of appraisal.[57] 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;[58] in contrast, Delaware limits its appraisal statute to mergers and consolidations.[59] Meanwhile, the Model Business Corporation Act follows a course between these two positions.[60]

Traditionally, appraisal has been viewed as an ineffective remedy for shareholders due to its cumbersome procedures and very limited scope. Commentators have identified three significant disadvantages with the appraisal remedy[61]: (1) the difficult procedural steps that must be followed in precise order to preserve one's right to the remedy;[62] (2) 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;[63] and (3) the narrow limits of the remedy.[64] Small shareholders were stymied by these problems, while larger blockholders made sparing use of the appraisal remedy.[65] As a result, historically few appraisal actions were filed and even

57. JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS § 22.19, at 619 (2d ed. 2003).

58. *See, e.g.*, CAL. CORP. CODE §§ 181, 1200–1203, 1300(a) (West 2015); N.Y. BUS. CORP. LAW § 910 (McKinney 2015).

59. *See* DEL. CODE ANN. tit. 8, § 262(b).

60. *See* MODEL BUS. CORP. ACT § 13.02(a) (2015).

61. *See* Charles R. Korsmo & Minor Myers, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 WASH. U. L. REV. 1551, 1560–61 (2015).

62. 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. Under the Delaware Act, after the vote, the corporation must give notice of the right to dissent within ten days, and thereafter, the shareholders have twenty days to make a written demand. DEL. CODE ANN. tit. 8, § 262(d)(2).

63. *See* Randall S. Thomas, *Revising the Delaware Appraisal Statute*, 3 DEL. L. REV. 1, 27–29 (2000) (describing the costs of appraisal proceedings).

64. 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). 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, *supra* note 63, at 11–12.

65. *See generally* Cede & Co. v. Technicolor, Inc., 884 A.2d 26 (Del. 2005) (showing the costs of pursuing appraisal, even to large shareholders). In *Cede & Co.*, after the minority shareholders of Technicolor, Inc. were cashed out, a beneficial owner sought appraisal. *Id.* at 31. Unsatisfied with the result, the beneficial owners appealed. *Id.* at 32. The result was an extensive sequence of litigation spanning almost twenty 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 the chancery court's initial analysis. *See id.* at 32–34.

fewer were actively litigated.[66] As developed below, the rise of hedge funds and their resourcefulness in maximizing gain have resurrected the appraisal remedy, at least in the hands of a large, sophisticated investor.

Professors Marcel Kahan and Edward Rock were the first scholars to note that hedge fund managers who were dissatisfied with the terms of an acquisition were adapting appraisal litigation for a new purpose.[67] They point out that activist hedge funds engage in appraisal arbitrage when they buy shares of a target company's stock with the objective of filing an appraisal petition, ultimately seeking a higher price for their stock.[68] Thus, appraisal arbitrage is a good example of how the increasing concentration of stock ownership may be leading to changes in shareholder-monitoring devices.[69]

Several authors have picked up this idea and written substantial articles debating the appropriate role of appraisal litigation as a monitor of M&A deals.[70] Professor George Geis focused on a Delaware Chancery Court appraisal decision, *In re Appraisal of Transkaryotic Therapies, Inc.*[71] This case resolved a technical question about which shareholders qualified to seek appraisal after the announcement of a merger.[72] 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 who therefore did not have the right to vote the shares at the meeting could nonetheless seek appraisal.[73] The net effect of the decision was the facilitation of hedge funds accumulating

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66. *See* Thomas, *supra* note 63, at 22–23 (finding an average of less than fourteen appraisal actions filed per year from 1977 to 1997).

67. *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1038–1039 (2007).

68. *See id.*

69. *See Appraisal Arbitrage: Will It Become a New Hedge Fund Strategy?*, *supra* note 20.

70. *See* George S. Geis, *An Appraisal Puzzle*, 105 NW. U. L. REV. 1635, 1640–41 (2011); Wei Jiang et al., *Appraisal: Shareholder Remedy or Litigation Arbitrage?*, 59 J.L. & ECON. (forthcoming 2016) (manuscript at 2–4), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2766776 [https://perma.cc/H75W-F2R8 (staff-uploaded archive)]; Korsmo & Myers, *supra* note 61, at 1555–57; *see also* Charles R. Korsmo & Minor Myers, *The Structure of Stockholder Litigation: When Do the Merits Matter?*, 75 OHIO ST. L.J. 829, 835–36 (2014).

71. No. Civ.A. 1554-CC, 2007 WL 1378345 (Del. Ch. May 2, 2007).

72. *Id.* at *1.

73. *See id.* at *3–4.

substantial stakes in target companies in order to file appraisal actions in the hopes of making large profits on their investments.[74]

Based on some hedge fund litigation over the scope of their appraisal rights, Geis argues that "it is possible that a robust 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."[75] 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."[76] Yet, Geis equivocates about whether this is beneficial to target company shareholders because of concerns that opening up the appraisal remedy will lead to more strike suits and therefore suggests further restrictions on shareholders' (already quite limited) ability to bring these cases.[77]

Professors Charles Korsmo and Minor Myers provide very useful empirical data on this phenomenon. Using a data set of appraisal cases from 2004 to 2013, they found that the dollar value of dissenting shares in appraisal actions spiked sharply in 2013.[78] They documented the rise of a small, but growing, group of hedge funds filing multiple appraisal actions arising out of different transactions.[79] These repeat petitioners "target deals where the merger premium is low and where controlling stockholders are taking the company private."[80] 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."[81]

Professor Wei Jiang and her coauthors conducted a large-scale empirical analysis of the characteristics, determinants, and returns to appraisal petitions during 2000–2014.[82] Using a hand-collected sample including every appraisal case filed during that time period, they found that appraisal petitions are more likely to be filed in going-private transactions, control shareholder squeezeouts, and transactions that pay target shareholders low premiums over the

74. *See* Geis, *supra* note 70, at 1654–56; *Appraisal Arbitrage: Will It Become a New Hedge Fund Strategy?*, *supra* note 20.

75. Geis, *supra* note 70, at 1638.

76. *Id.* at 1658.

77. *Id.* at 1676.

78. *See* Korsmo & Myers, *supra* note 61, at 1571 fig.3.

79. *Id.* at 1572.

80. *Id.* at 1583.

81. *Id.* at 1598.

