A Mission Statement for Mutual Funds in Shareholder Litigation

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Abstract

This Article analyzes the conduct of mutual funds in shareholder litigation. We begin by reviewing the basic forms of shareholder litigation and the benefits such claims might offer mutual fund investors. We then investigate, through an in-depth docket review, whether and how the ten largest mutual funds participate in shareholder litigation. We find that although shareholder suits offer potential benefits, the largest mutual funds have essentially forfeited their use of litigation. This finding is particularly striking given that index funds and other long-term oriented mutual funds generally cannot sell their shares when they are dissatisfied with company performance, leaving them with only two levers in corporate governance—voting and suing. Mutual funds vote, but they do not sue.

We analyze potential explanations for the failure of mutual funds to litigate on behalf of their investors. Collective action problems and conflicts of interest raise significant obstacles to mutual fund participation in shareholder litigation. Yet, we argue, there are situations in which shareholder litigation could create value for mutual fund investors. We therefore turn to the normative question: How should mutual funds litigate on behalf of their investors? Answering this question allows us to articulate a mission statement for mutual funds in shareholder litigation.

Our mission statement is grounded on the perspective of the broadly diversified "market investor." The repeat-play incentives and broad diversification of many mutual funds, index funds in particular, suggests that they could create value by focusing principally on deterrence objectives. Mutual funds should bring shareholder suits against portfolio companies when doing so would meaningfully enhance deterrence. They should also scrutinize the litigation brought by other shareholders, objecting to outcomes that fail to promote meaningful deterrence. At the same time, mutual funds should focus on compensatory goals in litigation against nonportfolio defendants because extraportfolio claims do not raise circularity concerns. In addition, mutual funds should consider whether litigation can be used to implement corporate governance reforms. Finally, in all cases, mutual funds should closely monitor litigation agency costs. We close by suggesting ways in which the incentives of mutual funds might be restructured to bring about these changes.

Keywords: mutual funds, index funds, institutional investors, corporate governance, stewardship, litigation, shareholder, engagement, monitoring, agency problems, activism, hedge fund, pension fund, market investor

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ARTICLES

A Mission Statement for Mutual Funds in Shareholder Litigation

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INTRODUCTION

Corporate law creates three basic levers for investors to use in influencing the governance of the companies they own. They can vote.[1] They can sell. And they can sue.[2] Each of these remedies serves to align the interests of managers and investors. Because managers would prefer not to be replaced by a new slate of directors, not to suffer a share price decline from widespread investor selling, not to have the company sold to a hostile bidder, and not to be sued, they are more likely to work to maximize investor welfare. That, at least, is the theory.

Reality, however, is considerably more complex. In US public markets, the vast majority of company shares are held by institutional intermediaries on behalf of investors. Mutual funds are among the most common institutional owners, holding about one-third of the total US stock market.[3] In particular, the "Big Three" fund families—BlackRock, State Street, and Vanguard—own significant blocks in virtually all publicly traded companies.[4] This

1 Engagement is arguably a fourth pillar of governance, but we view this as a component of voting because the effectiveness of the engagement is largely driven by the threat of voting against management.

2 William T. Allen and Reinier Kraakman, *Commentaries and Cases on the Law of Business Organization* 201–02 (Aspen 5th ed 2016).

3 *2018 Investment Company Fact Book* *40 fig 2.6 (Investment Company Institute, 2018), archived at https://perma.cc/UV9S-6C6B (providing data showing US mutual funds and other investment companies held 31 percent of all US corporate equities in 2017).

4 See Jan Fichtner, Eelke M. Heemskerk, and Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-concentration of Corporate Ownership, and New Financial Risk*, 19 Bus & Polit 298, 313–14 (2017) (finding that the Big Three own the largest stakes in at least 40 percent of all US-listed companies and in approximately 88 percent of the S&P 500). See also Sarah Krouse, David Benoit, and Tom McGinty, *Meet the New Corporate Power Brokers: Passive Investors* (Wall St J, Oct 24, 2016), online at https://www.wsj.com/articles/the-new-corporate-power-brokers-passive-investors-1477320101

gives them considerable authority over the governance of the companies in which they invest.[5] Yet many of these funds track the performance of an index, such as the S&P 500 or the Russell 2000,[6] rather than actively trading into and out of companies on the basis of their performance.[7] As a result, these funds do not have the same set of governance tools. Because they are effectively forced into the role of long-term holders of securities, they can access only two levers of corporate governance. They can vote, and they can sue.

After a long period of inactivity in corporate governance, large mutual funds have begun to establish "stewardship" groups to guide their governance activities.[8] The Big Three are especially vocal in promoting their stewardship practices. BlackRock, for example, advertises that they "take corporate governance very seriously."[9] State Street explains that its stewardship program "is designed to have an impact" and that the fund family "actively

(visited Apr 9, 2020) (Perma archive unavailable). Some commentators have suggested that the term ought to be the "Big Four," reflecting the growth of Fidelity, or the "Giant Three." See, for example, Lucian Bebchuk and Scott Hirst, *The Specter of the Giant Three*, 99 BU L Rev 721, 741 (2019); Leo E. Strine Jr, *Fiduciary Blind Spot: The Failure of Institutional Investors to Prevent the Illegitimate Use of Working Americans' Savings for Corporate Political Spending*, 97 Wash U L Rev *10–12 (forthcoming 2020), archived at https://perma.cc/SX7Y-JL7U. We will continue to use the "Big Three" terminology to refer to the largest mutual fund blockholders.

5 See Marcel Kahan and Edward Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders* *32 (European Corporate Governance Institute, Law Working Paper No 467/2019, July 2019), archived at https://perma.cc/57YU-4Z9H ("Index funds and indexed ETFs managed by the 'Big Three' . . . have grown to be the largest investors in the capital markets and have become the presumptive 'deciders' of corporate law controversies.").

6 In 2019, the amount of assets invested in passive funds surpassed that of active funds for the first time. See Dawn Lim, *Index Funds Are the New Kings of Wall Street* (Wall St J, Sept 18, 2019), online at https://www.wsj.com/articles/index-funds-are-the-new-kings-of-wall-street-11568799004 (visited May 8, 2020) (Perma archive unavailable). For brevity, we will refer to exchange-traded funds (ETFs), index funds, and other passively managed mutual funds that seek to track the performance of an index as "index funds."

7 On institutional investors' preference for exit (selling) over voice (voting), see John C. Coffee Jr, *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 Colum L Rev 1277, 1317–28 (1991) (arguing that in the absence of a controlling stake institutional investors prefer liquidity to control and therefore fail to monitor).

8 See Hortense Bioy, et al, *Passive Fund Providers Take an Active Approach to Investment Stewardship* *15–20 (Morningstar, Dec 2017), archived at https://perma.cc/Q897-9VMV (discussing research on how index managers carry out their investment stewardship responsibilities).

9 Madison Marriage, *Passive Houses Insist They Do Care About Governance* (Fin Times, Feb 5, 2017), online at https://www.ft.com/content/bd77d9b8-dd9f-11e6-86ac-f253db7791c6 (visited Feb 24, 2020) (Perma archive unavailable).

engage[s] with [ ] portfolio companies to promote [the] long-term value of [their] clients' investments."[10] And Vanguard insists that it cares "deeply" about governance and is "good at it."[11] However, the exclusive focus of stewardship groups has been on *voting*.[12] Mutual funds tout the number of votes in which they have participated and, increasingly, highlight their willingness to oppose management.[13] A lively academic debate has arisen in response to these claims, with scholars also predominantly focused on voting.[14] The potential for mutual funds to exert a governance role through litigation has been largely overlooked.[15]

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10 *Asset Stewardship* (State Street Global Advisors), archived at https://perma.cc/3ZKQ-N36K.

11 Bill McNabb, *The Ultimate Long-Term Investors* (Vanguard, July 6, 2017), archived at https://perma.cc/CH6X-3SMD.

12 Again, we are including "engagement"—that is, formal or informal communications between corporate managers and mutual fund investors—as a species of voting because the ability of mutual funds to be heard in these conversations ultimately depends upon their voting power.

13 See, for example, *Investment Stewardship Report: 2018 Voting and Engagement Report* *4–5 (BlackRock, Aug 31, 2018), archived at https://perma.cc/59MW-9LFT (noting votes at over 17,000 shareholder meetings on over 158,000 proposals from July 1, 2017 to June 30, 2018); *2018 Investment Stewardship Annual Report* *8 (Vanguard, 2018), https://perma.cc/FZJ8-2AKX (noting votes at over 19,000 meetings on over 168,000 proposals during proxy year 2018).

14 See, for example, Lucian A. Bebchuk and Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 Colum L Rev 2029, 2043–75 (2019) (arguing that agency costs at mutual funds inhibit engaged stewardship); Lucian A. Bebchuk, Alma Cohen, and Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J Econ Persp 89, 95–104 (2017) (applying the agency cost problem to mutual fund intermediaries); Luca Enriques and Alessandro Romano, *Institutional Investor Voting Behavior: A Network Theory Perspective*, 2019 U Ill L Rev 223, 266–67 (arguing that network effects may lead to engaged stewardship); Jill E. Fisch, Assaf Hamdani, and Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U Pa L Rev 17, 27–43 (2020) (arguing that competition between index and active funds for new investment creates an incentive for index funds to improve corporate governance); Sean J. Griffith and Dorothy S. Lund, *Conflicted Mutual Fund Voting in Corporate Law*, 99 BU L Rev 1151, 1172–86 (2019) (articulating a set of standard conflicts that may inhibit mutual funds from acting as loyal stewards); Sean J. Griffith, *Opt-in Stewardship: Toward an Optimal Delegation on Mutual Fund Voting Authority*, 98 Tex L Rev *34–53 (forthcoming 2020), archived at https://perma.cc/5EA4-HT58 (arguing that mutual funds have incentives and information to vote intelligently in contests but not in other corporate governance settings); Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J Corp L 493, 506–20 (2018) (arguing that index and passive funds lack the incentive to vote intelligently); Rock and Kahan, *Index Funds and Corporate Governance* at *36 (cited in note 5) (arguing that spillover effects allow index funds to act as engaged stewards).

15 An exception is Professors Lucian Bebchuk and Scott Hirst, who observed that mutual funds tend not to serve as lead plaintiffs in securities class actions. See Bebchuk and Hirst, 119 Colum L Rev at 2114 (cited in note 14). We confirm this observation

In this Article, we focus on the third lever of corporate governance—shareholder litigation—as a tool through which mutual funds might improve the performance of portfolio companies. Shareholder litigation has long served an important role in policing managerial misconduct.[16] Unfortunately, shareholder suits also have a dark side. Because most shareholder litigation is representative in nature, the lawyers controlling the litigation often use it to serve their own interests rather than those of the shareholder beneficiaries, leading to the failure of shareholder suits to produce meaningful benefits.

As "market investors"—holders of broadly diversified portfolios—mutual funds are in an ideal position to use litigation to produce benefits for shareholders and to prevent lawyers from diverting and destroying those benefits. Indeed, litigation may serve stewardship goals more effectively than voting. First, litigation can produce a direct monetary benefit to shareholders. Voting, by contrast, produces only indirect monetary benefits, as when an activist or an acquirer submits a proposal or a bid that has the effect of increasing shareholder value. Second, shareholder litigation can immediately target and thereby deter specific bad acts of management. Voting deters mismanagement more bluntly, and misconduct that does not lead to an activist intervention may be undeterred by voting alone. Third, unlike shareholder proposals that result, at best, in a nonbinding commitment to consider forming a committee to study an issue of concern, shareholder suits can produce governance reforms that come with the force of a

empirically. See Part II. Likewise, Professor David Webber has described how broadly diversified investors can benefit from using litigation as a form of shareholder activism. See David H. Webber, *Private Policing of Mergers and Acquisitions: An Empirical Assessment of Institutional Lead Plaintiffs in Transactional Class and Derivative Actions*, 38 Del J Corp L 907, 932, 946 (2014). A third exception is Alexander Platt, who has studied the Big Three's "enforcement" efforts, including litigation, and argues that there is an "enforcement shortfall" that could be corrected with regulatory changes, including mandatory disclosure of litigation activity. See Alexander I. Platt, *Index Fund Enforcement*, 53 UC Davis L Rev 1453, 1460 (2020).

16 See James D. Cox and Randall S. Thomas, *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law*, 6 Eur Co & Fin L Rev 164, 198–201 (2009) (finding that shareholder litigation may lead to strengthened corporate governance structures and may incentivize reduced executive compensation); C.N.V. Krishnan, et al, *Shareholder Litigation in Mergers and Acquisitions,* 18 J Corp Fin 1248, 1264 (2012) (finding that shareholder litigation "polices low-ball bids" and improves offer prices); Robert B. Thompson and Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 Vand L Rev 133, 142–43 (2004) (noting that derivative litigation has helped check and prevent managerial abuses).

court order. If the company does not implement the reforms as promised, it is in violation of the terms of its settlement, which shareholders can then enforce judicially. Voting, in other words, is no substitute for litigation. Voting and litigation should instead be viewed as complementary corporate governance mechanisms, with litigation in many ways the stronger of the two.

We examine mutual fund participation in shareholder suits both theoretically and empirically. Our analysis begins by reviewing the theoretical grounding of each of the major forms of shareholder suits: (1) derivative suits, (2) state law direct and class claims, (3) appraisal actions, and (4) private securities litigation. Mutual funds are empowered to bring each of these suits on behalf of their investors. Although some large institutional clients may not delegate the right to litigate on their behalf, most mutual fund investors, including all individual investors, allocate full ownership rights to the fund by default. This means that mutual funds always have the right to sue on behalf of at least some of their investors. Moreover, because mutual funds own more or less the entire market, they could bring litigation in virtually every instance of corporate or managerial misconduct.

Next, we examine the actual conduct of mutual funds in shareholder litigation. To do so, we collected data on mutual fund participation in each of the forms of shareholder litigation noted above over a ten-year period. We found that the ten largest mutual funds, including each of most vocal funds on corporate governance, *very rarely* participate in shareholder litigation. Collectively, these funds were involved in the filing of just eleven traditional shareholder suits over our sample period. However, these were often the same claims: the eleven suits involved only six different instances of managerial misconduct. All but one of these complaints alleged violations of the federal securities laws; we found a single appraisal suit and no instances of state law class or derivative litigation. The securities claims were typically not brought as class actions, but rather as individual actions separate from any class claims brought against the same corporate defendant. Moreover, none of our mutual funds served as lead plaintiff even a single time over our sample period.

These results are striking standing alone, but for additional perspective, we gather evidence on the litigation activity of prominent pension funds, hedge funds, and individual shareholder plaintiffs. Our evidence indicates that these other plaintiffs litigate frequently. Although we do not claim to know the optimal amount of litigation, the quantitative and qualitative differences between the litigation pursued by mutual funds and that of other institutional investors raises serious questions about the ability and incentives of mutual funds to act as faithful governance intermediaries for their investors.

This is a serious issue. Nearly half of US households invest in mutual funds.[17] In doing so, they entrust their governance rights to intermediaries. It is critically important that these intermediaries act to further investor interests when they make litigation decisions. What our evidence suggests is that mutual funds are not discharging this obligation. Indeed, they may not be thinking about it at all.

We survey a variety of possible explanations for mutual funds' failure to participate more aggressively in shareholder litigation. None is particularly compelling. The failure cannot be explained by substantive legal barriers or structural obstacles, both of which are limited and manageable. Nor can the failure be fully explained by the "circularity" problem that arises when shareholders are on "both sides of the v," as both plaintiff and defendant.[18] Although mutual funds own the market and are therefore likely to be on both sides in many suits, they may still benefit from systemic deterrence and governance benefits won through shareholder suits. Moreover, not all shareholder recoveries are funded by defendant corporations also owned by shareholder plaintiffs.

Agency costs and conflicts of interest present serious obstacles. Mutual funds likely do not want to offend the corporations that funnel them 401(k) and other advisory business by filing lawsuits against them. Furthermore, because the benefits of shareholder litigation must often be shared with a class that includes their competitors, mutual funds may see little advantage in litigating.[19] However, these incentives do not apply to all forms of shareholder litigation. Corporate defendants in their last period, facing bankruptcy or acquisition, are not a likely source of future

17 *2018 Investment Company Fact Book* at *142 fig 7.1 (cited in note 3) (showing that 44.5 percent of US households owned mutual funds in 2017).

18 See text accompanying notes 109–14.

19 These incentive problems have most often been discussed by others in the context of shareholder voting. See, for example, Bebchuk and Hirst, 119 Colum L Rev at 2060–62 (cited in note 14); Lund, 43 J Corp L at 506–23 (cited in note 14). Like us, Webber has raised the specter of agency costs in the context of litigation. In his study of shareholder derivative suits and class actions filed in Delaware between 2003 and 2009, he found that mutual funds served as lead plaintiffs only seven times and posits that agency costs may explain this low number. See Webber, 38 Del J Corp L at 940–43 (cited in note 15).

advisory business. Moreover, not all shareholder suits lead to pro rata recoveries. Mutual funds are typically large enough blockholders to litigate on their own.

It may be that the failure to litigate reveals mutual funds' motivations in stewardship generally. Stewardship ought to involve litigation as well as voting, yet mutual funds pursue stewardship through voting only, perhaps because mutual fund voting is a subject of regulatory attention while litigation is not.[20] But this suggests something about voting, too. Take away the regulatory impetus and mutual funds might neither litigate nor vote.

Mutual fund representatives deny this. In both public statements and private conversations, they maintain that governance is deeply important to them. Perhaps, then, the problem is not one of incentives, but of awareness or expertise. We therefore offer an account of how mutual funds could benefit their investors using "stewardship litigation." Focusing on the long-term perspective of the market investor, we argue that mutual funds ought to pursue extraportfolio litigation for compensation and intraportfolio claims for deterrence. They also ought to consider whether litigation can be used to implement corporate governance reforms. At the same time, recognizing that litigation often creates more costs than benefits, we argue that mutual funds can add value by exerting an oversight role over shareholder litigation across the portfolio and intervening to minimize litigation agency costs. These proposals form the core of our "mission statement" for mutual funds in shareholder litigation.

Our mission statement would be simple and relatively inexpensive for mutual funds to implement. The main difference is one of perspective. Engagement with shareholder litigation, whether in a participatory or an oversight role, is an important component of stewardship and ought to be viewed as such. Insofar as there are agency cost barriers in the way, we suggest ways in which pressure from investors or regulators may overcome these obstacles.

[20] Of course, the fact that mutual funds vote their shares does not necessarily mean that they vote them well, and recent scrutiny of their voting practices has led to some embarrassing revelations. See, for example, Asjylyn Loder, *Funds Don't Always Vote for Policies They Publicly Back* (Wall St J, Apr 2, 2019), online at https://www.wsj.com/articles/funds-dont-always-vote-for-policies-they-publicly-back-11554206401 (visited Apr 18, 2020) (Perma archive unavailable). Not only that, mutual funds often fail to support their public positions by bringing shareholder proposals themselves. Bebchuk, Cohen, and Hirst, 31 J Econ Persp at 101 (cited in note 14).