82. Jiang et al., *supra* note 70, at 3.

market price of their shares.[83] These findings support Korsmo and Myers's claim that appraisal acts as a shareholder remedy against abusive deals. However, Jiang and her colleagues found further evidence suggesting that appraisal actions may sometimes be strike suits—as of 2014, appraisal actions were filed in over one quarter of all deals in which appraisal is available; eighty percent of these suits were settled before trial, and many of these settlements were in actions filed by very small investors.[84]

We are 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 found that only slightly more than 15% of statutorily covered transactions had appraisal actions filed challenging the consideration paid in the deal,[85] although Jiang and her coauthors found it to be around 25%.[86] In addition, this percentage can be expected to fall if deal planners restructure the transaction so as to minimize or even avoid appraisal; one such strategy to remove any opportunity for appraisal is to distribute stock as consideration for the merger.[87]

The biggest class of public company transactions where appraisal is currently available consists of 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."[88] If this is correct, shareholders would not be expected to file such cases, as they are expensive to litigate and unlikely to result in judicial determinations that the plaintiffs are entitled to a price greater than the merger price. However, if such cases are being filed and settled

83. *See id.* at 4, 23–24.

84. *Id.* at 4, 19–20, 29.

85. *See* Korsmo & Myers, *supra* note 61, at 1569 fig.2.

86. *See* Jiang et al., *supra* note 70, at 42 fig.1.

87. *See* DEL. CODE ANN. tit. 8 § 262(b)(2) (2015). 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. *See, e.g.*, Korsmo & Myers, *supra* note 61, at 1606–07.

88. COUNCIL OF THE CORP. LAW SECTION, DEL. STATE BAR ASS'N, SECTION 262 APPRAISAL AMENDMENTS 2 (2015), https://www.lowenstein.com/files/upload/DGCL%20262%20Proposal%203-6-15%20Explanatory%20Paper.pdf [https://perma.cc/2ERX-MXPB].

for valuable consideration, that would suggest they are frivolous cases that have only nuisance value.

Among the remaining set of potential deals subject to the appraisal remedy, appraisal would be expected to 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."[89] Leveraged buyouts, which are sometimes not adequately shopped to the market, may also raise concerns about possible conflicts of interest because target firm managers could seek to preserve their jobs after the transaction closes or a private equity buyer may seek 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, appraisal, as it is currently structured, should be unattractive to 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 generally will not find appraisal to be cost effective.[90] If such cases are being filed and settled, as Jiang and her coauthors show, then it seems likely 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 it proposed a de minimis exception to the appraisal statute. The group was considering a proposal 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 . . . the value of the merger consideration for the total number of shares entitled to appraisal exceeds $1 million."[91] On June 16, 2016, Delaware enacted this change to its appraisal statute.[92]

89. *Id.*

90. 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.

91. COUNCIL OF THE CORP. LAW SECTION, *supra* note 88, at 3–4.

92. Act of June 16, 2016, ch. 265, sec. 11, § 262(h), 80 Del. Laws __, __ (codified at DEL. CODE ANN. tit. 8, § 262(h)); *Amendments to Delaware General Corporation Law Will Affect Appraisal Actions and "Intermediate-Form" Mergers*, ROPES & GRAY LLP (June 20, 2016), https://www.ropesgray.com/newsroom/alerts/2016/June/Amendments-to-Delaware-General-Corporation-Law-Will-Affect-Appraisal-Actions.aspx [https://perma.cc/ULW2-PTFE].

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 have collected data on cases that are tried in the Delaware Chancery Court, but this constitutes a small subset of all appraisal cases filed.[93] Jiang and her coauthors have provided data on a subset of these cases in which the terms of the settlements are disclosed. They found that the size of the shareholder's stake in the target company is the best predictor of whether a case will go to trial.[94] However, most of these cases are settled, and the terms of these settlements are private.[95] Without this information, it cannot be predicted confidently what appraisal will look like in the future and whether it will continue to 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 Delaware Supreme Court's *Time-Warner*[96] decision substantially weakened the market for corporate control when it made clear that the court would not force target companies to redeem their poison pills in the face of a non-coercive, fairly-priced hostile tender offer.[97] This was followed by that same court's *Unitrin*[98] decision that greatly reduced an acquirer's ability to win proxy contests for corporate control.[99] Similarly, Delaware upholds the impregnable defensive combination of a staggered board and poison pill.[100] Such doctrinal developments put a thumb on the scale—favoring managers. An accompanying decline of the hostile takeover removed this disciplining force so that managerial agency costs rose. When shareholder M&A litigation failed to fill the gap created, a space opened for shareholder activists to attack these increasing levels of managerial agency costs. Beginning in earnest in the early

93. *See* Charles Korsmo & Minor Myers, *Reforming Modern Appraisal Litigation*, 41 DEL. J. CORP. L. (forthcoming 2016) (manuscript at 9–10), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2712088 [https://perma.cc/G89Q-8543 (staff-uploaded archive)].

94. Jiang et al., *supra* note 70, at 5, 29–30.

95. *Id.* at 4, 9.

96. *See* Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1154–55 (Del. 1990).

97. Randall S. Thomas, *Judicial Review of Defensive Tactics in Proxy Contests: When Is Using a Rights Plan Right?*, 46 VAND. L. REV. 503, 516–17 (1993).

98. *See* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995).

99. *See id.* at 1389–90.

100. *See* Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 54–55 (Del. Ch. 2011).

2000s, a wave of hedge fund activism hit the United States, leading to an increased level of M&A activity among targeted firms.[101]

In recent years, hedge funds have actively engaged many companies in an effort to boost shareholder value.[102] Empirical studies find that the filing of an activist hedge fund's Schedule 13D creates positive average cumulative abnormal returns from 7% to 8%.[103] The filings reflect that hedge funds often accumulate 6% to 10% of the target company's stock,[104] which in addition to triggering the filing, also provides sufficient ownership to give them a strong negotiating position if target management resists their efforts. Moreover, 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.[105] 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.[106]

That such value is created invites an important question: Where do the gains reflected in the stock market price increase originate? 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.[107] For example, Robin Greenwood and Michael Schor found that activist hedge funds' returns are largely produced by takeover premiums.[108] Another recent article finds that in the second wave of activism running from 2008 to the present, the

101. *See* Robin Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362, 364, 365 tbl.1 (2009).

102. Brav et al., *supra* note 15, 1741.

103. *Id.* at 1730.

104. *See* Lucian A. Bebchuk et al., *Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy*, 39 J. CORP. L. 1, 4–5, 15 (2013).

105. *See* Edelman et al., *supra* note 15, at 1414; Gilson & Gordon, *supra* note 15, at 913–14.

106. *See* C.N.V. Krishnan, Frank Partnoy & Randall S. Thomas, *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J. CORP. FIN. 296, 297 (2016) (explaining how hedge fund activists have achieved support and success through their reputation).

107. *See* Alon Brav, Wei Jiang & Hyunseob Kim, *Hedge Fund Activism: A Review*, 4 FOUND. & TRENDS FIN. 185, 217–18 (2009). 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 Just Financial Engineering?*, N.Y. TIMES, Dec. 16, 2015, at B5 (noting that "a spinoff has become the transaction du jour[,]" whose benefits are disproportionately realized by short-term investors while long-term performance is weak).

108. Greenwood & Schor, *supra* note 101, at 363. Those authors find that activist targets which do not result in a takeover have abnormal returns statistically indistinguishable from zero. *Id.*

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.[109] Moreover, these 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 effectively regulating management antitakeover initiatives are being addressed through hedge fund activism.

Hedge fund activism also acts as a check on poor management performance. Poor management can contribute to why target firms are generally undervalued by the market. Through their active engagement, hedge funds often are able to create value by improving the operating performance of these firms. For example, one set of researchers found that firms targeted by activists experience a 1.22% increase in operating efficiency one year after acquisition.[110] Moreover, another recent paper reports 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%.[111] This suggests an additional path by which hedge fund activism combats managerial slack.

Corporate management and its 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.[112] Some advocates of this position have gone so

109. Krishnan et al., *supra* note 106, at 297.

110. Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 323, 324 (2008); *see also* Brav et al., *supra* note 15, at 1772.

111. *See* Krishnan et al., *supra* note 106, at 309 tbl.9. 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." Brav et al., *supra* note 15, at 1741. However, these capital structure changes do not appear to be the source of the market gains associated with hedge fund activism. *See id.* at 1771–73; Greenwood & Schor, *supra* note 101, at 371. 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. *See* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261, 279 (1958) (stating that "a firm cannot reduce the cost of capital . . . by securing part of its capital through the sale of bonds").

112. Martin Lipton, *Deconstructing American Business II and Some Thoughts for Boards of Directors in 2007*, NAT'L LEGAL CTR. FOR PUB. INT., Dec. 2006, at 1, 1 (noting that one of the principal problems 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 A. Bebchuk, *The*

far as to argue that hedge fund shareholders ought to have fiduciary duties to other shareholders as a check on their allegedly opportunistic conduct.[113] Yet, the data reviewed above shows that at least during a one-year time period there are performance improvements, and no one has yet published peer-reviewed research finding a longer-term problem.[114]

There are several other reasons to question the claim that hedge funds are short-term profit oriented. First, hedge funds seem to have little trouble recruiting institutional investors to support their activist goals.[115] If hedge funds' plans only produced short-term gains at the expense of long-term profitability, these long-term investors would be reluctant to support them.[116] Second, activist hedge fund holding periods average approximately twenty-one months,[117] which is substantially longer than almost all other investors. Finally, one study of hedge fund interventions from 1994 to 2007 finds that the stock price gains accompanying the initial announcement of a hedge fund's activism were sustained over a five-year period, as were improvements in other measures of returns.[118] Taken together, this

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Myth That Insulating Boards Serves Long-Term Value, 113 COLUM. L. REV. 1637, 1663–64 (2013) (arguing against claims that activist investors take profitable short term actions that decrease long term value); Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 982 (2013) (reporting that managerial and boardroom autonomy have been justified recently by claims that activist hedge fund 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 the claim that hedge funds are short-term shareholders).

113. *See* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1295–96 (2008).

114. For evidence that finds positive long-term impacts of hedge fund activisim, see Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1090 (2015) [hereinafter Bebchuk, Brav & Jiang, *Long-Term Effects*]. *See* Bebchuk et al., *supra* note 104, at 4–5 (finding that activist hedge funds are only a small portion of investors filing pursuant to section 13(d) disclosure requirements, with average shares amounting to less than ten percent, which is contrary to claims that activist hedge funds have accumulated more pre-disclosure shares over the years); Roe, *supra* note 112, at 1005–06 (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).

115. For a list of those parties from which hedge funds seek support, see Kahan & Rock, *supra* note 67, at 1089.

116. *Id.* at 1088.

117. *See* William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1420 tbl.VIII (2007).

118. *See* Bebchuk, Brav & Jiang, *Long-Term Effects*, *supra* note 114, at 1123–30; *see also* Nicole M. Boyson & Robert M. Mooradian, Experienced Hedge Fund Activists 2–3 (Apr. 3, 2012) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1787649 [https://perma.cc/WBW6-AXS6 (staff-uploaded archive)] (finding

evidence supports the claim that hedge fund activism is not dominated by short-term considerations but rather generates valuable monitoring of corporate management.[119]

Private equity firms interact in important ways with hedge funds and facilitate hedge fund 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.[120] These sales are generally at substantial premiums over the prior market prices 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. This serves as 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

Derivative suits are another type of representative litigation that shareholders can use as a monitoring device. Traditional derivative cases raise state law breach of fiduciary duty claims against directors and officers.[121] Typically, these claims allege breach of the duties of loyalty (including good faith) and care as well as other state law violations.[122] They are commonly used to attack directors or officers engaging in conflict of interest transactions with the corporation or taking corporate opportunities belonging to the corporation.[123] Small shareholders can bring these actions on behalf of the corporation in a

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that hedge fund activism can improve long-term performance for target firms and hedge funds).

119. *See* Davidoff, *supra* note 112, at B5; *see also* Dionysia Katelouzou, *Myths and Realities of Hedge Fund Activism: Some Empirical Evidence*, 7 VA. L. & BUS. REV. 459, 479 (2013) (finding that hedge funds are not short term in their focus).

120. *See* Greenwood & Schor, *supra* note 101, at 372.

121. *See* COX & HAZEN, *supra* note 57, § 15.02, at 423–24.

122. *See id.*

123. *See id.*

representative capacity; because they are focused primarily on abuses within a single self-dealing transaction, they customarily do not involve sums that are significant vis-à-vis the total value of the firm.[124] Hence, complaints claim that derivative suits are abusive, as they are prosecuted by investors with a small stake in the suit's outcome and produce results unlikely to impact overall shareholder wealth.[125]

Among the broad group of shareholder suits, derivative suit litigation consists of the most stable set of cases. 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.[126] The study found that Delaware public companies were hit with about thirty cases per year, with about thirty percent of them yielding relief to the corporation or its shareholders and the remainder being quickly dismissed with little litigation activity.[127] Private Delaware firms were targeted with a dozen lawsuits annually, typically raising claims of minority oppression.[128]

This research shows 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 remedying breaches of the 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.

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[129] or a more isolated problem involving a few bad

124. *See* Coffee, *supra* note 10, at 677–78.

125. *See, e.g.*, Romano, *supra* note 6, at 84 (arguing that shareholder litigation is a weak, if not ineffective, instrument to regulate managers or provide shareholder value).

126. *See* Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1760–61 (2004).

127. *Id.* at 1749–50.

128. *Id.* at 1750.

129. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 1–2 (Harvard Univ. Press 2004).

apples,[130] most experts agree that the derivative suit has been a weak tool to address executive compensation concerns.[131] As developed below, the derivative suit is hobbled both procedurally and substantively when directed at alleged excessive executive compensation.[132]

The procedural impediment results from a major feature of the derivative suit: the requirement that the plaintiff must either make a demand on the board of directors or establish a basis for why such a demand would be futile.[133] The outcome in either case ultimately depends on whether the court believes the board, or a subcommittee of the board, is sufficiently independent of alleged wrongdoing in the suit so that the board'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 failed derivative suits challenging executive compensation in public companies.

In the case of private corporations, 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 there is a healthy presumption of independence with respect to 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.[134] Immunity shields thus limit suits against directors that allege such a managerial failure to claims that the directors had knowingly engaged in systematic

130. *See* John E. Core, Wayne R. Guay & Randall S. Thomas, *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1143 (2005) (questioning whether the problems with CEO compensation are isolated to a few instances or applicable to CEOs as a whole).

131. Randall S. Thomas & Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers' Fiduciary Duties*, 95 MINN. L. REV. 846, 855 (2011).

132. *Id.*

133. *See, e.g.*, MODEL BUS. CORP. ACT § 7.42 (2015) (imposing a condition of universal demand for derivative suits).

134. *See* DEL. CODE ANN. tit. 8 § 102(b)(7) (2015). In some states, statutes that provide the standards for directors also protect officers. *See, e.g.*, ALA. CODE §§ 10A-2-8.30, -8.42 (West, Westlaw through 2016 Reg. Sess.).

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. A claim of this nature is even more difficult to mount because the entire process is guided by counsel who will assure that steps are taken to ensure that compensation is set in a manner consistent with the desired image of due deliberation.

The derivative suit has not always been impotent in confronting executive compensation.[135] During the Great Depression, a good deal of litigation ensued, successfully attacking bonus and incentive compensation policies of large public companies.[136] The leading case of the day, *Rogers v. Hill*,[137] held that compensation received by the firm's president and directors was large enough to merit investigation as to whether it was misuse under the bylaws.[138] *Rogers* reasoned that stockholder support and a presumption of regularity and continuity concerning the bylaws

> cannot . . . be used to justify payments of sums as salaries so large as in substance and effect to amount to spoliation or waste of corporate property. . . . "If a bonus payment has no relation to the value of the services for which it is given, it is in reality a gift in part and the majority stockholders have no power to give away corporate property . . . ."[139]

Rogers thus reflected the then-contemporary approach to assess the overall reasonableness of the compensation package. In current times, given the requirement that a majority of directors be independent at listed public companies, the barest approval by a majority of the board of directors insulates executive compensation.[140]

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

136. *See* George T. Washington, *The Corporation Executive's Living Wage*, 54 HARV. L. REV. 733, 736–56 (1941) (reviewing the case history of Great Depression era compensation cases).

137. 289 U.S. 582 (1933).

138. *Id.* at 591–92.

139. *Id.* (quoting Rogers v. Hill, 60 F.2d 109, 113 (2d Cir. 1932) (Swan, J., dissenting)).

140. *See* NYSE LISTED COMP. MANUAL § 303A.01, .05 (2016), http://nysemanual.nyse.com/lcm/ [https://perma.cc/39DG-6G8Y]; NASDAQ EQUITY RULES § 5605-1, -6 (2016), http://nasdaq.cchwallstreet.com/NASDAQ/Main/ [https://perma.cc/A7NB-FMM3]; *see also* 17 C.F.R. § 240.10C-1 (2015).

Illustrative of the high substantive protection executive compensation enjoys from challenges by shareholders is the recent decision of the Delaware Supreme Court, *Freedman v. Adams*.[141] A shareholder derivative suit was initiated to recover more than $130 million in bonuses approved by the board of XTO Energy Inc.[142] The plan lacked performance-based standards, a requirement by section 162(m) of the Internal Revenue Code for compensation in excess of $1 million to be a deductible business expense on XTO Energy's tax return.[143] After the plaintiff initiated the derivative suit, complaining that the lack of any performance benchmarks had the consequence of raising the corporation's taxes, the board prospectively modified the plan and the plaintiff dropped her suit.[144] In responding to the 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 that section because it believed its approach to compensation decisions should not be constrained by such a plan.[145] The court denied any award of fees to the plaintiff because it held that a claim for waste had not been stated.[146] The court reasoned that "[e]ven if the decision was a poor one," as alleged by the plaintiff, "it was not unconscionable or irrational."[147] In other words, the court held that the plaintiff had not established waste, even when the board of directors gave up an easily available tax deduction in exchange for no apparent benefit to the corporation.

In addition to the weak substantive standards in the regulation of executive compensation, a derivative suit plaintiff typically faces insurmountable procedural barriers in attacking compensation.[148]

141. 58 A.3d 414 (Del. 2013).

142. *Id.* at 416.

143. *Id.*

144. *Id.*

145. *Id.* at 417.

146. *Id.*

147. *Id.*

148. A typical example is *In re The Walt Disney Co. 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 decisions. The facts are complicated, but at their core, the complaint was that, under pressure from Disney CEO Michael Eisner, the Disney board hired Michael Ovitz with knowledge that Ovitz had no experience for the position, only to have that confirmed within an admittedly short period of time; subsequently 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. *See id.* at 699–714. Even though both the trial court and Delaware Supreme Court acknowledged grave departures from good corporate practices, each held that the misconduct did not rise to the level of bad faith and hence was protected under the firm's

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, a demand is excused on grounds of futility, which requires evidence that either (1) the compensation is so egregious as to be beyond the protection of the business judgment rule or (2) 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.[149] 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 thereby provide an independent voice on whether the suit's continuance is in the best interest of the company.[150]

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 that do not include the 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 supports arguments in favor of effective shareholder monitoring of these payments. As noted, shareholder derivative suits have proven

immunity shield. *See In re* The Walt Disney Co. Derivative Litig., 906 A.2d 27, 67–68 (Del. 2006).

149. *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 808 (Del. 1984) (finding no futility on an allegation that defendant controlled forty-seven 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, 1042–43 (N.Y. 1996) (excusing demand for compensation that directors set for themselves, but finding no factual basis to sustain allegations of wrongdoing or waste in directors' compensation increases).

150. *See, e.g.*, Zapata Corp. v. Maldonado, 430 A.2d 779, 785–86 (Del. 1981) (setting forth procedures for evaluating a committee recommendation in a suit challenging the board's decision to accelerate the 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 reduced in the instance of the rejection of a derivative suit's continuation. *See, e.g.*, Boland v. Boland, 31 A.3d 529, 561–62 (Md. 2011).