From this Introduction, the Article proceeds as follows. Part I reviews the basic theory underlying shareholder litigation though an examination of prototypical shareholder suits. Part II contains our empirical study of mutual fund participation in shareholder litigation. As a point of comparison, it looks at the litigation record of other institutional investors—pension funds and hedge funds—as well as individual shareholder plaintiffs. Part III considers various potential explanations for our findings. Part IV provides our normative analysis of how mutual funds *should* conceive of their role in shareholder litigation and tackles the question of implementation.

I. Shareholder Litigation

Before we can assign a role to mutual funds in shareholder litigation, we must first develop an understanding of what shareholder litigation is for. As noted above, litigation is one of the traditional levers of corporate governance. But what can shareholders expect to accomplish by suing the companies they own? And what are typical outcomes of shareholder suits? The answers to these questions will guide the analysis of whether and when mutual funds should instigate litigation on behalf of their investors. But answering them requires an account of shareholder litigation generally. This Part offers that account, first reviewing mainstream theories of shareholder litigation, then evaluating paradigmatic forms of shareholder suits in practice.

A. Shareholder Litigation in Theory

Shareholder suits do not exist in isolation. Rather, they are part of the broader ecosystem of corporate law as a whole, in which agency costs are a fundamental concern.[21] By severing ownership and control, the corporate form creates incentives for manager-agents to defect from the interests of their

[21] See Andrei Shleifer and Robert W. Vishny, *A Survey of Corporate Governance*, 52 J Fin 737, 738 (1997) (describing the core corporate governance problem as "how investors get the managers to give them back their money"). See also Sanjai Bhagat, Brian Bolton, and Roberta Romano, *The Promise and Peril of Corporate Governance Indices*, 108 Colum L Rev 1803, 1809 (2008) ("The key focus of U.S. corporate law and corporate governance systems is what is referred to as an agency problem: an organizational concern that arises when the owners—in a corporation, the shareholders—are not the managers who are in control.").

shareholder-principals.[22] These defections range from mild (shirking) to severe (theft).[23] Corporate governance mechanisms are designed to contain agency costs.[24] Intracorporate litigation—that is, investors' suits to enforce their rights as such—can thus be understood as a basic tool for shareholders to use in seeking to minimize managerial agency costs.[25]

Shareholder litigation targets agency costs in three ways.[26] First, the prospect of shareholder claims may deter managerial misconduct. According to the deterrence rationale, the risk of personal liability for misconduct may incentivize managers to adhere to shareholders' best interests. Even if they are not personally liable, managers may suffer personal consequences from corporate liability—for example, reduced compensation or diminished career prospects—that may also effectively deter misconduct. Second, successful shareholder suits may compensate investors for losses resulting from managerial agency costs. The compensation rationale for shareholder litigation suggests that such suits are necessary to make investors whole from severe managerial misconduct, such as theft or fraud.[27] Third and finally, shareholder suits may result in specific governance reforms designed to reduce agency costs going forward.[28] Shareholder suits may result in the judicial invalidation of a particular governance provision,

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22 See Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J Fin Econ 305, 327–28 (1976).

23 Edward B. Rock and Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U Pa L Rev 1619, 1662 (2001).

24 See Oliver E. Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* 305 (Free Press 1985) (explaining that a board of directors elected by shareholders is "a governance structure that holders of equity recognize as a safeguard against expropriation and egregious mismanagement").

25 See *In re Riverbed Technology, Inc Stockholders Litigation*, 2015 WL 5458041, *1 (Del Chanc):

> As a bench judge in a court of equity, much of what I do involves problems of . . . agency: insuring that those acting for the benefit of others perform with fidelity, rather than doing what comes naturally to men and women—pursuing their own interests, sometimes in ways that conflict with the interests of their principals.

The other two basic tools available to shareholders, as already noted, are the voting and selling of shares. See note 2 and accompanying text.

26 See Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, 51 Wm & Mary L Rev 1749, 1807 (2010).

27 See Amanda Marie Rose, *The Shifting Raison d'Être of the Rule 10b-5 Private Right of Action*, in Sean Griffith, et al, eds, *Research Handbook on Representative Shareholder Litigation* 39, 48 (Edward Elgar 2018) ("[T]he essence of corrective justice theory is that a wrongdoer is made to make whole their victim.").

28 See, for example, Erickson, 51 Wm & Mary L Rev at 1816–25 (cited in note 26).

such as a poison pill,[29] or they may result in settlements in which the company adopts specific governance reforms aimed at better aligning the incentives of shareholders and managers. We will refer to this objective, sometimes described as "corporate therapeutics," as the "governance rationale" for shareholder litigation.[30]

Most shareholder suits are brought in a representative capacity in which a single shareholder or group of shareholders asserts a claim on behalf of a larger class, often all shareholders as such.[31] This is not because individual shareholders cannot bring their own claims. Often they can.[32] It is simply that individual actions are often inefficient. The costs of litigating an individual claim may exceed the value of the shareholder's proportional share of the recovery. If all shareholders are economically disinclined to sue, there may be less litigation than all shareholders, on the whole, would prefer. The representative action thus solves a collective action problem in order to preserve litigation as a constraint on managerial agency costs.

But representative actions come with costs of their own. Representative shareholder suits, like other forms of representative actions, are typically controlled by a contingency-fee lawyer serving a quasi-regulatory role with a purely nominal client.[33] Such suits invert the ordinary lawyer-client relationship, with lawyers

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[29] See, for example, *Moran v Household International, Inc*, 500 A2d 1346, 1348–49 (Del 1985) (shareholder suit challenging adoption of poison pill); *Unocal Corp v Mesa Petroleum Co*, 493 A2d 946, 958 (Del 1985) (shareholder suit challenging the application of takeover defenses and setting the standard for such challenges going forward); *Revlon, Inc v MacAndrews & Forbes Holdings, Inc*, 506 A2d 173, 175 (Del 1986) (shareholder suit challenging the use of takeover defenses in the context of an acquisition). More recently, shareholder suits have challenged the application of defensive tactics to activist interventions. See, for example, *Kallick v Sandridge Energy, Inc*, 68 A3d 242, 261 (Del Chanc 2013) (scrutinizing defensive tactics in the context of an activist's proxy challenge); Oral Argument on Defendants' Motions to Dismiss and Rulings of the Court, *Pontiac General Employees Retirement System v Ballantine*, No 9789-VCL (Del Chanc filed Oct 14, 2014) (available on Westlaw at 2014 WL 6388645) (finding a potential breach of fiduciary duty in a board's use of a debt covenant as a defense against activism).

[30] See George D. Hornstein, *Legal Therapeutics: The "Salvage" Factor in Counsel Fee Awards*, 69 Harv L Rev 658, 662–63 (1956) (coining the idea of a "therapeutic" settlement).

[31] See generally Griffith, et al, eds, *Research Handbook on Representative Shareholder Litigation* (cited in note 27) (compiling recent scholarship on representative shareholder litigation).

[32] See Part I.B (discussing class fiduciary claims and private securities claims).

[33] See John C. Coffee Jr, *Entrepreneurial Litigation: Its Rise, Fall, and Future* 2 (Harvard 2015) ("[T]he private [class action] attorney is taking on a public role and acting as a quasi-public servant. . . . [T]his attorney is a private actor, wielding a degree of public power, but motivated by powerful economic incentives, and yet subject to only limited accountability.").

hiring clients, rather than clients hiring lawyers.[34] Lawyers advertise for clients on investor websites[35] or cultivate client relationships with institutional investors, often pension funds.[36] Having found a client, the lawyers are in control.[37] Individual investors are rationally indifferent to the conduct of the claim,[38] and institutional investor plaintiffs appear to be similarly disengaged.[39] These circumstances are ripe for the now-familiar phenomenon of "litigation agency costs," in which the attorney's personal incentives depart from those of their supposed clients, leading to claims that shareholders would prefer not to press and resolutions that benefit attorneys at the expense of the shareholders.[40]

Mutual fund plaintiffs need not sue in a representative capacity. Mutual funds are the largest shareholders of most public companies and may prefer, as a result, to litigate in an individual rather than representative capacity.[41] Even so, mutual funds

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34 See id at 1 ("[I]n group litigation in the United States, the lawyer often appears to be hiring the client, rather than the client hiring the lawyer.").

35 See Sean J. Griffith, *Innovation in Disclosure-Based Shareholder Suits*, 69 Case W Res L Rev 927, 929 (2019).

36 See Tom Baker and Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U Pa L Rev 755, 770 (2009) (noting that "[l]arge plaintiffs' law firms continuously monitor the portfolios of institutional investors, seeking to keep them apprised of potential claims").

37 See Coffee, *Entrepreneurial Litigation* at 1–2 (cited in note 33) (noting the "laws and practices that give attorneys in the United States a unique level of control over their clients in group litigation").

38 Robert Charles Clark, *Corporate Law* 389–94 (Little, Brown 2d ed 1986) (discussing a phenomenon where each shareholder's stake in the corporation is too small to justify the cost in terms of time and attention of actively engaging in corporate affairs).

39 Institutional plaintiffs were once proffered as a solution to this problem. See Elliot J. Weiss and John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L J 2053, 2121–23 (1995) (discussing the promise of institutional lead plaintiffs). But this solution seems to have failed. See Part III.

40 See John C. Coffee Jr, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 L & Contemp Probs 5, 23 (1985) (identifying the problem); Thompson and Thomas, 57 Vand L Rev at 135 (cited in note 16) (arguing that "just as with derivative suits and securities fraud class actions, good policy must balance the positive managerial agency cost reducing effects of these acquisition-oriented shareholder suits against their litigation agency costs"). See also Randall S. Thomas and Robert B. Thompson, *Empirical Studies of Representative Litigation*, in Claire A. Hill and Brett H. McDonnell, eds, *Research Handbook on the Economics of Corporate Law* 152, 154–57 (Edward Elgar 2012) (summarizing recent empirical work on the scope of the problem of litigation agency costs).

41 See Fichtner, Heemskerk, and Garcia-Bernardo, 19 Bus & Polit at 313–14 (cited in note 4).

remain subject to litigation agency costs. Because litigation is costly, in the form of both the direct costs of attorneys' fees and the indirect costs of the time and attention necessary to evaluate and oversee the litigation effort, prospective mutual fund plaintiffs may prefer to leave it to others, free-riding on the class-wide benefits they achieve. Litigation agency costs are a relevant consideration any time mutual funds leave claims to others. Moreover, as market investors, mutual funds are affected by every representative shareholder suit, whether or not they bring their own claims. Litigation agency costs therefore affect mutual funds much as they do other investors.

Litigation agency costs limit the ability of shareholders to use litigation to mitigate managerial agency costs. The question thus becomes how effectively shareholder suits mitigate managerial agency costs—achieving deterrence, compensation, or governance enhancements—in the face of litigation agency costs. We now turn to the various forms of shareholders suits with these questions in mind.

B. Shareholder Litigation in Practice

Shareholder litigation comes in various forms, each with the potential to mitigate managerial agency costs, and each with the potential to generate litigation agency costs. This Section reviews four basic forms of shareholder suits. The first two, derivative and direct suits, are different procedural means of enforcing state law fiduciary duties and, as such, are closely focused on mitigating managerial agency costs.[42] The third, appraisal, is a narrowly circumscribed right under state law invoked solely to increase the price paid in mergers and acquisitions transactions. The fourth, private securities litigation, is a creature of federal rather than state law and is aimed broadly at assuring that transactions in corporate shares are not affected by fraud or misinformation. Our

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[42] Fiduciary duty is essentially connected to agency cost minimization. According to Judge Frank Easterbrook and Professor Daniel Fischel:

> The fiduciary principle is an alternative to elaborate promises and extra monitoring. It replaces prior supervision with deterrence, much as criminal law uses penalties for bank robbery rather than pat-down searches of everyone entering banks. . . . Such rules preserve the gains resulting from the separation of management from risk bearing while limiting the ability of managers to give priority to their own interests over those of investors.

Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* 92 (Harvard 1991).

aim is to develop an understanding of the commonalities as well as the differences between these paradigmatic forms of claims, specifically as to how they affect the ability of shareholders to police managerial agency costs though litigation.

1. Derivative suits.

The derivative suit is the oldest form of representative litigation in the corporate law context.[43] In a derivative suit, an individual shareholder sues on behalf of the corporation to seek redress for some harm done to the corporation itself.[44] The shareholder alleges that the board is compelled by fiduciary duty to seek redress for the harm, often caused by a form of managerial misfeasance or malfeasance.[45] Because the derivative suit is filed on behalf of the corporation, there are several opportunities for the corporation to regain control of the claim.[46] Provided the

[43] Some commentators have suggested that, in addition to being old, it is obsolete. See Geoffrey Parsons Miller, *The Law of Governance, Risk Management, and Compliance* 471 (Wolters Kluwer 2d ed 2017) (referring to the derivative suit as a "platypus of the law"). Nevertheless, derivative suits are still regularly filed. See Erickson, 51 Wm & Mary L Rev at 1760–1807 (cited in note 26) (studying characteristics of 141 derivative suits filed on behalf of public companies in the mid-2000s).

[44] The defining feature of the derivative suit is that the underlying harm has been done to the corporation, not the shareholder directly, and therefore it is the corporation that would receive any recovery. See *Tooley v Donaldson, Lufkin, & Jenrette, Inc*, 845 A2d 1031, 1033 (Del 2004) (stating that the standard "must turn *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?"). The shareholder suit is, in the first instance, a request that the corporation seek redress itself. See *Aronson v Lewis*, 473 A2d 805, 811 (Del 1984) ("The nature of the action is two-fold. First, it is the equivalent of a suit by the shareholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it.").

[45] *Kamen v Kemper Financial Services, Inc*, 500 US 90, 95 (1991) ("[T]he purpose of the derivative action [is] to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of 'faithless directors and managers.'"), quoting *Cohen v Beneficial Industrial Loan Corp*, 337 US 541, 548 (1949). See also *Taormina v Taormina Corp*, 78 A2d 473, 475 (Del Chanc 1951):

> [W]henever a corporation possesses a cause of action which it [ ] refuses to assert . . . equity will permit a stockholder to sue in his own name for the benefit of the corporation solely for the purpose of preventing injustice when it is apparent that the corporation's rights would not be protected otherwise.

[46] These include, for example, the demand requirement and the formation of special litigation committees. Del Chanc Rule 23.1(a) (requiring that the plaintiff "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors . . . and the reasons for the plaintiff's failure to obtain the action or for not making the effort"). See also Minor Myers, *The Decisions of Corporate Special Litigation Committees: An Empirical Investigation*, 84 Ind L J 1309, 1317–20 & tbl 1

corporation does not retake control, however, the shareholder may press the claim on behalf of the corporation to a resolution, in which case any monetary recovery is paid into the corporation, not directly to the shareholder.[47]

Empirical studies of derivative suits have consistently found that monetary recoveries in derivative suits are rare.[48] But rare does not mean never, and meaningful financial recoveries do occur—including, for example, a $139 million settlement in 2013 involving News Corp, a $275 million settlement in 2014 involving Activision Blizzard, and a $137.5 million settlement in 2015 involving Freeport-McMoRan.[49] Payments made by individual directors and officers to resolve derivative suits upon a finding of personal responsibility cannot be indemnified by the corporation.[50] They can, however, be insured and are typically covered under the corporation's Directors and Officers (D&O) policy.[51] Insured recoveries will not have a direct deterrent effect on managerial misconduct.[52]

(2009) (studying the operation of special litigation committees between 1993 and 2006 and finding that committees pursue claims 10 percent of the time, settle 30 percent of the time, and seek dismissal 60 percent of the time).

47 Jessica Erickson, *Corporate Misconduct and the Perfect Storm of Shareholder Litigation*, 84 Notre Dame L Rev 75, 81 (2008) ("In a derivative suit, the corporation is the functional plaintiff—the real party in interest. . . . Any recovery in a derivative suit is returned to the corporation. As a result, shareholders . . . do not receive any direct financial benefit.") (citations omitted).

48 See, for example, Franklin S. Wood, *Survey and Report Regarding Stockholders' Derivative Suits* 1, 6–7 (NY Chamber of Commerce 1944) (finding that typical settlements in derivative suits between 1932 and 1942 amounted to less than 3 percent of damages alleged in the underlying complaint); Erickson, 51 Wm & Mary L Rev at 1799 (cited in note 26) (finding that 13 of 141 public company derivative suits sampled from the mid-2000s resulted in a monetary payment); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J L Econ & Org 55, 58, 61 n 12 (1991) (finding that 21 percent of derivative suits in a sample period from the late 1960s through 1987 ended in monetary recovery).

49 See Jessica Erickson, *The (Un)changing Derivative Suit*, in Griffith, et al, eds, *Research Handbook on Representative Shareholder Litigation* 58, 65 (cited in note 27); Daniel Fischer, *News Corp. Pays Itself $139 Million for Phone-Hacking Scandal—Minus Legal Fees* (Forbes, Apr 22, 2013), archived at https://perma.cc/DP4E-UKEH.

50 See, for example, 8 Del Code Ann § 145(a)–(b).

51 See 8 Del Code Ann § 145(g). See also Tom Baker and Sean J. Griffith, *Ensuring Corporate Misconduct: How Liability Insurance Undermines Shareholder Litigation* 46–47 (Chicago 2010) (noting that although corporate payments made in connection with derivative suits may generally not be indemnified, they are typically covered under "Side A" of a D&O insurance policy).

52 See Bernard S. Black, Brian R. Cheffins, and Michael Klausner, *Outside Director Liability: A Policy Analysis*, 162 J Inst & Theoretical Econ 5, 11–12, 16–17 (2006).

Governance reforms are a much more likely outcome of derivative litigation than monetary relief. Empirical studies suggest that derivative suits are more than two times more likely to settle for nonpecuniary relief than they are to settle for money.[53] These reforms are qualitative and therefore difficult to assess empirically, but the authors of the leading studies have expressed skepticism, noting that such reforms are typically "inconsequential" or "cosmetic,"[54] frequently amounting to the rote application of a common set of governance reforms—such as increased board independence or attendance requirements at board meetings—often without any clear connection to the alleged problems that led to the litigation.[55] This is not a uniform conclusion, however. In a study of derivative suits filed in the Delaware Court of Chancery in 1999 and 2000, Professors Robert Thomas and Randall Thompson found that although the claims often resulted in nonmonetary relief, the settlements nevertheless returned "very real gains" to the shareholders.[56] As a recent example, consider the derivative litigation filed against Twenty-First Century Fox in the wake of the decades-long patterns of sexual misconduct involving former CEO Roger Ailes as well as news anchor Bill O'Reilly. Rather than contesting the plaintiffs' claims, Twenty-First Century Fox promptly entered into a settlement in which it agreed to dedicate \$90 million to improving corporate governance at the company and also establish a "Workplace Professionalism and Inclusion Council" tasked with strengthening sexual harassment reporting and training, and helping to recruit and promote the advancement of women and minorities at the company.[57] The derivative suit also proved uniquely well-suited to addressing the problem of stock-option backdating in the mid-2000s, when

53 See Erickson, 51 Wm & Mary L Rev at 1798–99 (cited in note 26) (finding that 17 of 141 suits studied settled for nonpecuniary relief); Romano, 7 J L Econ & Org at 60–61 n 10 (cited in note 48) (finding nonpecuniary relief two times more often than monetary relief in settlements of executive compensation and self-dealing suits).