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.[151]

The federally mandated Say on Pay vote by shareholders is a recent regulatory initiative designed to bolster shareholder monitoring of executive compensation practices.[152] In the United States, Say on Pay was adopted when Congress passed the Dodd-Frank Act of 2010; Dodd-Frank required, among other things, that each U.S. public company hold an advisory shareholder vote on the compensation of its top executives.[153] 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 an average of 91.2% of shareholder support.[154] The average support levels remained 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.[155] At the other end of the spectrum, only 1% to 2% of firms (forty to sixty firms of the Russell

151. *See, e.g.*, *Aronson*, 473 A.2d at 808 (dismissing the suit for failure to excuse demand where six-figure annual compensation was payable to a stockholder who owned forty-seven percent of outstanding shares regardless of his ability to serve as executive); *Marx*, 666 N.E.2d at 1036 (dismissing the suit challenging CEO compensation for failure to excuse a demand where the board was not shown to have acted egregiously).

152. Thomas & Van der Elst, *supra* note 18, at 656.

153. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899 (2010) (codified at 15 U.S.C. § 78n-1 (2012)) (adding new section 14A to the Securities Exchange Act of 1934); *see* Randall S. Thomas, Alan R. Palmiter & James F. Cotter, *Dodd-Frank's Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?*, 97 CORNELL L. REV. 1213, 1225 (2012) (discussing the phase-in of the requirement based on the size of the company).

154. TED ALLEN ET AL., INSTITUTIONAL S'HOLDER SERVS. INC., PRELIMINARY 2011 U.S. POSTSEASON REPORT 1 (2011), http://mercyinvestmentservices.org/storage/documents/Pre-PSR.20110801.pdf [https://perma.cc/6UVR-PHJJ]; *see also Say-on-Pay Support Runs High in 2013, with Few Exceptions, Reports Show*, [June] Corp. L. Daily (BNA) (June 3, 2013) (reporting on a 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, Alan R. Palmiter & Randall S. Thomas, *The First Year of Say-on-Pay Under Dodd-Frank: An Empirical Analysis and Look Forward*, 81 GEO. WASH. L. REV. 967, 998–1001 (2013) (reporting results from the early 2012 proxy season, showing that 2012 was a more difficult season for issuers of Say on Pay proposals).

155. *Say-on-Pay Support Runs High in 2013, with Few Exceptions, Reports Show*, *supra* note 154.

3000) received less than 50% shareholder support during the 2011 proxy season.[156]

Small institutional shareholders tend to be more likely than larger ones to vote against management's Say on Pay proposals,[157] perhaps because of their lack of alternative methods for confronting management with their opinions. Furthermore, when ownership is more dispersed, the Say on Pay vote "provides an opportunity for many small institutional shareholders to coordinate, and to voice a unified opinion" about management's pay.[158] However, on occasion, large shareholders have joined smaller shareholders in expressing their displeasure with unjustifiable pay.

Although there have not been a large number of negative votes, Say on Pay votes can be seen as having a significant effect on American corporate governance.[159] Dodd-Frank's mandated shareholder votes focus directors on shareholders' concerns about executive pay, increase shareholder participation in corporate governance, and open lines of communication between management and shareholders (and proxy advisory firms) regarding executive compensation.[160] Multiple forces unleashed by mandated Say on Pay votes have caused management at many companies to make changes to the substance and disclosure of their pay programs in an attempt to more clearly align pay to performance.[161] Many companies have also revised the content of the Compensation Discussion and Analysis (CD&A) filed with the annual meeting proxy materials.[162]

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156. *See* Cotter et al., *supra* note 154, at 979–80. Some commentators claim that 67% support is a more important threshold because "ballots that fail to garner a two-thirds majority are an indication of potential problems, especially since more than 90 percent of the votes analyzed passed with a supermajority." Ryan Krause, Kimberly A. Whitler & Matthew Semadeni, *When Do Shareholders Care About CEO Pay?*, DIRECTOR NOTES, August 2013, at 2, https://www.conference-board.org/retrievefile.cfm?filename=TCB_DN-V5N16-131.pdf&type=subsite [https://perma.cc/WB53-CA95]; *see also Facts Behind 2013 Failed Say on Pay Votes*, GORGESON (June 11, 2013), http://www.computershare-na.com/sharedweb/georgeson/georgeson_report/GeorgesonReport_061113.pdf [https://perma.cc/8PLP-2V4Y].

157. *See* Schwartz-Ziv & Wermers, *supra* note 19, at 3.

158. *Id.* at 2.

159. *See* Thomas et al., *supra* note 153, at 1227, 1256–57.

160. *See* Luis A. Aguilar, Commissioner, U.S. Sec. & Exch. Comm'n, Speech by SEC Commissioner: An Inflection Point: The SEC and the Current Financial Reform Landscape (June 10, 2011) (transcript available at https://www.sec.gov/news/speech/2011/spch061011laa.htm [https://perma.cc/67D9-YC8H]).

161. *See* Michael Littenberg, Farzad Damania & Justin Neidig, *A Closer Look at Negative Say-on-Pay Votes During the 2011 Proxy Season*, DIRECTOR NOTES, July 2011, at 2, https://www.conferenceboard.org/retrievefile.cfm?filename=TCB-DN-V3N14-111.pdf&type=subsite [https://perma.cc/WZ38-UH2U].

162. Thomas et al., *supra* note 153, at 1257.

Meanwhile, 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.[163]

Since the introduction of Say on Pay as a regulatory tool on U.S. public companies, scholars have conducted multiple studies that measure the effects it has on corporate actions and executive pay. 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 determining executive compensation, (2) decrease the growth rate of the 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.[164]

This suggests that Say on Pay is most effective when a large blockholder serves as a "reluctant watchdog."[165]

Yet, in the United States, studies have suggested that Say on Pay has not led to lower executive pay levels or to changes in its composition.[166] Research on the United Kingdom has also found that overall CEO pay levels do not seem to have changed as a result of

163. Cotter et al., *supra* note 154, at 969–70.

164. *See* Schwartz-Ziv & Wermers, *supra* note 19, at 5.

165. *Id.*

166. Vicente Cuñat, Mireia Giné & Maria Guadalupe, *Say Pays! Shareholder Voice and Firm Performance*, 20 REV. FIN. 1799, 1826 (2016); Peter Iliev & Svetla Vitanova, The Effect of the Say-on-Pay Vote in the U.S. 3 (Feb. 1, 2015) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2235064 [https://perma.cc/5P2S-3BP4 (staff-uploaded archive)]. Iliev and Vitanova state the following:

> We find that compliance with the Say-on-Pay rule did not cause a decrease in levels of CEO pay. On the contrary, firms that had to comply with the new rule experienced both an increase in the total CEO pay and paid more cash bonuses. Firms with mandatory Say-on-Pay votes also showed an increase in the frequency of termination and change-of-control provisions, further supporting the notion that the overall pay increase is driven by higher risks for the CEO. Further, the market reacted negatively to the announcement of the unexpected two-year exemption for small firms, consistent with a positive net effect from the new rule. Finally, firms that had to comply with the Say-on-Pay rule experienced a significant increase in support for their directors during shareholder elections. Taken together, these results are consistent with the view that the new Say-on-Pay rule did not have the effect of curbing CEO compensation.