54 Romano, 7 J L Econ & Org at 63 (cited in note 48).

55 See Erickson, 51 Wm & Mary L Rev at 1808 (cited in note 26).

56 See Robert B. Thompson and Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 Vand L Rev 1747, 1778–79 (2004).

57 See Daniel Hemel and Dorothy S. Lund, *Sexual Harassment and Corporate Law*, 118 Colum L Rev 1583, 1622 (2018), citing Exhibit A to Stipulation & Agreement of Settlement, Compromise, & Release, *City of Monroe Employees' Retirement System v Murdoch*, No 2017-0833-AGB, *3, 10–11 (Del Chanc filed Nov 20, 2017); Emily Steel, *Fox Establishes Workplace Culture Panel After Harassment Scandal* (NY Times, Nov 20, 2017), archived at https://perma.cc/2R45-GVMX.

companies manipulated the date of the option grant to their executives in order to increase their value.[58] The derivative suits that followed in the wake of this scandal frequently resulted in the repricing of these options to benefit the corporation.[59]

Nevertheless, in many cases the governance reforms and other benefits that seem to be won by derivative suit plaintiffs may in fact be won by prosecutors, regulators, or other claimants. This is because derivative suits are frequently brought in the wake of other actions, a phenomenon known as the "tag-along" derivative suit.[60] For example, nearly half of all securities class actions filed between 2005 and 2008 were accompanied by a tag-along derivative suit,[61] and government investigations of corporate compliance failures are also frequently followed by derivative litigation.[62] Why do derivative plaintiffs bother filing claims when a prosecutor, regulator, or class action claimant (sometimes all three) has already targeted the same underlying misconduct? It is not because their results are better. They are worse.[63] It is more

58 See Ross D. Fuerman, *Securities Class Actions Compared to Derivative Lawsuits: Evidence from the Stock Option Backdating Litigation on Their Relative Disciplining of Fraudster Executives*, 8 J Forensic & Investigative Accounting 198, 204–07 (2016) (comparing the results of derivative suits to the results of class actions in responding to the option backdating crisis).

59 See Erickson, 51 Wm & Mary L Rev at 1802–03 (cited in note 26) (finding that 40 percent of stock option suits resulted in a financial benefit, compared to 2 percent of non–stock option suits).

60 See Jessica M. Erickson, *Overlitigating Corporate Fraud: An Empirical Analysis*, 97 Iowa L Rev 49, 61 (2011) (finding that almost 95 percent of derivative suits sampled were accompanied by at least one parallel lawsuit or government investigation and that over 80 percent were accompanied by two or more parallel lawsuits or government investigations with a median of four different types of litigation arising out of the same underlying event).

61 See Stephen J. Choi, Jessica Erickson, and A.C. Pritchard, *Piling On? An Empirical Study of Parallel Derivative Suits*, 14 J Empirical Legal Stud 653, 661 (2017).

62 See, for example, *In re Wal-Mart Stores, Inc Delaware Derivative Litigation*, 2016 WL 2908344, *5 (Del Chanc) (discussing derivative suit following in wake of a Foreign Corrupt Practices Act of 1977 and investigation of Wal-Mart which has already resulted in substantial reform of Wal-Mart's corporate compliance program); Ben W. Heineman Jr, *Who's Responsible for the Walmart Mexico Scandal?* (Harvard Bus Rev, May 15, 2014), archived at https://perma.cc/R6ZF-SZ2L. See Amy Deen Westbrook, *Double Trouble: Collateral Shareholder Litigation Following Foreign Corrupt Practices Act Investigations*, 73 Ohio St L J 1217, 1228–39 (2012) (examining recent shareholder litigation based on company behavior that violates the FCPA).

63 Choi, Erickson, and Pritchard, 14 J Empirical Legal Stud at 673–76 (cited in note 61) (finding that parallel suits are more likely to obtain lower monetary recoveries for their clients and are more likely to settle for nonpecuniary relief); Erickson, 97 Iowa L Rev at 80 (cited in note 60); Erickson, *The (Un)changing Derivative Suit* at 63 (cited in note 49) ("[I]n the hierarchy of corporate lawsuits, shareholder derivative suits may well be at the

likely because the representative nature of the derivative suit enables another attorney to extract a fee.[64]

In sum, although they may provide compensatory relief to the corporation and thereby its shareholders for an agent's misfeasance or malfeasance, derivative suits rarely result in monetary recoveries. Moreover, because they are insurable, when monetary recoveries do occur, they are unlikely to deter corporate managers. Derivative suits do often produce governance reforms, which may positively benefit the corporation. However, the indicia of litigation agency costs are high, suggesting that the real goal of the governance reforms may be to justify the payment of attorneys' fees.

2. State law direct and class claims.

Like derivative suits, state law direct claims invoke fiduciary duty to allege managerial malfeasance, but in the case of direct claims, the harm falls directly upon the shareholder and is not derivative of a primary injury to the corporation.[65] Claims involving shareholder voting rights or acquisitions, in which shares will be cancelled or merged, are paradigmatically direct.[66] Direct claims, especially those involving mergers and acquisitions, are frequently brought on a representative basis as class actions.[67]

Also like derivative suits, shareholder class actions can achieve compensatory, deterrence, or governance objectives. Most merger claims plead a sufficient basis for both monetary and

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bottom."); Westbrook, 73 Ohio St L J at 1229 (cited in note 62) (finding that "few [derivative] suits survive the defendant's motion to dismiss").

64 Even in the absence of a settlement, lawyers may be able to claim that their litigation effort created a "corporate benefit" thereby entitling them to a fee paid by the corporation. See Sean J. Griffith, *Correcting Corporate Benefit: How to Fix Shareholder Litigation by Shifting the Doctrine on Fees*, 56 BC L Rev 1, 22–25 (2015). See also Erickson, *The (Un)changing Derivative Suit* at 64 (cited in note 49) ("The empirical evidence suggests that attorneys are often using derivative suits not to uncover new types of misconduct or to advance new theories of liability, but rather to obtain a share of the attorneys' fees.").

65 See note 44 and accompanying text (distinguishing derivative and direct suits).

66 See *Gatz v Ponsoldt*, 925 A2d 1265, 1277 (Del 2007) (holding the shareholders' claim to be direct "because the Recapitalization constituted an expropriation of voting power and economic value from [the company's] public stockholders, and a transfer of that voting power and economic value to [the defendants]").

67 See Thompson and Thomas, 57 Vand L Rev at 152–56 (cited in note 16) (identifying frequent filings and low-value settlements as key indicia of litigation agency costs).

nonmonetary relief.[68] Nevertheless, the vast majority of such cases are settled for nonpecuniary relief, specifically supplemental disclosures, providing no demonstrable benefit for shareholders.[69] More recently, the pattern has been to end such suits not through settlement, but through the payment of a "mootness fee."[70] In this situation, the defendant issues corrective disclosures, thereby mooting the claim and entitling the defendant to dismissal, but at the same time entitling the plaintiffs' attorney to a fee under the corporate benefit doctrine.[71] The amount of the fee can be adjudicated, but it is more frequently agreed between plaintiffs and the defendant.[72] The virtue of this procedure, from the plaintiffs' perspective, is that it allows the litigants to avoid recent rulings, in Delaware and other jurisdictions, hostile to disclosure settlements.[73] Because the mootness fee is not a class

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68 Merger class actions typically allege that process defects have led to an inadequate deal price, thus creating a basis for damages. Most merger claims also allege defects of disclosure that can be remedied by nonpecuniary relief in the form of corrective disclosures. See, for example, Jill E. Fisch, Sean J. Griffith, and Steven Davidoff Solomon, *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform*, 93 Tex L Rev 557, 572 (2015).

69 Id at 559 ("[Deal litigation] lawsuits rarely result in a monetary recovery for the plaintiff class. Rather, the vast majority end in settlement or dismissal. In most settled cases, the only relief provided . . . consists of supplemental disclosures in the merger proxy statement."), citing Robert M. Daines and Olga Koumrian, *Shareholder Litigation Involving Mergers and Acquisitions* *6 fig 7 (Cornerstone Research, 2013), archived at https://perma.cc/TRL8-QNTK. See also Ann Woolner, Phil Milford, and Rodney Yap, *When Merger Suits Enrich Only Lawyers* (Bloomberg, Feb 16, 2012), archived at https://perma.cc/32HY-A22M.

70 Griffith, 69 Case W Res L Rev at 948 (cited in note 35).

71 As explained by the Delaware Supreme Court:

> Under the "mootness" exception, a court may award attorneys' fees where the fee applicant demonstrates that: (1) the litigation was meritorious when filed, (2) the action rendering the litigation moot produced the same or a similar benefit sought by the litigation, and (3) there was a causal relationship between the litigation and the action taken producing the benefit.

Dover Historical Society, Inc v City of Dover Planning Commission, 902 A2d 1084, 1092 (Del 2006).

72 The mootness award was cited by the Court of Chancery as the preferred method for resolving disclosure-based claims because of the potential for adversarial fee litigation to enable the court to value the benefit on an informed basis. See *In re Trulia, Inc Stockholder Litigation*, 129 A3d 884, 897–98 (Del Chanc 2016) (referring to mootness dismissals as the "preferred scenario," and noting that "[i]n the mootness fee scenario, the parties also have the option to resolve the fee application privately without obtaining Court approval"). Parties have tended to settle fee disputes in order to avoid additional adversarial process. Matthew D. Cain, et al, *The Shifting Tides of Merger Litigation*, 71 Vand L Rev 603, 623 (2018) (finding sharply increasing rates of mootness settlements).

73 The leading case is *Trulia*, 129 A3d at 898:

settlement and is therefore not binding upon absent members of the class, it need not be presented in a fairness hearing.[74] Mootness dismissals thus bypass judicial review, making it easier for lawyers to get paid.[75]

As this discussion suggests, merger class actions exhibit a high degree of litigation agency costs. They are filed automatically in the wake of most deals.[76] They overwhelmingly result in nonpecuniary relief, typically supplemental disclosures. The relief is of no apparent value to shareholders.[77] Yet the attorneys are paid, either for disclosure settlements or mootness fees.[78]

> [P]ractitioners should expect that disclosure settlements are likely to be met with continued disfavor in the future unless the supplemental disclosures address a plainly material misrepresentation or omission, and the subject matter of the proposed release is narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process, if the record shows that such claims have been investigated sufficiently.

Cases in other jurisdictions following *Trulia* include: *In re Walgreen Co Stockholder Litigation*, 832 F3d 718, 725 (7th Cir 2016); Order After Hearing on September 29, 2017, *Bushansky v Alliance Fiber Optics Products, Inc*, No 16-CV-294245, *9 (Cal Sup filed Oct 2, 2017), archived at https://perma.cc/3K3A-Q52R (adopting *Trulia* standard under California law); *Griffith v Quality Distribution, Inc*, 2018 WL 3403537, *7 (Fla App) (adopting *Trulia* standard). See also Statement of Reasons, *Vergiev v Aguero*, No L-2276-15, *6–7 (NJ Super filed June 6, 2016) (*Vergiev* Statement of Reasons), archived at https://perma.cc/5XMM-RZ4X (rejecting settlement and adopting *Trulia*).

74 See William B. Rubenstein, *The Fairness Hearing: Adversarial and Regulatory Approaches*, 53 UCLA L Rev 1435, 1452–67 (2006) (arguing that fairness hearings require a combination of adversarial and regulatory approaches).

75 Mootness settlements require, at most, notice to the class. See, for example, *Swomley v Schlecht*, 2015 WL 1186126, *1–2 (Del Chanc) (setting forth class notice procedure for mootness fee, after defendants mooted certain disclosure claims and successfully moved to dismiss rest of case); *In re Zalicus, Inc Stockholders Litigation*, 2015 WL 226109, *1–2 (Del Chanc) (supporting private mootness fee resolution procedure while requiring that adequate notice be provided to stockholders); *In re Astex Pharmaceuticals, Inc Stockholders Litigation*, 2014 WL 4180342, *1–2 (Del Chanc) (same).

76 By 2009, shareholder claims were brought against close to 90 percent of all third-party mergers, a number that held until 2016. After a brief interlude in the wake of *Trulia*, the percentage of filings has climbed again. Stefan Boettrich and Svetlana Starykh, *Recent Trends in Securities Class Action Litigation: 2018 Full-Year Review* *5–6 (NERA, Jan 29, 2019), archived at https://perma.cc/BWU6-ME72; *Securities Class Action Filings: 2017 Year In Review*, *2, 13 (Cornerstone Research, 2018), archived at https://perma.cc/J24F-7YDT (highlighting the growth in federal class action filings involving mergers and acquisitions post-*Trulia*).

77 Fisch, Griffith, and Solomon, 93 Tex L Rev at 600–01 (cited in note 68).

78 The average plaintiffs' attorney's fee for disclosure settlements had recently been $500,000. Id at 568. For mootness settlements, the recent range seems to be from $50,000 to $450,000, with an average of $185,285. See Exhibit 1 to Response to Order, *Sehrgosha v Kindred Healthcare, Inc*, No 18-0230-RGA (D Del filed Sept 19, 2018).

Again, we are not claiming that merger litigation never achieves meaningful relief for shareholders. There are examples of cases in which merger class actions have resulted in substantial monetary recoveries.[79] And there are other cases in which state-law direct claims have been brought to enjoin defective transaction processes—often involving the preferential treatment of bidders—the result of which has been to open the process to competitive bidding and thus higher deal values for target shareholders.[80] Moreover, such cases may have an ex ante deterrent effect on transaction planners, leading them to structure deals to avoid injunction risk. But the recent history of such claims more closely resembles a mass of nonmeritorious claims of no apparent value to anyone other than the attorneys involved.

3. Appraisal claims.

Shareholder suits for appraisal have a narrower focus than fiduciary duty claims filed as direct or derivative suits. As described by the Delaware Supreme Court: in an appraisal suit, "the only litigable issue is the determination of the value of the appraisal petitioners' shares on the date of the merger, the only party defendant is the surviving corporation and the only relief available is a judgment against the surviving corporation for the fair value of the dissenters' shares."[81] Appraisal suits are also narrow in that not all merger transactions will qualify for the appraisal remedy. In Delaware, for example, appraisal is available in cash deals, but not in transactions where target shareholders receive publicly traded equity in exchange for their shares.[82] Appraisal suits, in other words, serve a narrowly defined compensatory goal—making whole dissenting shareholders who have received less than fair value in a particular type of transaction.

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79 See Joel Edan Friedlander, *How* Rural/Metro *Exposed the Systemic Problem of Disclosure Settlements*, 40 Del J Corp L 877, 905–06 (2016) (compiling a list of fifteen merger cases resolved between 1997 and 2011 in which shareholder plaintiffs recovered a common fund for target shareholders greater than or equal to $40 million).

80 See, for example, *Paramount Communications Inc v QVC Network Inc*, 637 A2d 34, 46–47 (Del 1994); *Mills Acquisition Co v MacMillan, Inc*, 559 A2d 1261, 1284–87 (Del 1989); *Revlon*, 506 A2d at 182–83.

81 *Cede & Co v Technicolor, Inc*, 542 A2d 1182, 1187 (Del 1988).

82 8 Del Code Ann § 262(b). The availability of appraisal to specific transactions varies from state to state. For scholarship debating the purpose underlying various state appraisal statutes, see, for example, Daniel R. Fischel, *The Appraisal Remedy in Corporate Law*, 1983 Am Bar Found Rsrch J 875, 877–84; Hideki Kanda and Saul Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L Rev 429, 434–61 (1985).

Appraisal claims are also distinguishable from other forms of shareholder litigation because they cannot be brought as class or derivative actions.[83] They appear to be nonrepresentative. On closer inspection, however, this distinction breaks down.[84] Appraisal actions contain procedures for connecting dissenters and ultimately coordinating their efforts under a single lead counsel with fiduciary duties to represent the interests of dissenting shareholders as a class.[85] However, unlike class actions, there is no mechanism by which lead counsel can force all dissenting shareholders into a settlement. Settlements in appraisal actions must be presented to all dissenters, each of whom has the option of participating in the settlement or intervening to continue the proceeding.[86] Also unlike class actions, there is no shifting of attorneys' fees to the defendant.[87] Appraisal petitioners pay their own attorneys' fees and bear their own litigation costs, apportioning them among dissenters, but generally not shifting them to the corporation itself.[88] This distinction has important implications for the question of litigation agency costs, suggesting that appraisal actions are likely to be pursued only when the claimants determine that the benefits of an action exceed its costs, in

83 Ronald J. Gilson and Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U Pa L Rev 785, 799 (2003), citing 8 Del Code Ann § 262(a) (noting that "the Delaware corporate statute does not authorize a class appraisal procedure").

84 See generally Minor Myers, *Appraisal as Representative Litigation*, in Griffith, et al, eds, *Research Handbook on Representative Shareholder Litigation* 254, 254–68 (cited in note 27) (examining the ways in which appraisal actions may be seen as a form of representative litigation).

85 Id at 256–58 (describing procedures for consolidating appraisal actions and compiling cases).

86 See *Edgerly v Hechinger*, 1998 WL 671241, *4 (Del Chanc) (noting that nonsettling petitions must be "given notice . . . and an opportunity to intervene" to continue to press the appraisal proceeding); *Raynor v LTV Aerospace Corp*, 317 A2d 43, 47 (Del Chanc 1974) (holding that "dissenting stockholders shall be entitled to participate equally with the plaintiffs in any settlement of this consolidated appraisal action").

87 See, for example, *M.G. Bancorporation, Inc v Le Beau*, 737 A2d 513, 527 (Del 1999) (stating that appraisal petitioners "'should bear the burden of paying [their] own expert witnesses and attorneys,' unless some equitable exception applies"), quoting *Technicolor*, 684 A2d at 301.

88 See, for example, 8 Del Code Ann § 262(j):

> Upon application of a stockholder, the Court may order all or a portion of the expenses incurred by any stockholder in connection with the appraisal proceeding, including, without limitation, reasonable attorney's fees and the fees and expenses of experts, to be charged pro rata against the value of all the shares entitled to an appraisal.

contrast to class actions and derivative suits that may be pursued for attorneys' fees irrespective of the benefit to the putative class.[89]

Recent empirical studies support the notion that litigation agency costs are lower in appraisal actions than they are for class action merger litigation. Professors Charles Korsmo and Minor Myers have found that while class action merger litigation is strongly associated with nonmerit factors, such as deal size, appraisal claims are related to legally relevant criteria, including abnormally low deal premiums and insider participation in the transaction.[90] Recent work by other researchers has confirmed these findings.[91] Moreover, the availability of appraisal seems to improve rather than impair the operation of the merger market. Professors Audra Boone, Brian Broughman, and Antonio Macias find a correlation between stronger appraisal rights and higher acquisition premiums, and they find no evidence that acquirers hold back deal value to deal with the risk of appraisal.[92] The risk of an appraisal proceeding ex post appears to incentivize transaction planners to implement auction-based transaction structures ex ante, providing a potential benefit to all target shareholders in

89 See Myers, *Appraisal as Representative Litigation* at 262 (cited in note 84) ("The fee award [in class actions] is crucial to the operation of the liability system. By contrast, in appraisal, the stockholder is making a decision to dissent after taking into account the costs of the proceeding.").

90 See Charles R. Korsmo and Minor Myers, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 Wash U L Rev 1551, 1585, 1603 (2015), citing Charles R. Korsmo and Minor Myers, *The Structure of Stockholder Litigation: When Do the Merits Matter?*, 75 Ohio St L J 829, 874 (2014). See also Korsmo and Myers, 75 Ohio St L J at 847–48 (cited in note 90).

91 See Wei Jiang, et al, *Appraisal: Shareholder Remedy or Litigation Arbitrage?*, 59 J L & Econ 697, 727 (2016) (stating that "petitioners seem to target deals with characteristics that are most likely to be tainted by conflicts of interest, such as going-private deals, minority squeeze outs, and short-form M&A with low premiums"). See also Jonathan Kalodimos and Clark Lundberg, *Shareholder Rights in Mergers and Acquisitions: Are Appraisal Rights Being Abused?*, 22 Fin Rsrch Let 53, 54–57 (2017) (confirming that lower premiums are more likely to lead to appraisal actions).

92 See Audra Boone, Brian Broughman, and Antonio J. Macias, *Merger Negotiations in the Shadow of Judicial Appraisal*, 62 J L & Econ 281, 283 (2019) (finding that "Delaware targets receive higher acquisition premiums . . . following events that strengthen the appraisal remedy"). The authors also find that the bidding of appraisal arbitrageurs post-announcement effectively eliminates the post-announcement spread, enabling shareholders to obtain the deal price without having to wait for the transaction to close. See id at 303–04.

the form of a higher merger price.[93] These results have also been confirmed by other researchers.[94]

In this way, although appraisal actions are designed to accomplish a narrower compensatory end than class action merger litigation, they may ultimately have a greater effect on the target managers than fiduciary duty lawsuits. If this is so, it is likely because appraisal actions involve engaged plaintiffs—often specialized hedge funds—who bear their own litigation costs and therefore have incentives to pursue claims only when the monetary benefit exceeds the cost of litigation.[95] Appraisal claims, in other words, succeed when merger class actions fail because they control litigation agency costs.

4. Private securities litigation.

Finally, shareholders may bring private securities claims. Although they involve a variety of potential causes of action and a variety of potential defendants,[96] their essential basis is misinformation—fraud, misstatements, or omissions—provided in connection with transactions in corporate securities.[97] Securities claims based on misinformation may seem distinct from corporate law claims based on misconduct, but there is an essential link between the two. When corporate managers engage in misconduct, they typically also conceal it. These misstatements or omissions

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93 Id at 284 (summarizing their findings as suggesting that "bidders protect themselves against threat of appraisal, not through contractual terms that would allow a bidder to walk away from the deal . . . but rather by increasing their up-front bids and improving the price-setting process").

94 See Scott Callahan, Darius Palia, and Eric Talley, *Appraisal Arbitrage and Shareholder Value*, 3 J L Fin & Acct 147, 181–82 (2018).

95 On the role of appraisal arbitrage hedge funds, see Korsmo and Myers, 92 Wash U L Rev at 1573 n 85 (cited in note 90).

96 For example, private securities litigation may be brought under § 11 of the Securities Act for misstatements or omissions made in a registration statement, 15 USC § 77k(a); under § 12(a)(1) of the Securities Act for violations of the offering process, 15 USC § 77*l*(a)(1); under § 12(a)(2) of the Securities Act for misstatements and omissions made in the prospectus, 15 USC § 77*l*(a)(2); and under § 10(b) of the Exchange Act for misstatements and omissions made in securities transactions generally, 15 USC § 78j(b). Potential defendants include the corporate issuers, responsible officers and directors, accountants, lawyers, and underwriters. These are statutorily defined under some causes of action. See, for example, 15 USC § 77k. But the same defendants are potentially vulnerable under other causes of action as well, often as aiders and abettors of the primary violation. See, for example, *Stoneridge Investment Partners, LLC v Scientific-Atlanta, Inc*, 552 US 148, 158 (2008).

97 See Louis Loss, Joel Seligman, and Troy Paredes, 1 *Securities Regulation* 4–8, 304–14 (Wolters Kluwer 6th ed 2019).

thus transform what might otherwise be only a state-law derivative or direct claim into a federal securities claim, making securities claims a catchall means of targeting managerial misconduct.[98]

Private securities litigation can be brought in class action form, and securities class actions make up nearly half of all class actions filed in federal courts.[99] The quintessential securities class action is the 10b-5 claim, alleging a material misrepresentation (or omission) in connection with the purchase or sale of securities.[100] Pleaded as a "fraud on the market" claim, which encompasses all trading in a company's shares prior to the correction of a public misstatement, 10b-5 can reach effectively all forms of corporate misconduct.[101] As a result, securities filings alleging violations of Rule 10b-5 predominate other forms of private securities litigation, typically at a rate of more than ten to one.[102]

98 See Robert B. Thompson and Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 Vand L Rev 859, 861 (2003) (arguing that outside of the contexts of self-dealing and acquisitions, "corporate governance . . . has passed to federal law and in particular to shareholder litigation under Rule 10b-5"). For a lighter take on the same point, see Matt Levine, *Everything Everywhere Is Securities Fraud* (Bloomberg, June 26, 2019), archived at https://perma.cc/F5BP-TM9B.

99 John C. Coffee Jr, *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum L Rev 1534, 1539 (2006) (showing that at least 47 percent of all class actions pending between 2002 and 2004 were securities actions).

100 Rule 10b-5 under the Securities Exchange Act of 1934 makes it unlawful, among other things, to "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security." 17 CFR § 240.10b-5. A private right of action does not exist in rule or statute but was judicially created first in 1946 and finally blessed by the US Supreme Court in 1971. See *Superintendent of Insurance v Bankers Life & Casualty Co*, 404 US 6, 13 n 9 (1971); *Kardon v National Gypsum Co*, 69 F Supp 512, 513–14 (ED Pa 1946) (recognizing a private right of action under Rule 10b-5).

101 Levine, *Everything Everywhere Is Securities Fraud* (cited in note 98) (compiling disparate examples of corporate misconduct pleaded as securities fraud class actions). The fraud on the market claim, like the private right of action, is a judicial creation. See *Halliburton Co v Erica P. John Fund, Inc*, 573 US 258, 274–77 (2014) (recognizing the fraud on the market class action as established precedent); *Basic Inc v Levinson*, 485 US 224, 241–42 (1988), quoting *Peil v Speiser*, 806 F2d 1154, 1160–61 (3d Cir 1986) (creating the fraud on the market class action).

102 Boettrich and Starykh, *Recent Trends in Securities Class Action Litigation* at *5 (cited in note 76); *Securities Class Action Filings* at *9 fig 8 (cited in note 76). The exception to this claim is the recent proliferation of securities class actions under Rule 14a, alleging defective disclosures in connection with M&A transactions. After years of amounting to no more than a small minority of all securities claims, merger objection suits increased sharply in 2016 and in 2017 outnumbered even 10b-5 claims. See Boettrich and Starykh, *Recent Trends in Securities Class Action Litigation* at *5 (cited in note 76) (reporting 204 merger objection cases in 2017 compared to 193 10b-5 filings). See also *Securities Class*

Furthermore, recoveries in securities class actions vastly exceed typical recoveries under state fiduciary duty claims. Average securities settlements are in the tens of millions of dollars. In 2017, for example, the average securities class action settlement was $25 million, down from $73 million in 2016.[103] Fiduciary duty suits, recall, most often result in no money at all (except for the lawyers).[104]

Given their ability, properly pleaded, to reach most forms of corporate misconduct and their greater potential to result in meaningful monetary recoveries, private securities claims would seem to promise generally greater potential to control managerial agency costs than state fiduciary duty claims. Nevertheless, there are considerable indicia of litigation agency costs in securities cases as well. As in the case of merger class actions, corporate defendants fund the full cost of all claims that are not dismissed, paying not only the settlement amount but also the plaintiffs' attorneys' fees.[105] Furthermore, there are strong pressures on both sides to settle,[106] which securities class action claims typically do, often for "pennies on the dollar"—that is, a few cents in settlement proceeds for every dollar claimed in investor loss.[107] The fact that recoveries are a small portion of claimed damages is often used to claim that securities class actions do not achieve their compensatory objectives.[108]

Action Filings at *9 fig 8 (cited in 76). This is a direct result of the migration of merger objection suits to federal court in the wake of Delaware's crackdown on disclosure-only settlements. See Sean J. Griffith, *Private Ordering Post-*Trulia*: Why No Pay Provisions Can Fix the Deal Tax and Forum Selection Provisions Can't*, in Steven D. Solomon and Randall S. Thomas, eds, *The Corporate Contract in Changing Times* 292, 293 (Chicago 2019).

103 See Boettrich and Starykh, *Recent Trends in Securities Class Action Litigation* at *28 (cited in note 76). These averages are strongly influenced by a small number of very large settlements. Median settlements were $6 million in 2017 and $9 million in 2016. Id at *30.

104 See Parts I.B.1–2.

105 See 15 USC § 78u-4(a)(4) (allowing awards of costs and fees in private securities litigation).

106 Amanda M. Rose, *The "Reasonable Investor" of Federal Securities Law: Insights from Tort Law's "Reasonable Person" & Suggested Reforms*, 43 J Corp L 77, 81, 85–86, 93–94 (2017) (emphasizing defendants' incentives to settle even weak cases given the unpredictability of juries combined with the uncertainty of certain liability elements).

107 See Boettrich and Starykh, *Recent Trends in Securities Class Action Litigation* at *34–35 (cited in note 76).

108 See, for example, Elizabeth Chamblee Burch, *Reassessing Damages in Securities Fraud Class Actions*, 66 Md L Rev 348, 371–73 (2007).

The more profound objection to the compensation rationale, however, is that given that it is the corporation that pays, it is the shareholders themselves that fund their own settlements.[109] This "circularity" critique of the compensation rationale operates on two levels simultaneously.[110] Not only will some portion of the class—those who do not sell out of the company entirely—fund the class recovery in the lawsuit itself,[111] but also diversified shareholders—because they are as likely to be buyers as they are to be sellers—will fund the vast majority of such recoveries across their portfolio over time.[112] Shareholders will, in other words, be paying themselves.[113] Were it not for the amounts they must also pay plaintiffs' and defense counsel, the result would be more or less a wash.[114] Given those amounts, however, shareholders' compensatory goals are unlikely to be well served through class action securities litigation.

But securities litigation may still serve deterrence goals. The securities class action may have a role to play in forcing managers to internalize the costs of their own misconduct.[115] Managers who fear personal liability, of course, may hesitate to engage in misconduct. However, in this context it is worth noting that personal

109 See Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 Ariz L Rev 639, 648–49 (1996); Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 Colum L Rev 1301, 1323 & n 101 (2008).

110 See Rose, *Shifting Raison d'Être* at 47 (cited in note 27) (explaining that the "circularity exists at the micro and macro level").

111 See James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 Ariz L Rev 497, 509–10 (1997).

112 See Coffee, 106 Colum L Rev at 1546–47 & n 42 (cited in note 99).

113 The circularity critique is not limited to securities class actions and may apply to state-law claims, especially derivative suits as well. Indeed, concerns about circularity explain why state law forbids corporations from indemnifying directors and officers for amounts paid to resolve derivative suits. In such a case indemnification would essentially amount to a payment from the corporation to the manager to pay back an amount paid by the manager to the corporation. But state law does allow such settlements to be insured, and as a result, corporations fund their settlements largely through proceeds. See text accompanying notes 50–51.

114 See Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 Va L Rev 623, 668–69 (1992).

115 The scholarly literature suggests, however, that damages calculations may be miscalibrated for serving this end. See, for example, Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 Stan L Rev 1487, 1493–500 (1996); Frank H. Easterbrook and Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U Chi L Rev 611, 635, 642–44 (1985).

liability in private securities litigation is vanishingly rare.[116] Managers are typically indemnified by the corporation for any personal liabilities arising in connection from securities suits, and corporations are typically insured under a D&O policy not only for their indemnification obligations to manager-defendants but also for any liabilities arising from having been named as a codefendant in the suit.[117] As a result, any deterrent effect of securities class actions depends entirely upon the D&O insurer, and studies show that although insurers seek to distinguish between good and bad insurance risks, there is not necessarily a large marginal difference between the premiums paid by well-governed firms, on the one hand, and poorly governed firms, on the other.[118] If this is so, the effect of insurance is to substantially weaken the deterrence potential of securities class actions.[119]

II. MUTUAL FUND PLAINTIFFS

Mutual funds, as already noted, hold approximately one-third of the US equity market and, as such, are positioned to play a major role in corporate governance.[120] Governance power accrues to the mutual fund family—the larger entity that organizes and sells interests in funds—under their contracts with investors. Take, as an example, an equity mutual fund offered by Fidelity Investments, an asset manager that manages a large family of mutual funds. Fidelity first assembles the fund's portfolio by purchasing securities and then sells fund shares to investors. Fidelity will also utilize an investment adviser (which is usually a related entity) to oversee the day-to-day operations of the mutual fund.[121]

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116 Black, Cheffins, and Klausner, 162 J Inst & Theoretical Econ at 9–10 (cited in note 52).

117 Tom Baker and Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 Georgetown L J 1795, 1802 (2007) (distinguishing between Side B coverage for corporate indemnification obligations and Side C coverage for corporate liabilities as a named defendant).

118 Consider Tom Baker and Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, 74 U Chi L Rev 487, 534 (2007).

119 For an analysis finding a similar conclusion, see Coffee, 106 Colum L Rev at 1536 (cited in note 99) ("[C]ompensation [is] unobtainable and deterrence [is] deeply compromised by a variety of inconsistent legal doctrines that pull the punch of private enforcement.").

120 See text accompanying notes 3–5.

121 See William A. Birdthistle, *Empire of the Fund: The Way We Save Now* 45–49 (Oxford 2016); John Morley and Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 Yale L J 84, 91–96 (2010).

Pursuant to the investment contract, the right to cast the portfolio's shareholder votes, as well as bring shareholder suits, is held by the investment adviser.[122]

When it comes to shareholder voting, most of the large mutual fund families require the investment adviser to follow the recommendation of the fund family's corporate governance group.[123] But what about litigation? How and when do mutual funds pursue shareholder litigation? How does the conduct of mutual funds in shareholder litigation compare to other institutional intermediaries, such as pension and hedge funds? And how does it compare to the efforts of individual shareholder plaintiffs? These are empirical questions, and the sections that follow endeavor to answer them empirically.

A. Mutual Fund Participation in Shareholder Litigation

In order to develop data on whether and how mutual funds engage in shareholder litigation, we searched court dockets for shareholder litigation involving the largest mutual funds. We ran our docket searches in Bloomberg Law, an online service that collects docket information from all federal courts as well as prominent state courts. We searched within the Bloomberg Law database of all federal district court dockets because securities claims are typically filed in federal district courts, and we searched within the Delaware Court of Chancery dockets because much

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122 See *Form of Investment Advisory Agreement* ¶ 4 (Law Insider, July 25, 2014), archived at https://perma.cc/H84B-PFTE (providing that the fund's investment adviser "may vote, exercise consents and exercise all other rights appertaining to such securities and other assets on behalf of the Fund"). See also Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies: Final Rule, 68 Fed Reg 6564, 6565 (2003), codified at 17 CFR §§ 239, 249, 270, 274 (describing how mutual funds are the beneficial owner of the fund's securities, and thus the votes accrue to the investment adviser); Jonathan D. Glater, *Suits Contend Mutual Funds Fail to Collect in Settlements* (NY Times, Jan 19, 2005), archived at https://perma.cc/YG6F-9JE3:

> Individual investors in mutual funds may not file a claim for a piece of the pie from a settlement with a company whose shares the fund owns. The mutual fund owns the shares on behalf of those investors, and so the right to file a claim belongs to the fund.

Types of Investors (Broadridge), archived at https://perma.cc/QK4M-MMGR ("Mutual fund managers vote on behalf of all of their customers, and, as an individual investor with a limited number of shares, you can't influence how the fund votes."). A small fraction of institutional investors that invest in mutual funds retain their governance rights. See notes 248–51 and accompanying text.

123 See Bioy, et al, *Passive Fund Providers* at *22 (cited in note 8); Griffith and Lund, 99 BU L Rev at 1170–71 (cited in note 14).

corporate fiduciary duty and appraisal litigation is brought in that court.

We limited our searches to the litigation activity of the ten largest mutual funds over a ten-year period: January 2009 through year-end 2018. We ranked the largest mutual fund families by the amount of assets under management invested in equity strategies.[124] Because we are interested in shareholder litigation, we sought to capture the litigation activity of the asset managers with the largest equity shareholdings; however, this meant that certain large asset managers that primarily offer bond funds, such as PIMCO, did not make our top-ten list. We searched under various permutations of the names of the following ten mutual fund companies: Vanguard, BlackRock, State Street, Fidelity, Capital Group, T. Rowe Price, Dimensional Fund Advisors, BNY Mellon Investment Management, JP Morgan Asset Management, and Invesco. As summarized in Table 1, below, the combined assets under management of these ten mutual fund companies is a staggering $24 trillion.

124 We collected this information from annual and quarterly reports whenever possible. For the asset managers that did not report this figure, we were often able to estimate it by summing the amount of assets in different funds (and we assumed that multi-asset funds were composed of 60 percent equities and 40 percent bonds). Some asset managers did not report even that information, and in those cases, we contacted the asset managers directly.

TABLE 1: THE TOP 10 US ASSET MANAGERS
BY EQUITY ASSETS UNDER MANAGEMENT (AUM)
DECEMBER 2018

Asset Manager	**Equity AUM ($ billion)**	**Total AUM ($ billion)**
Vanguard	3,200	5,200
BlackRock	3,030	5,980
State Street	1,544	2,500
Fidelity	1,337	2,530
Capital Group	1,113	1,462
T. Rowe Price	539	962
BNY Mellon Investment Management	415	1,700
Dimensional Fund Advisors	395	576
JP Morgan Asset Management	384	1,980
Invesco	381	888

By searching under various name permutations, we hoped to capture instances in which a fund family might use alternative business names as well as situations in which lawsuits are brought by individual funds rather than the entity itself—the BlackRock Global Allocation Fund, for example, rather than BlackRock Advisors. Likewise, by searching for the fund name in any party capacity, we sought to capture litigation in which the funds participated without necessarily serving as lead plaintiff. After weeding out unrelated suits—predominantly contract and employment claims—we were left with a total of nineteen suits involving these funds *as investors*.

TABLE 2: PARTICIPATION OF MUTUAL FUNDS IN SHAREHOLDER SUITS 2009–2018

Asset Manager	Shareholder Suits	Traditional Shareholder Suits
Vanguard	2	2
BlackRock	9	4
State Street	1	1
Fidelity	0	0
Capital Group	0	0
T. Rowe Price	4	3
BNY Mellon Investment Management	0	0
Dimensional Fund Advisors	2	1
JP Morgan Asset Management	1	0
Invesco	0	0
Total	**19**	**11**

Table 2 summarizes the total number of shareholder complaints filed by our group of mutual funds over a ten-year period. The first column includes all shareholder complaints filed by the relevant funds. However, many of these cases included in the column are *not* traditional shareholder suits. For example, BlackRock brought several cases alleging misconduct in connection with the sale of residential mortgage-backed securities (RMBS) in which the funds had invested. Although these cases were brought as derivative suits against the banks as trustees and also contained federal securities law allegations, they are not traditional shareholder suits brought against a corporation or its managers.[125] There are five such RMBS cases in the table. Excluding them reduces the total number of claims brought by BlackRock to four.