Iliev & Vitanova, *supra*, at 27.

Say on Pay votes.[167] However, internationally, Ricardo Correa and Ugur Lel have found that pay growth rates are lower in their comparative study of countries that have adopted Say on Pay legislation.[168] Their cross-country study of thirty-nine nations—twelve that have adopted Say on Pay and twenty-seven that have not—finds that although "CEO compensation has increased in several [Say on Pay] countries, including the United States and the United Kingdom, the growth in CEO pay is higher [in countries] not subject to [Say on Pay] laws."[169]

In sum, Say on Pay acts as a low-cost monitoring measure for shareholder groups and has some impact on executive compensation abuses. While it does not have a dramatic effect on compensation 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 take course when large outside blockholders join smaller institutional investors in voting "no" on excessive compensation packages. Finally, the up-to-date data supports the intuition that a periodic Say on Pay vote and the dialogue it prompts with proxy advisors and large blockholders diminish the rate of compensation increases from what would be the case were there no Say on Pay vote requirement.

C. *Hedge Fund Activism and Executive Compensation*

While Say on Pay is a low-cost shareholder monitoring technique that has had relatively limited effects, shareholder monitoring of excessive 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 in part by claims that target company managers were entrenched in power and helping

167. Martin Conyon & Graham Sadler, *Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the U.K.*, 18 CORP. GOVERNANCE 296, 297 (2010) (finding no change in the overall level of executive pay or its rate of growth subsequent to Say on Pay votes); *see also* Fabrizio Ferri & David A. Maber, *Say on Pay Votes and CEO Compensation: Evidence From the U.K.*, 17 REV. FIN. 527, 559 (2013) (finding that firms did adjust contractual features and increase sensitivity to pay for performance in response to negative vote outcomes).

168. Ricardo Correa & Ugur Lel, *Say on Pay Laws, Executive Compensation, Pay Slice, and Firm Value Around the World*, J. FIN. ECON. (forthcoming 2016) (manuscript at 8), http://www.sciencedirect.com/science/article/pii/S0304405X16301544 [https://perma.cc/R7S6-28RT (staff-uploaded archive)].

169. *Id.* Figure 1 illustrates the gap between the two groups of countries. *See id.* at 9 fig.1.

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.[170]

While the 1980s traditional hostile takeover has largely disappeared, in recent years, hedge fund activists have targeted firms with high levels of executive pay.[171] 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.[172] Alon Brav and others found 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 of CEO compensation at peer companies in the same industry that are of similar size and stock valuation" but that "[o]ne year after hedge fund intervention, CEO pay at targeted firms is not distinguishable from peer levels."[173] Compensation form also changed with increases in pay-for-performance sensitivity levels.[174]

Thus, we argue that derivative litigation's weaknesses in monitoring excessive managerial pay have been compensated by the introduction of low cost Say on Pay monitoring and by the rapid expansion of higher impact hedge fund activism.[175] This statement leads to the question: 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. Such claims find their source in former Chancellor

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170. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 113 (1965) (noting that executive compensation leads to lower share prices, which makes companies 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").

171. *See* Brav et al., *supra* note 15, at 1742 tbl.1 (depicting a summary of hedge funds' stated goals).

172. *See id.* at 1768 tbl.7.

173. *Id.* at 1767.

174. *Id.*

175. *See* Krishnan et al., *supra* note 106, at 297 (demonstrating increased levels of hedge fund activism in the post-financial crisis period).

Allen's path-breaking *Caremark*[176] decision, holding that directors' duty of good faith is breached when there is evidence of a "sustained or systematic failure of a director to exercise reasonable oversight."[177]

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*.[178] In that case, the court noted that the complaint would have survived a motion 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 twenty-nine miners—the deadliest mine accident in the United States in forty years.[179]

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, and therefore, the immunity shield often insulates the board from liability.

Indeed, the Delaware judiciary has 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*,[180] which held that the business judgment rule insulated the directors against claims that they failed to take precautions to protect against losses from Citigroup's large exposure to the subprime lending markets.[181] The suit alleged 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.[182]

176. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).
177. *Id.* at 971.
178. C.A. No. 5430-VCS, 2011 WL 2176479 (Del. Ch. May 31, 2011).
179. *See id.* at *21.
180. 964 A.2d 106 (Del. Ch. 2009).
181. *See id.* at 139.
182. *Id.* at 115.

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 such 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 allegations that do not state a claim for relief under *Caremark*.[183]

The above reasoning appears consistent with the observation made in a widely-noted Delaware Supreme Court decision, *In re The Walt Disney Co. Derivative Litigation*,[184] that conduct offending good corporate governance practices nonetheless is not inherently negligent conduct.[185] Thus, the immunity shield requires that the derivative suit plaintiff show that the board was more than merely negligent, and the plaintiff must prove a high standard of fault to even show that directors acted negligently. These two principles, in tandem, severely restrict the scope of the 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 of the corporation's adherence with the law when

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183. *Id.* at 128–30 (quoting David B. Shaev Profit Sharing Account v. Armstrong, No. Civ.A. 1449-N, 2006 WL 391931, at *5 (Del. Ch. Feb. 13, 2006)); *see also* Cent. Laborers' Pension Fund v. Dimon, 638 Fed. App'x 34, 35–36 (2d Cir. Jan. 6, 2016) (affirming the dismissal of a shareholder derivative suit bringing a *Caremark* claim under Delaware law against JPMorgan Chase for its failure to institute internal controls sufficient to detect Bernie Madoff's Ponzi scheme).

184. 906 A.2d 27 (Del. 2006).

185. *Id.* at 64–65.

implementing business strategies. After all, Chancellor Allen's opinion emphasized the important role that compliance programs had assumed for U.S. 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.[186] 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.[187]

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, a litigation support group, reported that even though the total securities class action filings in 2015 (189) were the most since 2008, filings against companies within the S&P 500 remained well below historical averages.[188] More generally, the number of securities class action filings in 2013, although in line with the immediate two preceding years, was thirteen percent below the historical average number of annual filings.[189] At least since 2005, the trend line in filings has been downward.[190]

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 from 1996–2013

186. *See* Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130–31 (Del. 1963).

187. *See* Kent Greenfield, *Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (with Notes on How Corporate Law Could Reinforce International Law Norms)*, 87 U. VA. L. REV. 1279, 1299 n.60 (2001); Mae Kuykendall, *Producing Corporate Text: Courtrooms, Conference Rooms, and Classrooms*, 55 N.Y.L. SCH. L. REV. 593, 624 (2010–2011).

188. *See* CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2015 YEAR IN REVIEW 4–5, 18 (2016), https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Filings-2015-Year-in-Review [https://perma.cc/B4A9-ARVN].

189. *See id.* at 30 app.1.

190. *See id.* (showing trend).

is 124 per year, there were just ninety-four in 2012.[191] While these downward declines were occurring, median settlement size increased from $5.6 million in 1996 to $9.3 million in 2013 (although declining to $6.5 million in 2014, albeit after years of noticeable increases).[192] This increase in median settlement size supports the claim that plaintiffs are more discriminating in the cases they file, focusing on suits likely to compensate them for the costs and risks of securities class action litigation that are cataloged below.

The high risk incident to filing 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 suits, forty-three securities class actions were dismissed; whereas, in 2013, in an era when many fewer securities class actions were being filed, eighty suits were dismissed.[193] Overall, as of 2014, approximately forty-two percent of filed securities class actions were dismissed in response to defendants' motions to dismiss or motions for summary judgment.[194] At the core of these trend lines is the cost curve for the suits' maintenance. Those costs have, not surprisingly, been impacted by several legal, legislative, and judicial developments.

However, securities fraud class actions are 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 when the Supreme Court sought to curb the ever-expanding scope of Rule 10b-5 by ruling that it could not address "instances of corporate mismanagement."[195] This phrase arose from the *Birnbaum v. Newport Steel Corp.*[196] opinion, where the gravamen of the complaint was that the controlling stockholder thwarted an ongoing acquisition of the company at a premium so that he could garner the entire control premium for himself.[197] The defendant's

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191. *See* RENZO COMOLLI & SVETLANA STARYKH, NAT'L ECON. RESEARCH ASSOCS., INC., RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2014 FULL-YEAR REVIEW 20 fig.17 (2015), http://www.nera.com/content/dam/nera/publications/2015/PUB_Full_Year_Trends_2014_0115.pdf [https://perma.cc/2RRW-9GQN]. However, in 2013, there were 102 settlements, the first increase in total settlements in years. *See id.*

192. *See id.* at 28 fig.24 (adjusted for inflation).

193. *See id.* at 20 fig.17.

194. *See id.*

195. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477, 479–80 (1977); *see also* 17 C.F.R. 240.10b-5 (2015).

196. 193 F.2d 461 (2d Cir. 1952).

197. *See id.* at 462 (compelling premium received for transferring control to be disgorged pro-rata among company stockholders).

misconduct in *Birnbaum* was ultimately addressed under state law as a breach of the controlling stockholder's fiduciary duty.[198] However, *Birnbaum* reasoned that the antifraud provision reached only fraud in connection with a plaintiff's own purchase or sale and did not extend to breaches of fiduciary duty by managers or controlling stockholders absent such a connection with a plaintiff's actual purchase or sale.[199]

Later, the Supreme Court in *Santa Fe Industries, Inc. v. Green*[200] 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.[201] The *sine qua non* for a violation of the securities laws, therefore, is a material deception; an egregious breach of fiduciary obligation absent deception is not within the reach of the antifraud provision.[202] 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, there has been a growing use of it to redress lapses in management oversight.[203] Given all of the obstacles that shareholders face in bringing these cases,[204] resorting to private suit under the securities laws to address oversight situations is an indictment of the comparative weakness of state law mechanisms to curb this variety of managerial agency cost. As seen earlier, a state fiduciary duty claim that the directors and officers were poor stewards must confront not only the business judgment rule's strong presumption of propriety but also, more importantly, the additional protection provided the

198. *See* Perlman v. Feldmann, 219 F.2d 173, 175–76 (2d. Cir. 1955).

199. *Birnbaum*, 193 F.2d at 464.

200. 430 U.S. 462 (1977).

201. *See id.* at 473–74.

202. *See id.* at 474–77.

203. *See* Henry Ordower, *The Regulation of Private Equity, Hedge Funds, and State Funds*, 58 AM. J. COMP. L. 295, 308–10 (2010).

204. Among the obstacles facing the securities fraud plaintiff is (1) a bar to discovery until all pretrial motions to dismiss have been resolved, Securities Exchange Act of 1934 § 21D(b)(3)(B) (codified at 15 U.S.C. § 78u-4(b)(3)(B)(2012)); (2) a heightened pleading standard that requires facts to be alleged with particularity that establish a strong inference of scienter, *see id.* § 21D(b)(2) (codified at 15 U.S.C. § 78u-4(b)(2)(2012)); (3) a requirement that the plaintiff must set forth affirmative allegations that the alleged misrepresentation caused an economic loss, *see* Dura Pharm. Inc. v. Broudo, 544 U.S. 336, 338 (2005); and (4) a requirement that when the transaction occurs in a public market the plaintiff must establish features regarding the market consistent with the security's price likely being impacted by a material misrepresentation, *see* Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2417 (2014).

board's decision by the available immunity shield provision.[205] The effect of the immunity shield is to force the suit's focus toward the responsible officers rather than the outside directors.[206] 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, oversight failures and harmful stewardship escape scrutiny under state law except in the extreme instances of conscious abandonment of compliance with the law, as illustrated in *Massey*.[207] The vacuum created by the weakness of the state law based derivative suit has been filled by the federal securities law antifraud provision, even if not a perfect fit.

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.[208] However, investors could proceed when they 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."[209]

The demands of this requirement were recently strengthened by a Second Circuit 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 uncertainty does not exist.[210] More generally, management, certainly within regulated industries, proffers statements of the firm's

205. *See supra* Section III.A.

206. *See generally* Darian M. Ibrahim, *Individual or Collective Liability for Corporate Directors?*, 93 IOWA L. REV. 929 (2008) (arguing that an individual focus in duty of care cases along with a collective focus in duty of loyalty cases sets a perfect balance between the board's authority and accountability).

207. *See supra* text accompanying notes 178–79.

208. ECA & Local 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co., 553 F.3d 187, 196 (2d Cir. 2009) ("[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.' " (second alteration in original) (quoting 15 U.S.C. § 78u-4(b)(1)–(2)); Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 320 (2007))).

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

210. Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 101–02 (2d Cir. 2015).

compliance with prevailing legal requirements or offers opinions about the firm's business strategies and operations as it seeks to meet the ongoing regulatory and competitive challenges that confront the firm. These statements are attuned to well-understood investor concerns about the effect of regulation and competition on the firm. Investors value management's reassurances, but these reassurances are often tainted by over-optimism that appears to abound among managers.[211] Within this informational environment, the Supreme Court's most recent antifraud decision allows Rule 10b-5 to play an expanded role in addressing failures of stewardship.