125 As defined above, a traditional securities suit involves an investor suing a corporate issuer for misconduct or misinformation. See text accompanying note 97. In the RMBS suits, investors sued the banks that packaged and securitized their mortgage loans. Because these suits do not involve a corporate issuer as the defendant, we treat them as distinct from traditional shareholder suits.

Furthermore, many of the cases in the table were brought by different funds against the same defendants. Three funds (Dimensional, State Street, and Vanguard) brought 10b-5 cases against Petrobras.[126] Two funds (BlackRock and T. Rowe Price) brought 10b-5 cases against Countrywide. Two funds (BlackRock and Vanguard) brought 10b-5 cases against American Realty/ VEREIT. Two funds (BlackRock and T. Rowe Price) brought 10b-5 cases against Valeant. Interestingly, BlackRock is also named as a plaintiff along with one other fund, T. Rowe Price, in an earlier class action complaint against Valeant. Finally, our docket search found a single appraisal action, the infamous Dell appraisal case in which T. Rowe Price petitioned for appraisal in Michael Dell's management buyout but ultimately failed to perfect its appraisal rights due to an administrative error.[127]

In sum, over a ten-year period, the largest mutual funds in the United States, in whom the management of trillions of dollars of investor wealth is entrusted, brought only eleven traditional shareholder suits, based on only six different episodes of managerial misconduct.[128] All but one of these claims allege violations of Rule 10b-5 of the federal securities laws. Although we did find examples of contract litigation in state courts, apart from T. Rowe Price's appraisal claim in Dell, we found not a single claim, derivative or direct, brought under state corporate law. Furthermore, the vast majority of claims in our sample are not representative actions. The only class actions in the table above are complaints filed against Petrobras and Valeant, and in each of those cases, the funds involved later filed their own complaints.[129] In no cases did these mutual funds serve as lead plaintiffs. When the funds

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126 Dimensional is also named in an earlier securities action against Petrobras. See Individual Plaintiffs' Joint Memorandum of Law In Opposition to Defendants' Motion to Dismiss the Individual Action Complaints, *In re Petrobras Securities Litigation*, No 14-cv-09662 (JSR), *1 (SDNY filed Sept 18, 2015).

127 See *In re Appraisal of Dell, Inc*, 2015 Del Ch LEXIS 184, *1 & n 1. We discuss this case in more detail below. See text accompanying notes 193–97.

128 There were, in other words, only five defendants. The cases we found include the same set of allegations filed more than once against Countrywide, Petrobras, Valeant, and VEREIT.

129 Dimensional filed a separate action after being named in the class action against Petrobras, and BlackRock filed a separate action after being named in the class action against Valeant. See Parts II.A.2 and II.A.5. Likewise, T. Rowe Price filed a separate complaint in the Valeant class action. See Michael Rapoport, *T. Rowe Price Sues Valeant, Alleging 'Fraudulent Scheme'* (Wall St J, Aug 18, 2016), online at https://www.wsj.com/articles/t-rowe-price-sues-valeant-alleging-fraudulent-scheme-1471532680 (visited Feb 24, 2020) (Perma archive unavailable).

in our sample chose to litigate, they opted out of the class and pursued the claims on their own.

In the sections that follow, we describe the basic facts and procedural history underlying the five 10b-5 lawsuits we found in our sample. These cases demonstrate at a minimum that mutual funds could participate actively in shareholder litigation if they chose to do so. The puzzle remains as to why they do so little of it.

1. Countrywide.

In the wake of the 2008 financial crisis, the beleaguered mortgage issuer Countrywide Financial faced litigation from dozens of plaintiffs, which eventually included three mutual fund families. The vast majority of Countrywide's earnings had come from its mortgage-related operations, which included originating, purchasing, servicing, and investing in mortgages.[130] During the years leading up to the financial crisis, Countrywide had lowered its mortgage underwriting standards significantly and shifted into risky products without disclosing these business practice modifications to investors.[131] Accordingly, when the crisis hit, Countrywide posted massive losses and was hastily sold to Bank of America in early 2008.[132] But even before the company was sold, in August 2007, investors brought a class action suit against Countrywide in the United States District Court for the Central District of California alleging securities law violations for false and misleading statements and omissions regarding its lending standards and the quality of its loans.[133] The consolidated complaint was 416 pages and contained 21 claims of securities fraud against 50 defendants.[134]

Bank of America settled the class action suit in May 2010 for $624 million.[135] But thirty-three investors, including BlackRock and T. Rowe Price, were unhappy with the settlement and opted

130 *In re Countrywide Financial Corp Securities Litigation*, 588 F Supp 2d 1132, 1144 (CD Cal 2008).

131 Id at 1145–46, 1150, 1153–54.

132 See Laurie Kulikowski, *Countrywide Losses Mount* (TheStreet, Jan 29, 2008), archived at https://perma.cc/WVP4-WA7V (reporting that Countrywide reported losses of $704 million in 2007); Gretchen Morgenson and Eric Dash, *Bank of America to Buy Countrywide* (NY Times, Jan 11, 2008), archived at https://perma.cc/TA8B-3S5L.

133 *Countrywide*, 588 F Supp 2d at 1145–50.

134 Id at 1142.

135 Jonathan Stempel, *BofA's Countrywide in $624 Million Lawsuit Settlement* (Reuters, May 7, 2010), archived at https://perma.cc/S9YF-LA3Y.

out so that they could file their own lawsuit.[136] By July 2011, these mutual fund families joined a group of thirteen investors in order to sue Bank of America and Countrywide in district court, again pursuing securities fraud claims arising out of Countrywide's mortgage lending practices.[137] Those claims were settled confidentially in November 2011.[138]

2. Petrobras.

Once the fifth-largest company in the world by market capitalization, Brazilian oil and gas giant Petrobras suffered a fall from grace (and a precipitous stock price decline) after the Brazilian government uncovered a complex corruption scheme in 2015.[139] In 2010, Petrobras began expanding its production capacity by acquiring and constructing new facilities. But rampant corruption and bribery within Petrobras led the company to substantially overpay for these projects.[140] After the government investigation uncovered details of the corruption scheme, which involved thousands of employees and cost the company at least $28 billion,[141] Petrobras's stock price declined precipitously. By March 2015, the company's common stock price had fallen by 80 percent.[142]

By January 2015, Petrobras investors began filing suits under § 10(b) of the Exchange Act in the Southern District of New York.[143] The plaintiffs alleged that the company's financial

[136] David Benoit, *Calpers, BlackRock, Others Reject $600M Countrywide Settlement* (American Banker, Feb 28, 2011), online at https://www.americanbanker.com/news/calpers-blackrock-others-reject-600m-countrywide-settlement (visited Feb 24, 2020) (Perma archive unavailable). This forced the class action settlement to include a provision that would allow Countrywide to set aside $22.5 million of the original amount to pay the investors who rejected the agreement. Id.

[137] Barry B. Burr, *Investors Sue Bank of America, Countrywide* (Pensions & Investments, July 29, 2011), archived at https://perma.cc/XAB9-UP5W.

[138] Evan Weinberger, *BofA Reaches Deal with Countrywide Settlement Holdouts* (Law360, Nov 22, 2011), online at https://www.law360.com/articles/288007/bofa-reaches-deal-with-countrywide-settlement-holdouts (visited Feb 24, 2020) (Perma archive unavailable).

[139] See *In re Petrobras Securities Litigation*, 116 F Supp 3d 368, 373–74 (SDNY 2015). See also Zack Beauchamp, *Brazil's Petrobras Scandal, Explained* (Vox, Mar 18, 2016), archived at https://perma.cc/563F-RELP.

[140] See *Petrobras*, 116 F Supp 3d at 374.

[141] Beagan Wilcox Volz, *More Fund Managers Sue Scandal-Hit Petrobras* (Fin Times, Oct 24, 2015), archived at https://perma.cc/BX69-JNWF).

[142] *Petrobras*, 116 F Supp 3d at 375.

[143] Id at 375–76.

statements were false and misleading because recorded payments were inflated due to large bribes and overcharges. The plaintiffs also alleged that the company made false and misleading statements about the integrity of the company's management and the effectiveness of its compliance program.[144]

In February 2015, the court consolidated the claims against Petrobras and appointed Universities Superannuation Scheme Ltd, a UK pension scheme for university employees, as the lead plaintiff.[145] But in the subsequent months, mutual funds began to file their own actions. By September 2015, mutual funds owned by Vanguard, Dimensional, State Street, and at least ten other fund families had all sued Petrobras, alleging § 10(b) violations.[146] These funds declined to join the consolidated class action, and instead opted to pursue their own claims. The sheer number of opt-out plaintiffs, as well as their size and importance, led one observer to call Petrobras "the watershed case for opt-out plaintiffs."[147]

By opting out, the mutual funds received several benefits. For one, they settled their claims and were paid much more quickly than the class action plaintiffs: Dimensional and State Street settled their lawsuits in November 2016,[148] as did Vanguard in June 2017.[149] Pursuant to the settlements, the funds recovered "hundreds of millions of dollars in direct settlement payments."[150] By contrast, the class action settlement was not announced until January 2018, and claimants will have to wait years for the settlement administration process to take place before their claims are paid. And although the terms of the direct settlements are confidential, the mutual funds likely did better than they would have under the class action settlement, under which a $2.95 billion payment is expected to result in only $1.33 per

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144 See id at 375.

145 Id at 373.

146 Beagan Wilcox Volz, *Lord Abbett, Russell Funds Join Line of Petrobras Plaintiffs* (Ignites, Sept 30, 2015), archived at https://perma.cc/TQS4-95VV.

147 Volz, *More Fund Managers Sue Scandal-Hit Petrobras* (cited note in 141).

148 *Petrobras Reaches Agreement with Investors to Settle Eleven Individual Securities Actions in the United States* (Petrobras, Nov 23, 2016), archived at https://perma.cc/BKX9-XUYF.

149 Paul Kiernan, *Brazil's Petrobras Settles Lawsuit with Shareholder Vanguard* (Wall St J, June 19, 2017), online at https://www.wsj.com/articles/brazils-petrobras-settles-shareholder-lawsuit-with-vanguard-1497909907 (visited Apr 18, 2020) (Perma archive unavailable).

150 Marissa Parker and Joseph T. Kelleher, *Funds as Plaintiffs: A New Set of Questions* (Mondaq, Apr 24, 2018), archived at https://perma.cc/634L-U242.

share.[151] For Vanguard, which as of September 2018 had only 5,483,191 Petrobras shares, that would have meant an expected recovery of approximately $7.29 million.[152] Further supporting that conclusion is the fact that Petrobras raised the financial provision allocated for shareholder settlements from $372 to $445 million after the announcement of the settlement with Vanguard.[153]

3. American Realty/VEREIT.

Before 2014, American Realty Capital Properties was known for managing a $30 billion real estate portfolio that included hundreds of Red Lobster locations and a large portfolio of single-tenant homes.[154] In October 2014, the real estate investment trust admitted to the SEC that it overstated income from its operations. Correcting the error "erased roughly a third of [American Realty's] value at the time."[155] On the same day as the announcement, three American Realty executives—including the CEO and COO—stepped down.[156] By October, the FBI had opened a criminal probe,[157] which ultimately led to an eighteen-month prison sentence for the REIT's CFO.[158]

In the wake of the scandal, the company rebranded as VEREIT and replaced its board. But this did not deter plaintiffs from filing multiple class action complaints in the United States District Court for the Southern District of New York in January

151 Exhibit I-B-1 to Declaration of Jeremy A. Lieberman in Support of Plaintiffs' Unopposed Motion for Preliminary Approval of Class Action Settlement, *In re Petrobras Securities Litigation*, No 14-cv-9662 (JSR), *3–4 (SDNY filed Feb 1, 2018). See also Brendan Pierson, *Petrobras to Pay $2.95 Billion to Settle U.S. Corruption Lawsuit* (Reuters, Jan 3, 2018), archived at https://perma.cc/5ZZH-BS2K (reporting that the settlement was smaller than many analysts expected).

152 *Form 13F* (Vanguard Group, Sept 30, 2018), archived at https://perma.cc/QM74-L6UE.

153 Kiernan, *Brazil's Petrobras Settles Lawsuit* (cited in note 149).

154 Chris Matthews, *Accounting Scandal at American Realty Capital Claims More Victims* (Fortune, Dec 15, 2014), archived at https://perma.cc/BQ9F-J2XT.

155 Id.

156 See id.

157 Emily Flitter, *Exclusive: American Realty Capital Facing Criminal Probe over Accounting* (Reuters, Oct 31, 2014), archived at https://perma.cc/5A2G-8XZ5.

158 Christian Bautista, *VEREIT Pays $85M to Settle Accounting Scandal Class-Action Suits* (Real Deal, Oct 2, 2018), archived at https://perma.cc/LYJ4-X2KE. The sentence was eventually reduced to a $160,000 fine and a lifetime ban from the securities industry. Id.

2015.[159] The plaintiffs alleged that the REIT violated federal securities laws by making false and misleading statements, by misrepresenting the company's business prospects, and by engaging in fraud.[160] The complaints were consolidated and the TIAA-CREF was named lead plaintiff.[161] However, BlackRock maintained a separate securities action in the SDNY.[162] One other fund family—Vanguard, which had a 13 percent stake in the REIT[163] and had alleged that its investors had "lost billions" due to the fraud[164]—filed a separate securities fraud complaint in the United States District Court for the District of Arizona.[165]

The class action continues, but the mutual funds have since settled their suits. In June 2018, VEREIT announced that it had settled the Vanguard litigation for $90 million.[166] A few months later, in October 2018, VEREIT settled with BlackRock and six other funds that together held 11 percent of the REIT for $85 million.[167] In September 2019, the class action announced a billion-dollar settlement, pending judicial approval and the claims administration process.[168]

4. Tyco.

In a notorious example of corporate greed, Tyco CEO Dennis Kozlowski, along with the company's CFO, looted hundreds of

159 *In re American Realty Capital Properties Inc. Litigation* (Cohen Milstein), archived at https://perma.cc/4FWJ-7LEN.

160 See Third Amended Class Action Complaint for Violations of the Federal Securities Laws, *In re American Realty Capital Properties, Inc Litigation*, No 1:15-mc-00040-AKH, *19, 31, 75 (SDNY filed Sept 30, 2016) (*American Realty* Third Amended Class Action Complaint). See also *In re American Realty* (cited in note 159).

161 *American Realty* Third Amended Class Action Complaint at *2 (cited in note 160).

162 See Letter, Scott A. Edelman to Judge Alvin K. Hellerstein, *In re American Realty Capital Properties, Inc Litigation*, No 15-mc-00040-AKH, *1 (SDNY filed Oct 10, 2018).

163 Bruce Kelly, *Former Schorsch REIT Reaches $90 Million Settlement with Vanguard* (Pensions & Investments, June 12, 2018), archived at https://perma.cc/WLE6-PMYX.

164 Konrad Putzier, *Vereit Pays Vanguard $90M over 2014 Accounting Scandal* (Real Deal, June 11, 2018), archived at https://perma.cc/2S4P-K8LC.

165 See *Vanguard Specialized Funds v Vereit Inc*, 2016 WL 5858735, *1–2 (D Ariz).

166 Putzier, *Vereit Pays Vanguard $90M* (cited in note 164).

167 *Form 10-Q Filing for the Quarter Ending Sept 30, 2018* *40 (VEREIT, Inc, Nov 5, 2018), archived at https://perma.cc/US7S-XG2N; Bautista, *VEREIT Pays $85M* (cited in note 158).

168 See Bruce Kelly, *ARCP Class Action Investors Get 50 Cents on the Dollar: Attorneys* (Investment News, Oct 7, 2019), archived at https://perma.cc/2E69-ATRB. On difficulties encountered in the claims administration process, see generally Jessica Erickson, *Automating Securities Class Action Settlements*, 72 Vand L Rev 1817 (2019).

millions of dollars from the company in the early 2000s. Notable expenditures included a $15,000 umbrella stand, a $6,000 shower curtain, and a $2 million Roman-orgy themed birthday party, all paid for by Tyco shareholders.[169] Kozlowski was eventually accused of stealing $170 million from the company, in addition to securing $430 million by artificially inflating the value of the company's stock and then selling it.[170] He was convicted of fraud and sent to prison.[171] But as his criminal trial waged on, Tyco shareholders pursued civil claims against the company. Specifically, a class of shareholders alleged that Tyco made false and misleading statements that artificially inflated the stock price and failed to disclose related party transactions and payments made to Kozlowski and other insiders.[172] The subsequent revelation of these facts caused the company's stock price to fall more than 40 percent, resulting in potentially more than $100 billion in losses.[173] Tyco eventually settled these claims for more than $3 billion—at the time, the largest payment made by a corporate defendant in the history of securities class action litigation.[174] But a group of institutional plaintiffs, including BlackRock, decided to opt out of the class settlement. Approximately a year later, the opt-out claimants announced a $54 million settlement.[175]

5. Valeant.

Once a large holding of hedge fund and mutual fund investors alike, the Canadian drugmaker's stock lost almost all of its value after its deceptive and abusive business practices came to light. At the company's peak, investors were unaware that Valeant's business strategy relied on price gouging—by its own eventual

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169 Catherine S. Neal, *Former Tyco CEO Dennis Kozlowski Was One of the Great All-Time Value Creators* (Forbes, Dec 9, 2013), archived at https://perma.cc/4Z6D-B7K7; *Tyco Wants Its Money Back* (CNN Money, Sept 17, 2002), archived at https://perma.cc/B5EF-823P.

170 Andrew Ross Sorkin, *2 Top Tyco Executives Charged with $600 Million Fraud Scheme* (NY Times, Sept 13, 2002), archived at https://perma.cc/6T7E-9MGY.

171 *Ex-Tyco Executives Get up to 25 Years in Prison* (NBC News, Sept 20, 2005), archived at https://perma.cc/92VE-FYRT.

172 See *Case Summary: Tyco International Ltd* (Stanford Law School Securities Class Action Clearinghouse, July 10, 2013), archived at https://perma.cc/49ZY-7UKU.

173 See id; Sree Vidya Bhaktavatsalam, *BlackRock Opts Out of Tyco Class-Action; Files Suit* (Bloomberg News, Mar 4, 2008), archived at https://perma.cc/3RQ4-BWYQ.

174 *Case Summary: Tyco* (cited in note 172).

175 *Tyco International* (Lieff Cabraser Heimann & Bernstein), archived at https://perma.cc/W4WL-LNLB.

admission, Valeant would buy a company and immediately raise prices by an average of 66 percent.[176] To implement this strategy, Valeant "created a secret network of specialty pharmacies" that would raise pharmaceutical prices and engage in other deceptive practices to defraud drug purchasers.[177] One of these pharmacies was Philidor, which purported to be independent but was actually created and controlled by Valeant.[178]

By 2015, however, Valeant's pricing strategy was under investigation by Congress, and various media outlets had exposed its deceptive practices.[179] Soon after, Valeant's true relationship with Philidor, as well as its secret network of pharmacies, was exposed. By October 2015, it was announced that Philidor would shut down, and by February 2016, Valeant admitted to fraudulent accounting and had announced that it was under investigation by the SEC.[180] As each scandal unfolded, Valeant's stock price declined precipitously.