In *Omnicare, Inc. v. Laborer's District Council Construction Industry Pension Fund*,[212] the Supreme Court established the template for how management opinion statements regarding its policies, practices, and oversight are actionable under the antifraud provision.[213] In its registration statement for a public offering of its securities, Omnicare stated management "believe[d]" its various contracts were "in compliance with applicable federal and state laws" and "legally and economically valid arrangements."[214] The belief was misplaced, as subsequent to the public offering, several federal enforcement suits were initiated against Omnicare alleging that multiple aspects of its contractual relationships and business arrangements violated federal health care laws.[215] Purchasers of the registered securities thereafter initiated the class action suit and alleged they had been misled by the false opinion of legal compliance.[216]

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."[217] *Omnicare*'s template analyzes 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 the

211. *See* James D. Cox, *"We're Cool" Statements After* Omnicare*: Securities Fraud Suits for Failures to Comply with the Law*, 68 SMU L. REV. 715, 725 (2015).

212. 135 S. Ct. 1318 (2015).

213. *See id.* at 1323.

214. *Id.* (citation omitted).

215. *Id.* at 1324.

216. *Id.*

217. *Id.* at 1328.

statement from being materially misleading. This formulation is captured by the Court's illustration:

> Consider an unadorned statement of opinion about legal compliance: "We believe our conduct is lawful." If the issuer makes that statement without having consulted a lawyer, it could be misleadingly incomplete.... [A]n investor, though 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.[218]

Before *Omnicare*, generalized statements of optimism, such as "our conduct is lawful," were perfunctorily viewed as harmless puffery.[219] The ultimate significance of *Omnicare* is that the decision invites inquiry about whether optimism professed by management is 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 allow potential plaintiffs to 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 today's subject of the securities laws. Because *Omnicare* promotes greater transparency around the firm's information and compliance systems, greater effort within the firm is expected to assure it is fulfilling its objective of reducing managerial agency costs.

At a minimum, we therefore find that disclosure-oriented federal securities suits can address errant stewardship. This can occur where the managers proffer bold claims of their compliance with the law, that their business strategies are yielding great returns, or that

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218. *Id.* at 1328–29.

219. *See, e.g.*, ECA & Local 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co., 553 F.3d 187, 205–06 (2d Cir. 2009) (stating that the company's "risk management processes... are highly disciplined" was non-actionable puffery even though the risk processes were poorly designed to forecast systematic risk posed by home mortgages (citation omitted)).

existing contracts will add immensely to future profits when behind each assertion is an ongoing 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.[220] Complaints abound that suits, or at least 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. Not only does this result in the therapeutic effect of warding some from misbehavior, but it also alerts 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.[221] Furthermore, as noted earlier,[222] 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 any red flags that might signal systemic operational weaknesses.

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220. *See* Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2222 (2010) (arguing that private enforcement of securities laws imposes reputational damage and thus deters bad actors).

221. 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, *Activist Hedge Funds, "Golden Leash" Special Compensation Arrangements, and Advance Notice Bylaws*, DIRECTOR NOTES, December 2015, at 6, https://www.conference-board.org/retrievefile.cfm?filename=TCB-DNV7N5-Activist-Hedge-Funds1.pdf&type=subsite [https://perma.cc/V23K-WQ77]. 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." *Id.*

222. *See supra* Section I.C.

Private equity firms are another important monitor of managerial oversight failures. For one thing, they stand ready to purchase firms that have previously been targeted by hedge funds because of large losses from poor managerial oversight. Should that occur, corporate management of the newly privatized firm would be under the strict scrutiny of a strong board of directors appointed by the new controlling shareholder that seeks to ensure the maximization of shareholder value so that the private equity firm realizes substantial gains on its investment.[223] 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.[224] As a result, it is expected that they would exercise strong managerial oversight with all cost-justified internal control systems deployed by the board in an effort to ensure firm value is maximized. Thus, if private equity firms take on the oversight function, derivative suits will be unnecessary as monitoring devices.

Private equity firms are better risk monitors than public company boards for other reasons as well.[225] First, management team members will have greater equity interest in their firms than their public company counterparts, especially at the more junior levels.[226] 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. 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.[227] 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

223. *See* Masulis & Thomas, *supra* note 17, at 228.

224. *Id.* at 251–52 (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").

225. *See id.* at 253–54.

226. Steven Kaplan, *The Effects of Management Buyouts on Operating Performance and Value*, 24 J. FIN. ECON. 217, 245 (1989).

227. *See* Dan Galai & Ronald W. Masulis, *The Option Pricing Model and the Risk Factor of Stock*, 3 J. FIN. ECON. 53, 58–61 (1976).

equity firms are filling a monitoring gap created by the shortcomings of derivative litigation.

CONCLUSION

Derivative suits and M&A class actions have enjoyed periods of great repute as well as tough times when they have been vilified. Their usefulness as monitoring devices for managerial agency costs has lately been called into question, while courts and legislatures have cut back on the scope and long-term viability of these tools. 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.

In this Article, we argue that these two sets of developments are related to malfunctions in the market for corporate control, abuses in executive compensation practices, and breakdowns in managerial oversight. In each case, as managerial agency costs began 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 can screen out frivolous appraisal strike suits while permitting meritorious actions to survive, then appraisal arbitrage could 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.

These new governance responses are influenced by, or created out of, the rising concentration of share ownership of public companies. It is well documented that share ownership has steadily evolved so that there are now a significant number of large blockholders at many public companies.[228] 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, 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, some evidence suggests that these trends will continue. Hedge fund activism seems to be rising to new levels in the economy. Private equity buyouts are cyclical in nature, rising to higher levels with good economic times but dropping off in times of recession, and therefore reflect the strong benefits of concentrated ownership over dispersed ownership systems. Furthermore, current market trends in the IPO markets show 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.[229] All of these forces should lead to higher levels of ownership concentration and managerial agency cost reductions as new forms of shareholder monitoring develop.

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228. *See* Holderness, *supra* note 12, at 1378 (presenting new evidence of the concentration of holdings in public corporations). This activism is further facilitated by private equity firms' ownership consolidation.

229. *See* Tom Braithwaite, *Tech 'Unicorns' Opt for Dual Share Listings*, FIN. TIMES (Oct. 16, 2015), http://www.ft.com/cms/s/0/96a7e362-73cb-11e5-a129-3fcc4f641d98.html #axzz4EyZwREHC [https://perma.cc/THN6-6GBC (staff-uploaded archive)]. *See generally* Laura Casares Field, Control Considerations of Newly Public Firms: The Implementation of Antitakeover Provisions and Dual Class Shares Before the IPO (Feb. 10, 1999) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=150488 [https://perma.cc/6TFV-JR6W (staff-uploaded archive)] (describing this trend among IPOs between 1988 and 1992).