In June 2016, Valeant investors brought a class action in the United States District Court for the District of New Jersey alleging violations of the Exchange Act as a result of Valeant's false and misleading statements, as well as its failure to disclose information about its true business practices.[181] Shortly thereafter, T. Rowe Price filed its own direct action against Valeant, on behalf of dozens of its mutual funds, that contained similar charges. Up until April 2016, T. Rowe Price had been Valeant's third-largest shareholder[182] and a steadfast proponent of the company: in March 2016, even after Valeant's misconduct had come to light, T. Rowe Price's top Valeant analyst reassured investors that "many of Valeant's strengths have been overlooked."[183] But by May, T. Rowe had sold most of its Valeant shares, which had

[176] *In re Valeant Pharmaceuticals International, Inc Securities Litigation*, 2017 WL 1658822, *3 (D NJ).

[177] Id, quoting Consolidated Complaint for Violations of the Federal Securities Laws, *In re Valeant Pharmaceuticals International, Inc Securities Litigation*, No 3:15-cv-07658-MAS-LHG, ¶ 82 (D NJ filed June 24, 2016).

[178] *Valeant Pharmaceuticals*, 2017 WL 1658822 at *3.

[179] See id at *4–5.

[180] See id.

[181] *Case Summary: Valeant Pharmaceuticals International, Inc Securities Litigation* (Stanford Law School Securities Class Action Clearinghouse, Sept 10, 2019), archived at https://perma.cc/CJQ9-VCRB.

[182] Nathan Vardi, *T. Rowe Price, Valeant's Longest Supporter, Alleges Company Committed Fraud* (Forbes, Aug 18, 2016), archived at https://perma.cc/8ZCV-L6PF.

[183] Nathan Vardi, *The Investor Who Keeps Sticking by Valeant Pharmaceuticals Longer Than Anyone Else* (Forbes, Mar 14, 2016), archived at https://perma.cc/6SPC-T4R7.

continued to fall in price.[184] And by June, T. Rowe Price had sued Valeant and six of its executives directly, alleging that Valeant had engaged in fraud and securities violations.[185]

In January 2018—about a year and a half after T. Rowe filed its complaint—BlackRock brought a direct lawsuit against Valeant, on behalf of eighty of its mutual funds, in the United States District Court for the District of New Jersey.[186] Like T. Rowe and the class plaintiffs, BlackRock's suit alleged that the company had violated the securities laws by materially misstating or omitting material facts that caused Valeant's price to be artificially inflated.[187] The two direct actions, as well as the class action, are still pending.

* * *

These cases demonstrate that mutual funds could participate actively in shareholder litigation if they chose to do so. Indeed, these examples are encouraging, as they demonstrate instances in which mutual funds took an active approach to litigation in order to secure additional compensation for investors, as well as deterrence. But the puzzle remains as to why there are so few examples. Many other egregious instances of fraud or misconduct occurred over these past ten years and the ten largest mutual fund families ignored them.[188] Moreover, in each of these instances of obvious misconduct that attracted lawsuits, none was pursued by more than three of the ten mutual fund families in our sample.

B. Mutual Fund Participation in Appraisal Actions

The docket search described in the prior Section found only one appraisal case involving any of the ten largest mutual fund families. Recall, however, that although appraisal actions are brought by a petitioner, who appears in the docket as the named claimant, they are often prosecuted on behalf of a larger group of

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184 See Vardi, *Valeant's Longest Supporter* (cited in note 182).

185 See id.

186 Jennifer Bennett, *Between BlackRock and a Hard Place: Valeant Faces Fraud Suit* (Bloomberg Law, Jan 10, 2018), online at https://bnanews.bna.com/pharma-and-life-sciences/between-blackrock-and-a-hard-place-valeant-faces-fraud-suit?context=article-related (visited Feb 24, 2020) (Perma archive unavailable).

187 See *BlackRock Global Allocation Fund, Inc v Valeant Pharmaceuticals International, Inc*, 2018 WL 4401727, *1 (D NJ).

188 See notes 199–201 and accompanying text.

dissenting shareholders.[189] Hence, docket searches under party names will retrieve the names of the petitioners but not the names of other dissenting shareholders. Thus, insofar as a mutual fund does not file as the appraisal petitioner but rather participates as an unnamed dissenting shareholder, their role would not have been captured by the empirical methodology employed in the prior Section. Nevertheless, when an appraisal action is filed, the law requires the defendant to provide a "verified list" of all shareholders eligible for appraisal so that the petitioner can coordinate with other dissenting shareholders.[190] The verified list is filed in the public docket of appraisal suits and is thus the key to determining whether unnamed dissenters were involved in seeking appraisal.

In redesigning our search procedures to identify any appraisal suits in which our mutual funds may have participated as nonpetitioning dissenting shareholders, we began by compiling a dataset of appraisal suits. To do so, we started with a list maintained by an appraisal arbitrage hedge fund of appraisal petitions filed in the Delaware Court of Chancery over a ten-year period, 2004–2013. The list contained a total of 189 appraisal suits. We then looked up these suits on Bloomberg Law and searched for the verified list in the docket. We found the verified list for 157 appraisal suits. We then searched these lists for any reference to our mutual funds. We found none. Next, to make the time period of the appraisal sample match our sample of shareholder suits, 2009 through 2018, we searched in the Delaware Court of Chancery Dockets on Bloomberg Law for the term "verified list" for that time period. We found 303 total filings, many of which also appeared on the hedge fund's list.[191] But again, apart from the T. Rowe Price appraisal petition involving Dell, we found no reference to our mutual funds on the verified lists.

This does not mean that mutual funds never engage in appraisal. It is possible that mutual funds have an alternative method of seeking appraisal. For example, perhaps they contribute their shares into a special LLC with no reference to the fund name in order to seek appraisal anonymously.[192] If so, their participation would have escaped our empirical methodology. Having

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189 See Part I.B.3.

190 8 Del Code Ann § 262(f).

191 Data on file with authors.

192 Doing so would enable them to avoid conflict with management. See Part III.D.1.

read ten years' worth of verified lists, however, we can state that such anonymous entities are rarely involved. The most common dissenters are appraisal hedge funds, individuals, and family trusts. Of course, it is also possible that mutual funds invest in appraisal by investing capital with these specialized appraisal hedge funds. If so, again, they would have escaped our notice. Nevertheless, we have no reason to believe that mutual funds participate in appraisal in this way. And a hedge fund manager we spoke with on this subject noted that, in his experience, this did not occur.

However, there is the well-publicized counterexample of T. Rowe Price's botched attempt to seek appraisal rights in Dell's 2013 management buyout. Along with other shareholders, T. Rowe Price was a vocal opponent of the buyout, in which Michael Dell and his consortium of buyers offered to pay $13.75 per share to take the company private.[193] T. Rowe Price had intended to vote against the merger so that it could preserve its appraisal rights, but mistakenly voted in favor due to an administrative error.[194] This mistake ended up costing T. Rowe Price investors dearly. In the appraisal action, the Delaware Court of Chancery determined that that the fair value of Dell's shares was about 25 percent higher than the amount paid in the buyout, meaning that T. Rowe Price's investors lost $194 million.[195] To avoid the prospect of investor lawsuits (and the concomitant bad publicity), T. Rowe Price decided to pay their investors the money that they would have been eligible to receive from Dell.[196]

This example demonstrates that mutual funds are willing and able to participate in appraisal actions—at least, when the deal appears obviously bad for shareholders. In the Dell case, the

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193 See Guhan Subramanian, *Deal Process Design in Management Buyouts*, 130 Harv L Rev 590, 608 (2016).

194 See id at 609, citing *In re Appraisal of Dell Inc*, 143 A3d 20, 22–23, 32 (Del Chanc 2016); Matt Chiappardi, *Chancery Knocks T. Rowe Price Funds out of Dell Appraisal* (Law360, May 11, 2016), archived at http://perma.cc/5DQG-UQVK. Shares must be voted against the transaction in order to have the right to sue for appraisal. See 8 Del Code Ann § 262(a).

195 See *In re Appraisal of Dell Inc*, 2016 WL 3186538, *51 (Del Chanc); H. Adam Prussin, *Huge Appraisal Remedy Awarded in Dell Merger Case* (Pomerantz LLP Monitor, July/Aug 2016), archived at https://perma.cc/6LYK-S6F3; Antoine Gara, *T. Rowe Price to Take $194 Million Charge Due to Voting Error on Dell LBO* (Forbes, June 6, 2016), archived at https://perma.cc/BRP8-RKDU.

196 Stephen Gandel, *Here's Why This Investment Fund Had to Refund $194 Million* (Fortune, June 8, 2016), archived at https://perma.cc/DSB8-ECU3.

price appears to have been low enough that T. Rowe Price would have been comfortable scuttling the deal—a genuine risk when a large shareholder perfects its appraisal rights. This sentiment seemed to be validated by the Delaware Court of Chancery's conclusion that the deal price "shortchanged shareholders by more than $6 billion."[197] It seems unlikely, however, that Dell is the only bad deal in which a mutual fund owned shares.[198]

* * *

Our results reveal that mutual funds almost never participate in shareholder litigation: The mutual funds in our set—the largest mutual funds in the world, with a combined $24 trillion in assets under management—participated in a total of eleven lawsuits, based on only six distinct claims, over a ten-year period. All but one of these ten suits involved securities claims. To put this litigation record in perspective, consider that studies find over four hundred securities class actions were filed in 2018 alone, nearly half of which constituted merger claims filed under federal causes of action.[199] Excluding merger claims, Cornerstone finds 1,620 securities class actions filed from 2008 to 2017,[200] and NERA finds 1,863 over a similar time period.[201] Whichever denominator you choose, the ten securities lawsuits pursued by mutual fund plaintiffs amount to less than 1 percent of the total claims available. And that is counting only securities claims, not the many state fiduciary duty claims that could have been

197 Liz Hoffman, *Judge Finds Michael Dell, Silver Lake Underpaid for Dell in 2013* (Wall St J, June 1, 2016), archived at https://perma.cc/PDF9-WGZM.

198 Appraisal litigation changed following Delaware decisions deeming the merger price to be the best evidence of fair value. See *Verition Partners Master Fund Ltd v Aruba Networks, Inc*, 210 A3d 128, 135–36 (Del 2019); *DFC Global Corp v Muirfield Value Partners, LP*, 172 A3d 346, 374 n 145 (Del 2017); *Dell, Inc v Magnetar Global Event Driven Master Fund Ltd*, 177 A3d 1, 19 (Del 2017). However, appraisal claims remain viable in situations indicating a flawed sales process or breach of fiduciary duty. In any event, these changes to appraisal litigation occurred toward the end of our collection period and likely had little or no influence on our findings.

199 Boettrich and Starykh, *Recent Trends in Securities Class Action Litigation* at *1 (cited in note 76) (counting 441 securities class action filings in federal courts in 2018); *Securities Class Action Filings* at *5 (cited in note 76) (counting 412 securities class action filings in federal courts in 2018, 198 of which were merger claims).

200 *Securities Class Action Filings* at *5 (cited in note 76) (counting only "core" securities class actions, most often cases under Rule 10b-5).

201 Boettrich and Starykh, *Recent Trends in Securities Class Action Litigation* at *5 fig 3 (cited in note 76) (counting all federal securities filings except merger objection claims).

brought during the same period, of which mutual funds brought none. In sum, this evidence reveals that the largest and most influential mutual funds have essentially forfeited their use of a principal lever to protect investors.

C. Compared to the Litigation Efforts of Other Shareholder Plaintiffs

To put mutual fund litigation into perspective, we compare the litigation record of other shareholder plaintiffs. In the sections that follow, we first compare the litigation conduct of pension fund plaintiffs. Then we compare the litigation conduct of hedge funds and individual repeat plaintiffs. This study is not intended to provide an apples-to-apples comparison; instead, we seek only to provide additional evidence that mutual funds litigate much less often than other investors in spite of the fact that they hold large investments in a broad swath of companies. We also highlight interesting differences in litigation patterns between these classes of investors.

1. Public pension funds.

Much of the literature on institutional plaintiffs in shareholder suits focuses on pension funds, especially public pension funds and labor union funds, both of which have established reputations as especially active shareholder litigants.[202] The reputation is not entirely positive. Some of this literature identifies ways in which pension fund managers' incentives in shareholder suits depart from the interests of their investors.[203] Furthermore, studies document ways in which pension fund involvement has led to the transfer of pay-to-play emoluments between plaintiffs' lawyers and pension fund managers.[204] We acknowledge these problems but nevertheless ask: How does the record of pension funds in shareholder litigation compare with that of mutual funds?

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[202] See David Webber, *The Rise of the Working-Class Shareholder: Labor's Last Best Weapon* xii (Harvard 2018).

[203] See, for example, Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 Colum L Rev 795, 796 (1993) (recognizing that "public pension funds face distinctive investment conflicts that limit the benefits of their activism").

[204] See, for example, Stephen J. Choi, Drew T. Johnson-Skinner, and A.C. Pritchard, *The Price of Pay to Play in Securities Class Actions*, 8 J Empirical Legal Stud 650, 678 (2011) (finding that pay-to-play imposes a cost on investors in class actions).

We ran a series of docket searches for the ten largest pension funds by assets under management parallel to the searches we had run for the ten largest mutual funds. We searched Bloomberg Law, for a period running from January 2009 through December 2018, for all cases in federal district courts and in the Delaware Court of Chancery in which any of the ten largest public pension funds appeared as a named party. The pension funds we searched included: CalSTERS, CalPERS, New York State Common Retirement Fund, New York City Retirement, Florida SBA, Texas Teachers, New York State Teachers, State of Wisconsin Investment Board, North Carolina Retirement, and Washington State Investment Board. These funds were more active than mutual funds, bringing a combined total of thirty-one shareholder suits—three times as many as the ten largest mutual fund investors—over the period, against a total of twenty-two defendants. That is so despite managing smaller portfolios—for example, CalPERS, the largest US pension fund, manages $354 billion in assets,[205] compared to BlackRock, which manages nearly $6 trillion.[206]

In addition to higher overall numbers, there was a greater diversity in the type of shareholder suits brought by pension funds. Like the mutual fund cases we found, the pension fund suits were skewed toward securities claims, and the securities claims were predominantly 10b-5 class actions. But three pension fund suits were based on state law causes of action, as compared to zero for mutual fund litigants. Many of these suits resulted in large settlement payments,[207] as well as corporate governance reforms. As an example of the latter, the pension fund CalPERS

205 *Facts at a Glance for Fiscal Year 2017–18* *1 (CalPERS), archived at https://perma.cc/7HWF-K2L2.

206 Christine Williamson, *BlackRock's AUM Down for the Quarter, Year* (Pensions & Investments, Jan 16, 2019), archived at https://perma.cc/MNE9-29Y6.

207 As a few examples, pension fund litigants won large settlement payments in suits filed against the following companies: Big Lots, Inc ($3.5 million payment to the company in addition to governance and compliance reforms); Green Mountain Coffee Roasters ($36.5 million payment); and CBOT Holdings ($475 million in additional deal compensation). See Opinion and Order, *In re Big Lots, Inc Shareholder Litigation*, No 2:12-cv-00445, *2 (SD Ohio filed Aug 28, 2018), archived at https://perma.cc/D4RV-8UMD; Notice of (I) Pendency of Class Action and Class Certification; (II) Proposed Settlement; (III) Motion for an Aware of Attorneys' Fees and Reimbursement of Litigation Expenses; and (IV) Settlement Fairness Hearing, *Louisiana Municipal Police Employees' Retirement System v Green Mountain Coffee Roasters*, Inc, No 2:11-CV-00289-WKS, *1 (D Vt filed Sept 10, 2018), archived at https://perma.cc/UWZ9-X6U5; *CBOT Holdings, Inc. Shareholder Litigation* (Bernstein Litowitz Berger & Grossmann LLP), archived at https://perma.cc/4HTS-TEU9.

successfully convinced IAC to abandon its plan to issue nonvoting stock that would have solidified the controlling shareholder's control over the company.[208]

Although we limited our analysis to the ten largest pension funds, a pension fund's incentives to litigate may not increase with size. A public-employee pension fund's board members are appointed by politicians or directly elected by voters.[209] Accordingly, litigation activity may provide a way for the fund's board to demonstrate alignment with investors and politicians—regardless of the size of the pension fund's investment in the underlying company. For these reasons, earlier studies that looked beyond the ten largest pension funds reported even starker differences in litigation patterns. For example, in a study of shareholder derivative and class action lawsuits challenging M&A transactions filed in the Delaware Court of Chancery from November 1, 2003 to December 31, 2009, Professor David Webber finds that public pension funds and labor union funds dominate the litigation process, while mutual funds play a minimal role.[210] Specifically, of the 137 claims involving an institutional lead plaintiff in his dataset, Webber found only seven in which a mutual fund served as lead plaintiff. By contrast, pension and union funds served as a lead plaintiff for sixty cases, and private nonmutual funds (which include private equity funds and hedge funds) were lead plaintiffs for the remainder. Mutual funds have more assets under management than public pension funds do, and they have substantial stakes in the transactions that were subject to litigation. They would appear to be excellent lead plaintiff candidates, but they do not apply for the job.[211] Another study found similar results with regard to securities class actions. Of 1,811 securities class actions from 1996 to 2005, 97 were led by public pension funds, 61 had

[208] *In Response to CalPERS Lawsuit, IAC Abandons Plan to Issue Non-Voting Stock* (CalPERS, June 23, 2017), archived at https://perma.cc/89RR-N9RU.

[209] Edward B. Rock, *Institutional Investors in Corporate Governance*, in Jeffrey N. Gordon and Wolf-Georg Ringe, eds, *The Oxford Handbook of Corporate Law and Governance* 363, 367 (Oxford 2018).

[210] Webber, 38 Del J Corp L at 932, 935 tbl 2 (cited in note 15).

[211] See id at 940 ("[Mutual funds] are sophisticated and credible, and Delaware judges would likely be eager to appoint them if they applied. But they don't.") (citations omitted). See also Marcel Kahan and Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U Pa L Rev 1021, 1048–56 (2007) (discussing the advantages and disadvantages that mutual funds might have in monitoring corporate governance).

union pension fund lead plaintiffs, but only 12 featured mutual funds as lead plaintiffs.[212]

We ran an additional docket search for the litigation activity of the Louisiana Municipal Police Employee Retirement Fund (LAMPERS), which is not among the largest but is reputed to be one of the most active institutional plaintiffs. Our results confirm this reputation. LAMPERS was involved in ninety-three shareholder claims over the ten-year period we studied. These claims included a large number of both state law fiduciary duty claims as well as federal securities class actions, predominantly under Rule 10b-5 but also including a small number of claims brought under §§ 11, 12(a)(2), and 15 of the Securities Act as well as § 14(a) of the Securities Exchange Act.

Why are pension funds much more active participants in litigation than their mutual fund counterparts? In addition to their political motivations, there are other factors at play. Public pension funds, unlike mutual funds, do not count on corporations as a source of revenue.[213] Furthermore, there may be less network overlap between the boards of public pension funds—which may consist of firefighters, police officers, and teachers—and corporate boards of directors, which may more closely resemble mutual fund boards.[214] Each of these factors may contribute to greater willingness, on the part of public pension funds, to pursue litigation against corporate defendants. Additionally, public pension funds do not compete with each other for cash inflows. Instead, all

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[212] C.S. Agnes Cheng, et al, *Institutional Monitoring Through Shareholder Litigation*, 95 J Fin Econ 356, 364 (2010). There is also evidence that some institutional-investor lead plaintiffs in securities fraud class actions, notably public-pension funds, provide better shareholder outcomes in the form of higher settlements, lower attorneys' fees, and improved board independence. See id at 357–58; Stephen J. Choi, Jill E. Fisch, and A.C. Pritchard, *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 Wash U L Q 869, 897 (2005) (finding that public pension funds pay approximately 5 percent less than individuals); James D. Cox, Randall S. Thomas, and Lynn Bai, *There Are Plaintiffs and . . . There Are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*, 61 Vand L Rev 355, 379 (2008) (demonstrating a positive impact on settlement size from the presence of a public pension or labor union fund as lead plaintiff); Michael Perino, *Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions*, 9 J Empirical Legal Stud 368, 381–84 (2012) (finding that cases with public pension funds as lead plaintiffs settle for greater amounts and lower fees).

[213] Which is to say they are unaffected by Corporate Client Conflict, discussed in Part III.D.1. See also Webber, 38 Del J Corp L at 941–42 (cited in note 15).

[214] See Webber, 38 Del J Corp L at 942 (cited in note 15).

covered employees contribute.[215] Because pension funds do not compete with each other for pension assets, any reluctance on the part of pension funds to engage in conduct that might also benefit their competitors—the collective action problem we describe below—is nonexistent. As state-sponsored monopolists, public pension funds are free to make litigation decisions without regard to the effect on their (nonexistent) competitors.

None of this is to say that public pension funds engage in the optimal amount of litigation. As discussed, they have their own agency problems, including heightened vulnerability to political influence.[216] Our point here is simply to demonstrate the different approaches that pension funds and mutual funds take to shareholder litigation. Pension funds are far more likely to assert claims against portfolio corporations. They are more likely to assert these claims in class action form. And they are more likely to seek appointment as lead plaintiff.

2. Hedge fund plaintiffs.

We also gathered data on the litigation record of hedge funds. We ran the same Bloomberg docket search—January 2009 through December 2018, for all cases in federal district courts and the Delaware Court of Chancery—for the ten largest activist hedge funds (by equity assets) that had been involved in at least twenty-five campaigns: Icahn Associates Holding LLC, Elliot Management Corp, GAMCO Asset Management, Inc, ValueAct Capital Management LP, Trian Fund Management LP, Southeastern Asset Management, Inc, Third Point LLC, Pershing Square Capital Management, Carlson Capital LP, and Starboard Value LP.[217]

The hedge funds in our sample did not file a vast quantity of claims. We found twenty-one distinct investor suits filed by the

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[215] See id at 941 (explaining that public pensions and labor union funds have "no true competitors" because "[i]f a fund beneficiary is unhappy with the fund's performance, the beneficiary's only option is to change jobs, not move one's retirement savings to a competitor").

[216] Note that this political influence may lead to too little or too much litigation, depending on the political alignment of the politicians who appoint them. For example, political contributions from large corporations may reduce incentives to sue, whereas contributions from the plaintiffs' bar would likely increase them. See Choi, Johnson-Skinner, and Pritchard, 8 J Empirical Legal Stud at 655, 678 (cited in note 204).

[217] See SharkWatch 50, Key Activists (on file with the authors).

ten hedge funds over a ten-year period.[218] But a relatively small number of intensely litigated cases is commensurate with an activist hedge fund's investment strategy—hedge funds are not broadly diversified, and instead make large, concentrated investments in a small number of companies.[219] As such, we would expect that their overall litigation record would involve a much smaller number of companies than that of broadly diversified mutual funds.

In addition, the cases pursued by hedge funds are qualitatively different from the cases brought by mutual funds. For one, the hedge fund cases are more often state law fiduciary duty claims than federal securities claims. We found only four investor lawsuits filed in federal district court by the hedge funds in our sample.[220] By contrast, recall that apart from a single appraisal claim, the mutual funds in our study brought claims exclusively

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218 This number represents distinct causes of action, not necessarily distinct claims. For example, funds controlled by Third Point filed six separate appraisal claims involving Petsmart, which were later consolidated into a single action. See Stipulation and (Proposed) Consolidation Order, *Third Point Reinsurance (USA) Ltd v PetSmart, Inc*, No 10782-VCN, *4–5 (Del Chanc filed Apr 30, 2015). Likewise, Icahn Partners filed two different fiduciary duty suits involving Amylin Pharmaceuticals, one seeking books and records and another for breach of fiduciary duty relating to board conduct in connection with an acquisition offer. See Verified Complaint Pursuant to 8 Del C § 220, *Icahn Partners LP v Amylin Pharmaceuticals, Inc*, No 7418-CS, *1 (Del Chanc filed Apr 12, 2012) (*Icahn Partners* § 220 Complaint) (books and records); Verified Complaint, *Icahn Partners LP v Amylin Pharmaceuticals Inc*, No 7404-VCN, *1–2 (Del Chanc filed Apr 9, 2012) (*Icahn Partners* Verified Complaint) (breach of fiduciary duty). We counted these claims as one and counted all claims involving the same plaintiff against the same defendant for the same underlying conduct a single time. Two fiduciary duty claims brought by Icahn Enterprises against Dell for different underlying conduct were counted separately. See Verified Complaint Pursuant to 8 Del C § 220, *High River Limited Partnership v Dell Technologies Inc*, No 2018-0790-AGB, *19–20 (Del Chanc filed Oct 31, 2018) (*High River* § 220 Complaint) (requesting inspection of corporate books and records); Verified Complaint, *High River Limited Partnership v Dell Inc*, No 8762-CS, *23 (Del Chanc filed Aug 1, 2013) (suit alleging breach of fiduciary duty in connection with Michael Dell's management buyout).

219 See Kahan and Rock, 155 U Pa L Rev at 1070 (cited in note 211).

220 Three of these were Rule 10b-5 cases filed as individual actions (two by Elliott, one by GAMCO). See *Elliott Associates v Porsche Automobil Holding SE*, 759 F Supp 2d 469, 470 (SDNY 2010); Complaint for Violations of the Federal Securities Laws, *Gamco Global Series Funds, Inc v Vivendi SA*, No 1:09-cv-07962-SAS, *82 (SDNY filed Sept 16, 2009). One was a 10b-5 class action filed by GAMCO. See Class Action Complaint for Violation of the Federal Securities Laws, *Joshi Living Trust v Akorn, Inc*, No 1:18-cv-01713, *16 (ND Ill filed Mar 8, 2018). The fifth case was a federal court case brought by Pershing Square in the wake of the financial crisis claim alleging that the US Treasury Department illegally deprived them of the value of their investment in Fannie Mae and Freddie Mac. See Complaint, *Rafter v Department of the Treasury*, No 1:14-cv-01404-RCL, *39, 42 (DDC filed Aug 15, 2014).

under Rule 10b-5 of the federal securities laws. They did not bring a single state fiduciary duty suit.[221]

In addition, the hedge fund cases in our sample often directly related to the funds' governance interventions in portfolio companies. Four cases involved petitions for appraisal.[222] But most of the hedge fund cases we found were state corporate law claims relating directly to activist interventions. Several of the suits in our sample involve books and records requests, seeking information that will either help the activists challenge management or simply provide access to the shareholder list so that the activist can lobby shareholders directly.[223] Several claims seek to compel shareholder meetings in connections with proxy fights.[224] Other suits allege breaches of fiduciary duty in connection with specific transactions.[225] In other words, the majority of the hedge fund claims we found were motivated by deterrence or governance objectives, not the desire to win compensation in the lawsuit itself. Hedge funds litigate for leverage to support their interventions.

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221 See text accompanying notes 127–28.

222 See Petition for Appraisal of Stock, *Third Point Reinsurance (USA) Ltd v PetSmart, Inc*, No 10782-VCN (Del Chanc filed Mar 12, 2015). The other three appraisal cases were all brought by GAMCO. See Verified Petition for Appraisal, *Gabelli Small Cap Growth v Federal-Mogul Holdings LLC*, No 2017-0330, *1 (Del Chanc filed May 1, 2017); Petition for Appraisal, *Gabelli Securities, Inc, v Crown Media Holdings, Inc*, No 12680, *1 (Del Chanc filed Aug 23, 2016); *In re Zale Corp Appraisal Litigation*, 2015 Del Ch LEXIS 249, *19.

223 See, for example, *High River* § 220 Complaint at *19 (cited in note 218); Verified Complaint Pursuant to 8 Del. C. § 220, *High River Ltd Partnership v Forest Laboratories, Inc*, No 7663-ML, *1–2 (Del Ch filed June 28, 2012); *Icahn Partners* § 220 Complaint at *1 (cited in note 218); Verified Complaint Pursuant to 8 Del. C. § 220, *High River Ltd Partnership v Forest Laboratories, Inc*, No 6614-CS, *13 (Del Chanc filed June 28, 2011).

224 See, for example, Verified Complaint Pursuant to 8 Del. C. § 225, *High River Ltd Partnership v Biogen Idec Inc*, No 4642-VCS, *5 (Del Chanc filed June 3, 2009); Verified Complaint for Declaratory Relief and Injunctive Relief, *PS Fund 1, LLC v Allergan, Inc*, No 9760-CB, *29–30 (Del Chanc filed June 12, 2014); Verified Complaint Pursuant to 8 Del. C. § 211, *Starboard Value and Opportunity Master Fund Ltd v comScore, Inc*, No 2017-0533-AGB, *1 (Del Chanc filed July 25, 2017); Verified Complaint Pursuant to 8 Del. C. § 211, *Starboard Value and Opportunity Master Fund Ltd v Office Depot, Inc*, No 8640-VCL, *1 (Del Chanc filed June 12, 2013).

225 Icahn brought cases against Dell (for books and records and breach of fiduciary duty), AmTrust Financial (to halt an IPO), and Amylin Pharmaceuticals (for breach of fiduciary duty). See, for example, Verified Class Action Complaint, *Employees Retirement System of St. Louis v Ruprecht*, No 9497-VCP, *2 (Del Chanc filed Apr 1, 2014); Verified Complaint, *Icahn Partners LP v Zyskind*, No 2018-0358-AGB, *31 (Del Chanc filed May 21, 2018); *High River* Verified Complaint at *23 (cited in note 218); *Icahn Partners* Verified Complaint at *1–2 (cited in note 218).

To paraphrase Carl von Clausewitz, their lawsuits are governance by other means.[226]

Finally, it is worth noting that the hedge funds' claims were generally not brought in a class or other representative capacity. Third Point's breach of fiduciary duty claim to invalidate Sotheby's poison pill was ultimately joined by class action plaintiffs (two pension funds: LAMPERS and the Employees Retirement System of the City of St. Louis) and consolidated into a single action.[227] None of the other hedge fund cases we found was litigated as a class action. Instead, all were direct actions filed by the hedge fund as named plaintiff.

3. Individual plaintiffs.

As a final comparison, we examined the litigation patterns of repeat-play individual plaintiffs. One of us has recently studied litigation filed by seven individuals who regularly appear as named plaintiffs in shareholder suits—Robert Berg, Stephen Bushansky, Natalie Gordon, Paul Parshall, Matthew Sciabacucchi, John Solak, and Shiva Stein.[228] Over a five-year period, from 2014 through 2018, half the time period of our mutual fund study, these seven plaintiffs filed 282 shareholder suits. The vast majority of these lawsuits (76 percent) involve challenges to mergers and acquisition transactions, which are typically settled for nonpecuniary relief or for mootness fees.[229]

Initially, these plaintiffs filed the bulk of their lawsuits in state court, but this trend has now reversed, with most of their claims now being filed in federal court. The transformation took place over our collection period. In 2014, 82 percent of these plaintiffs' claims were brought in state courts. In 2015, the percentage of their claims brought in state court fell to 68 percent, then fell even more dramatically in 2016 to 41 percent. By 2017 and 2018, the relationship had flipped completely, with 96 percent and 87 percent of their claims being brought in federal rather than

[226] See Carl von Clausewitz, *On War* 87 (Princeton 1989) (Michael Howard and Peter Paret, eds and trans) ("War is merely the continuation of policy by other means.").

[227] See *Third Point LLC v Ruprecht*, 2014 WL 1922029, *2 (Del Chanc).

[228] Sean J. Griffith, *Class Action Nuisance Suits: Evidence from Frequent Filer Shareholder Plaintiffs*, in Brian Fitzpatrick and Randall Thomas, eds, *Cambridge International Handbook of Class Actions* *6 (forthcoming 2020), archived at https://perma.cc/Z9KL-7JPS.

[229] Id at *8.

state court.[230] This reversal is likely a direct response to the Delaware Court of Chancery's opinion in *In re Trulia, Inc Stockholder Litigation*,[231] which made it more difficult to settle merger cases for nonpecuniary relief.[232] Such cases are the bread-and-butter claims of these plaintiffs. Rather than dropping the claims, these plaintiffs merely shifted them to federal court, bringing them under § 14a of the Exchange Act, to which *Trulia* does not apply.[233]

The litigation activity of repeat-play individual plaintiffs and hedge fund plaintiffs can be seen as polar opposites. Individual plaintiffs bring a great many merger claims on a class or other representative basis and settle them for nonpecuniary relief. Hedge funds, by contrast, bring a small number of lawsuits, typically on a nonrepresentative basis, often for injunctive relief aimed at increasing leverage in their governance interventions. The indicia of litigation agency costs are high for claims brought by individual repeat-play plaintiffs, who are often controlled by repeat-player attorneys,[234] and low for claims brought by hedge fund activists. Interestingly, both litigate differently from mutual funds, which most often bring federal securities claims for monetary relief on a nonrepresentative basis.

III. WHY DON'T MUTUAL FUNDS PARTICIPATE IN SHAREHOLDER LITIGATION?

The most striking outcome of the empirical analysis above is the simple finding that mutual funds generally do not participate in shareholder litigation. Over the ten-year time period we studied, mutual funds filed a single appraisal case, rarely pursued securities claims, and never participated in state law fiduciary duty suits. By contrast, pension funds litigated frequently across a variety of claims; hedge funds used state fiduciary duty suits as leverage in activist interventions; and repeat-play individual claimants filed a mass of claims. While we do not mean to suggest that all of these suits would have benefitted mutual fund investors if pursued, there are many examples of missed opportunities. Most

[230] Id at *8–10.

[231] 129 A3d 884 (Del Chanc 2016).

[232] See id at 896. See also Part I.B.2.

[233] Griffith, *Private Ordering Post-*Trulia at 293, 300–01 (cited in note 102).

[234] See Jessica Erickson, *The New Professional Plaintiffs in Shareholder Litigation*, 65 Fla L Rev 1089, 1107 (2013).

obviously, the claims against Valeant, Countrywide, Tyco, Petrobras, and American Realty attracted the attention of only a few fund families in our sample; other funds with standing to sue missed out on potentially large opt-out settlements.

Nor do the data suggest that mutual funds are merely free riding, letting others do the hard work of litigation, while they stand to collect the benefits. Mutual funds have a history of failing to claim settlement proceeds at the end of class action cases.[235] Furthermore, mutual funds exert no apparent effort to channel the conduct of such litigation or to prevent litigation agency costs from wasting corporate assets. In other words, with rare exceptions, mutual funds participated in shareholder litigation in essentially the same way as rationally apathetic shareholders—by staying out of it.[236]

These results are surprising given the large blocks held by the mutual funds in our sample. For example, as of March 2016, Vanguard had at least a 5 percent stake in 1,855 publicly traded companies.[237] A stake of that size should provide a powerful incentive to participate in litigation that might lead to shareholder compensation. It would also provide the fund with the ability to shape litigation outcomes and contain litigation agency costs if it was interested in doing so.

Furthermore, mutual funds tend to be diversified across the market, which makes them repeat players in litigation and governance. Because they can anticipate that similar issues will

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[235] See James D. Cox and Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 Stan L Rev 411, 424 (2005) (finding that only 28 percent of eligible institutional investors filed claims to collect settlement proceeds, effectively leaving substantial sums of money unclaimed). See also Glater, *Suits Contend Mutual Funds Fail to Collect* (cited in note 122) (noting lawsuits filed in the wake of this discovery). More recent work suggests not much has changed in this regard. See *10 Years Removed from Cox & Thomas: A Survey of the Claims Filing Landscape for U.S. and Non-U.S. Securities Litigation Recoveries* (Kessler Topaz Meltzer Check LLP, Nov 5, 2015), archived at https://perma.cc/BY5N-SMRY (citing research estimating that 35 percent of eligible institutional investors claim settlement proceeds). See also Jessica Erickson, *Automating Securities Class Action Settlements*, 72 Vand L Rev 1817, 1830 (2019) (reporting conversations with claims administrators who estimate that "approximately twenty to twenty-five percent of claim forms will be returned").

[236] See John C. Coffee Jr, *Litigation Governance: Taking Accountability Seriously*, 110 Colum L Rev 288, 304 (2010) (stating that "the same apathy that confounds the opt-in class action at the outset also arises at the back end of the opt-out class action when claims must be filed").

[237] Fichtner, Heemskerk, and Garcia-Bernardo, 19 Bus & Polit at 312 tbl 2 (cited in note 4).

recur across their portfolio, they ought to have strong incentives to use litigation to achieve portfolio-wide deterrence and governance benefits. If a shareholder lawsuit will deter bad behavior, the mutual fund will accrue benefits across their broad portfolio. Additionally, mutual funds' limited exit options should increase the desirability of using litigation to implement deterrence and governance reform. This is especially true for the large index fund providers. As Bill McNabb, the former CEO of Vanguard put it: "Index fund managers must care as much as—if not more than—anybody else. We essentially own shares forever, because we can't sell out of an equity listed on an index."[238] Index funds have another reason to pursue shareholder litigation that results in compensation: the inflow of settlement proceeds can be a source of income for funds, allowing them to reduce fees to investors, thereby attracting greater fund inflows.[239]

Yet we have found that mutual funds—actively managed and indexed alike—generally do not use the lever of litigation to influence the governance of portfolio companies. Why not? This Part evaluates potential explanations for the failure of mutual funds to participate in shareholder litigation. It considers legal barriers, structural obstacles, agency costs and conflicts, the circularity problem, and finally, the possibility that nonparticipation in shareholder litigation is a revealed preference of mutual funds.

A. Legal Barriers

It is possible that some kinds of shareholder claims present substantive legal barriers that prevent mutual funds from taking a leading role. For example, 10b-5 claims require both that the claimant be a "purchaser or seller" of the underlying security and that the claimant relied upon the defendant's misrepresentation in transacting in the security, both of which may present difficulties for index funds in particular.[240] As long-term investors, most of an index fund's investment in the relevant company will have been acquired prior to the defendant's false statements and held

[238] McNabb, *The Ultimate Long-Term Investors* (cited in note 11).

[239] In this way, settlement proceeds could serve a function much like mutual funds' securities lending activities, providing a source of revenue to mitigate the cost of lower fees. See generally John Waggoner, *Securities Lending Adds Return, Risk for Funds* (InvestmentNews, May 16, 2017), archived at https://perma.cc/P2NE-FA6L (explaining that index funds are significant lenders of shares because returns from securities lending help offset losses due to declining fees).

[240] See *Blue Chip Stamps v Manor Drug Stores*, 421 US 723, 737–38, 749 (1975).

through to the revelation of truth. Index funds, in other words, will generally be holders, not buyers or sellers, and the bulk of their portfolio may thus be ineligible to bring a 10b-5 claim.

Nevertheless, even index funds engage in significant trading activity.[241] Index funds regularly rebalance their portfolios to bring their holdings in line with the index they track, and buy and sell shares to manage flows of capital into and out of the fund. As a result, although a large portion of their assets under management may not trade during the relevant period, it is highly likely that large index funds will engage in at least some trading during the period. As a result, index funds likely have standing to be involved in virtually every claim.

What about reliance? If an index fund does trade to rebalance its portfolio or to accommodate investors buying into or selling out of the fund, it may have difficulty establishing that it did so in reliance upon a portfolio company's underlying misstatement. The claim might be that any such trading is motivated by the company's proportional representation in the index, not by anything the company has said or done. Such an argument might seem to have the effect of systemically rebutting reliance, at least for index funds.

While we acknowledge that this argument renders reliance contestable, we also think index funds have a powerful reply, based upon the dynamics of fraud on the market.[242] The price of a portfolio company's shares determines its proportional representation in an index.[243] As a result, if fraud inflates prices, it will often lead to a security's overrepresentation in the index. Hence, in buying shares based upon a security's proportional representation in an index, the fund may buy more (or less) of the security than it otherwise would as a result of the fraudulent inflation (or deflation) of the security's price.[244] This is just a further link in

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241 See Davidson Heath, et al, *Passive Investors Are Passive Monitors* *3 (unpublished manuscript, Mar 15, 2018), archived at https://perma.cc/Y4A2-JPXQ (documenting trading by passive and indexed mutual funds).

242 See *Basic Inc v Levinson*, 485 US 224, 247 (1988) (adopting the fraud on the market theory); *Halliburton Co v Erica P. John Fund, Inc*, 573 US 258, 274–77 (2014) (reaffirming the fraud on the market theory).

243 See Chad Langager, *How Is the Value of the S&P 500 Calculated?* (Investopedia, June 28, 2019), archived at https://perma.cc/L4J4-DAV5.

244 For indices that weight companies based on their market capitalization, the inflated price may not require the company to buy more shares—holding the same number of shares valued at a higher price will increase the weight of the company in the index. But even in these cases, if funds rebalance because of inflows or outflows of investor cash,

the chain of reliance. Funds may not trade in direct reliance on price, but they do buy in reliance on the security's proportional representation in the index, which is determined by price. Fraud thus affects an index fund's investment much as it does an active investor who trades based on price. The reliance requirement likely does not pose a meaningful barrier.

Furthermore, contrary to what we have just argued, if either reliance or the purchaser/seller requirement were the primary barrier to mutual fund participation in shareholder litigation, we would expect active funds to be more involved in shareholder litigation than index funds.[245] Yet this is not the case. None of our empirical investigations into the litigation activity of mutual funds suggested any difference between active and index funds, or more specifically, mutual fund companies that predominantly offer index funds (such as T. Rowe Price and Fidelity) and those that predominantly offer passive funds (such as Vanguard and State Street). Their participation in shareholder litigation is essentially indistinguishable. This suggests that substantive legal rules are not the problem.

Finally, not only are mutual funds *eligible* plaintiffs in securities suits, they are *ideal* plaintiffs in derivative suits. Because they are paradigmatic long-term investors, index funds easily satisfy the requirement that derivative plaintiffs hold shares from the time of injury through conclusion of the suit (the "contemporaneous ownership" requirement).[246] The contemporaneous ownership requirement may pose an obstacle to active traders who prefer exit to litigation, but because long-term shareholding is the core of index funds' investment strategy, it poses no obstacle to them. Yet we could not find a single derivative suit filed by an index fund (or any of our mutual funds) over a ten-year period. The explanation must be something other than substantive legal barriers.

the increased price will cause the fund to buy or sell too many shares of the fraudulent company, which would likely satisfy the reliance requirement.

[245] Active funds seek to overweight well-performing companies and underweight poorly performing companies. See Bernard S. Black and John C. Coffee Jr, *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 Mich L Rev 1997, 2048, 2063–64 (1994) ("*Overweighting* means that the institution owns a greater share of the specific company than it owns of the market generally. An overweighted firm has a greater incentive to intervene, because it will gain more from success than its competitors.").

[246] See J. Travis Laster, *Goodbye to the Contemporaneous Ownership Requirement*, 33 Del J Corp L 673, 674–76, 694 (2008) (discussing the contemporaneous ownership requirement, and recommending that it be eliminated).

B. Structural Obstacles

A second possibility is that the structure of ownership rights and decision-making authority allocated to mutual funds presents an obstacle to active participation in shareholder litigation. As discussed, the power to bring litigation on the basis of portfolio company holdings is a default feature of the standard mutual fund investment contract.[247] But not every mutual fund investor gets the standard contract. Approximately 10 percent of mutual fund investors are institutions—funds, corporations, and financial institutions—not individuals.[248] Those institutional investors may have different contractual relationships with the mutual fund family than the individuals who invest in managed accounts. For example, some institutional clients contract for investment advisory services only.[249] Pursuant to these arrangements, institutional clients may retain their voting and litigation rights.

This division of rights can present problems for the mutual fund family, which will not be able to sue on behalf of the clients that have retained their litigation rights. In general, mutual fund families opt to solicit consent from those institutional clients before bringing a shareholder suit. Some investors might never consent to litigate,[250] and administrative difficulties associated with soliciting and obtaining investor consent might deter mutual funds from bringing shareholder suits in the first place. While we recognize that this administrative difficulty exists, we do not view it as a substantial impediment to shareholder litigation. For example, funds could issue different shares to institutional and individual clients in order to separate those on whose behalf they do or do not have the right to litigate.[251]

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247 See note 122 and accompanying text.

248 *Investment Company Fact Book* at *60 (cited in note 3) (showing that institutions held 10 percent of mutual fund assets in 2017).

249 See, for example, *Vanguard Institutional Advisory Services: Partnering with Your Organization* *1 (Vanguard, 2016), archived at https://perma.cc/6HUP-8R27 (explaining that institutions can secure Vanguard as a cofiduciary and retain investment advice for assets that remain under institutional management).

250 For example, a corporate pension fund (for example, the Apple 401(k) plan) seems unlikely to consent to litigation against the corporate issuer (Apple). See Part III.D.1.

251 The practice would be similar to issuing different classes of shares to track different fee arrangements, a practice currently followed by several mutual funds in order to reward (and encourage) larger investors. For example, Vanguard offers lower expense ratios with its "Admiral" class shares, which have eligibility requirements that differ from "Investor" class shares only in their minimum investment thresholds. See *Admiral Shares*

Perhaps the obstacle is not the organization of the fund's investors, but rather the organization of fund management. The mutual fund representatives that we spoke to informed us that litigation decisions are often siloed in the general counsel's office and made without input from either the stewardship group charged with overseeing portfolio company governance or the portfolio managers charged with making investment decisions. Insofar as a fund's litigation activities are housed in the general counsel's office, distinct from fund management, then those with the best information and expertise—that is, portfolio managers with intimate knowledge of the companies in which they invest—may be unable to influence whether and how litigation proceeds. Note too that legal departments are generally seen as cost rather than profit centers, suggesting incentives—remaining within budget and mitigating risk—that are inconsistent with entrepreneurial litigation. As a result, the general counsel's office may disfavor bringing even those claims that are suggested by portfolio managers.[252]

Still, while we acknowledge that organizational obstacles can pose a challenge, such problems are entirely within the power of fund families to solve. The siloing of legal and operational departments can be solved by reorganizing reporting lines within the firm and empowering fund managers or stewardship groups to consider at least some kinds of shareholder claims. Moreover, funds could hire outside law firms to assist in these efforts; they could also hire in-house attorneys to assist fund managers and members of the stewardship team in evaluating and monitoring claims.[253] These costs would more than pay for themselves if they resulted in just one additional recovery each year.[254] The fact that funds have generally not made these changes suggests that some

Help Keep Your Costs Under Control (Vanguard), archived at https://perma.cc/MVV3-98YC.

252 Portfolio managers may have their own reasons for avoiding litigation, such as a fear of having their access to management cut off as a result of bringing a claim. See Bebchuk and Hirst, 119 Colum L Rev at 2062–65 (cited in note 14). We consider these incentive conflicts below. See Part III.D.1.

253 Many mutual fund families are in the process of expanding their stewardship groups. See, for example, Ning Chiu, *BlackRock's Annual Letter to CEOs Focuses on Doing Good and Continues to Emphasize Governance and Strategy* (Davis Polk, Jan 17, 2018), archived at https://perma.cc/TU83-LKL3 (explaining that BlackRock plans to double the size of its corporate governance group).

254 As Part II.A reveals, mutual funds can reap tens of millions of dollars when settling claims against portfolio companies.

factor other than structural obstacles explains the failure to participate in shareholder litigation.

C. Circularity

Perhaps it is the structure of mutual fund holdings, not the organizations that hold them, that inhibits shareholder litigation. Mutual funds are broadly diversified. Index funds, in particular, own essentially all publicly traded securities. As a result, some shareholder suits instigated by a mutual fund will be paid by the fund itself, as a shareholder of the corporate defendant.[255] This, of course, is a version of the circularity problem reviewed above.[256]

In our conversations with mutual fund representatives, they emphasized the circularity problem in answering why they are not more active participants in shareholder litigation. And they have a point. The circularity critique applies against several of the forms of shareholder litigation we reviewed above. Circularity suggests that compensation from successful securities class actions and even derivative suits are unimportant to long-term diversified shareholders. Circularity would also apply in the rare merger cases that recover additional deal compensation, provided that both the buyer and the target are represented in the fund's portfolio. In such cases, broadly diversified long-term shareholders would not necessarily prefer that the buyer pay more for the target company because they are effectively paying themselves.[257] However, in this context, the extent of the circularity problem depends on the relative weight of a fund's holdings. For example, a fund that owns a substantially larger fraction of the target than

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[255] See, for example, Amanda M. Rose and Richard Squire, *Intraportfolio Litigation*, 105 Nw U L Rev 1679, 1688 n 32 (2011).

[256] See text accompanying notes 110–13.

[257] Because broadly diversified shareholders are as sensitive to overpayment as they are to underpayment, they would have a preference for passivity in takeover defenses. See Frank H. Easterbrook and Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv L Rev 1161, 1177–78 (1981). See also Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 Stan L Rev 819, 831–48 (1981). For index funds, however, the incentives may be slightly different. Index funds are likely to own a proportionally greater interest in large market cap companies than in small market cap companies due to their weighting in the index. See text accompanying notes 243–44. Their interest in M&A thus depends on who is buying whom. If the deal is one in which a large company buys a smaller one, as is often the case, the index fund may prefer to pay the smallest possible premium because they are more exposed to overpayment than underpayment. This will be a systematic preference. Index funds will be indifferent to premia only in deals in which companies of similar size (and therefore similar weight in the index) acquire each other.

the acquiring company may still have incentives to pursue merger litigation or seek appraisal.

More fundamentally, however, compensation is not the only goal of shareholder litigation. Shareholder suits can also provide deterrence and governance enhancements. Lawsuits that actively police managerial misconduct will benefit the fund across its holdings not only by punishing misconduct when it occurs but also by discouraging misconduct at other firms in the portfolio. Likewise, governance enhancements extracted through litigation may improve the performance of firms in the portfolio, leading other firms to copy these innovations, and enhancing the value of the portfolio as a whole. Of course, litigation is an expensive way to accomplish these goals, but in certain cases, such as those involving egregious industry-wide fraud, litigation could pay off for investors.

Moreover, not all shareholder suits are intraportfolio. Shareholder suits may also arise against firms as they exit the portfolio. In some cases, the mutual fund may be able to exit from the investment by selling down shares: for example, T. Rowe Price's actively managed funds unloaded the bulk of their Valeant shares before commencing litigation against the drug company.[258] But not all funds will be able to exit by selling their shares. In those circumstances, a company can still exit the fund's portfolio through bankruptcy or acquisition, in which case compensation paid to shareholder plaintiffs would not be funded by other public shareholders. For example, a severe fraud may push a company into bankruptcy, in which case shareholder recoveries from securities or fiduciary duty lawsuits come not from other public shareholders but from assets otherwise available to creditors of the firm.[259] Shareholder suits against Enron and WorldCom, firms driven into bankruptcy by managerial misconduct, were not funded by public company shareholders and therefore do not present the circularity problem.

Likewise, acquisitions of public companies by nonpublic entities, such as private equity funds, also do not invoke circularity concerns. Because a company that is taken private does not by

[258] See Vardi, *Valeant's Longest Supporter* (cited in note 182) (noting that T. Rowe Price sold most of its Valeant shares just months before filing suit). See also Part II.A.5.

[259] They likely come from D&O insurance proceeds. See Baker and Griffith, 95 Georgetown L J at 1802–03 (cited in note 117) (discussing how D&O policies fund litigation recoveries against insolvent companies).

definition have a public company buyer, public company investors are not on both sides of the transaction. The Dell transaction we discussed above is a good example of this—the mutual fund plaintiffs with investments in Dell did not need to worry that the appraisal litigation would affect the share price because they were no longer shareholders of the new privately held company.[260] As a result, shareholder suits that cause additional consideration to be paid in take-private transactions, whether these suits are brought as fiduciary duty claims or appraisal actions, are not subject to the circularity critique. Mutual funds would benefit from such suits.

D. Agency Problems

Mutual funds' lack of engagement in shareholder litigation may be explained by a principal-agent problem: the interests of the institution charged with making the litigation decisions may diverge from the interests of the institution's investors. Agency cost issues are frequently raised to account for perceived defects in how mutual funds exercise their voting rights.[261] They may thus also play a role in explaining how mutual funds exercise litigation rights.[262] In discussing these issues, we will distinguish between three distinct agency cost problems. First, mutual fund complexes are for-profit institutions and suffer from conflicts of interest that may affect litigation decisions. Second, intermediation creates collective action problems that may cause mutual funds to engage in a suboptimal amount of litigation. Third and relatedly, a mutual fund's fee structure may lead to suboptimal incentives to litigate. We address each of these agency problems in turn below.

1. Corporate client conflict.

Mutual funds' incentives to cater to the interests of their corporate clients may lead them astray from acting as faithful stewards of their investors' capital, a situation we have elsewhere

260 See text accompanying notes 193–97.

261 See Bebchuk and Hirst, 119 Colum L Rev at 2043–75 (cited in note 14); Gilson and Gordon, 152 U Pa L Rev at 789 (cited in note 83); Lund, 43 J Corp L at 498–506 (cited in note 14); Rock and Kahan, *Index Funds and Corporate Governance* at *16 (cited in note 5).

262 See, for example, Webber, 38 Del J Corp L at 923 (cited in note 15) (discussing agency problems that may compromise mutual funds' efforts in litigation).

referred to as "Corporate Client Conflict."[263] The most obvious—but by no means only—such conflict is corporate 401(k) accounts. Insofar as fund families derive profits from assets under management and corporate 401(k) accounts are a large source of potential assets under management, fund families have a strong incentive not to sue the corporations that direct 401(k) assets to them.[264] In this way, corporate client conflict may undermine mutual funds' efforts in litigation.

Consider BlackRock, one of the world's largest asset managers with over $6 trillion assets under management (AUM).[265] Approximately two-thirds of BlackRock's AUM comes from corporate pension plans.[266] Investors pay a fee that is calculated as a percentage of these assets, and that fee accrues to BlackRock, rather than the fund.[267] In total, these fees make up about 83 percent of BlackRock's revenue.[268]

Recently, however, BlackRock—like all mutual fund families—has faced pressure to lower fees. This is in part because competition over fees has become more intense, especially for the passively managed mutual funds in which BlackRock specializes.[269] Hence, BlackRock has focused on diversifying its revenue sources, primarily by providing other services to corporations and institutional clients.[270] BlackRock is not unique in this respect—large mutual fund complexes often provide a range of client services, including brokerage, underwriting, insurance, or banking

263 Griffith and Lund, 99 BU L Rev at 1157 (cited in note 14).

264 This conflict results in problems for investors in other contexts as well. See William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 Tulane L Rev 1401, 1441–42 (2006); Tamar Frankel, *Advisory Fees: Evolving Theories*, 10 Investment Lawyer 21, 21–23 (2003); John P. Freeman and Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J Corp L 609, 639–40 (2001); Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J Econ Persp 161, 172 (2004).

265 This example also appears in our recent publication, Griffith and Lund, 99 BU L Rev at 1176–79 (cited in note 14). Note that by choosing BlackRock as an example, we do not suggest that it experiences more severe conflicts than other mutual fund complexes. Similar conflicts likely exist at all institutional investors.

266 See *Fiduciary for You: 2017 Annual Report* *6 (BlackRock, 2018), archived at https://perma.cc/3P48-3YU3.

267 Fisch, Hamdani, and Solomon, *The New Titans of Wall Street* at *9 (cited in note 14).

268 *Q4 2017 Earnings: Earnings Release Supplement* *9 (BlackRock, Jan 12, 2018), archived at https://perma.cc/UM7S-U839.

269 Jason Zweig and Sarah Krouse, *Fees on Mutual Funds and ETFs Tumble Toward Zero* (Wall St J, Jan 26, 2016), archived at https://perma.cc/2NWR-R6HZ.

270 See *Fiduciary for You* at *35 (cited in note 266).

services. But insofar as BlackRock and other funds depend upon corporate revenue lines, they may be less likely to oppose corporations, in either voting or litigation.

Evidence supporting this view comes from findings that mutual fund complexes are very likely to vote for management proposals, especially when they hold a large percentage of assets under management in passive investment vehicles.[271] Likewise, mutual funds almost never bring shareholder proposals or proactively engage in shareholder activism.[272] If voting against management likely threatens the mutual fund business, suing management certainly does.[273] Any suit that requires the mutual fund to take a position contrary to management—which is to say all shareholder suits—would threaten to disrupt the fund's ability to retain or win 401(k) assets or other business from management.[274] These incentives are compounded by reputational effects. For example, if BlackRock were known in the market to litigate against managers, regardless of whether they in fact managed assets or had other business from that particular corporate client, it might discourage other corporate clients from placing business with BlackRock.

Nevertheless, Corporate Client Conflict does not necessarily dampen funds' incentives to bring *all* forms of shareholder litigation. For one, challenging egregious instances of fraud is not as likely to result in blowback from chastened management teams or other companies. Indeed, the examples of misconduct described in Part II.A all involved instances of headline-making fraud and misconduct and generated litigation from dozens of defendants.

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271 Alon Brav, et al, *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests* *3 (European Corporate Governance Institute, Finance Working Paper No 601/2019, Mar 2019), archived at https://perma.cc/5DNZ-KYQZ; Ryan Bubb and Emiliano Catan, *The Party Structure of Mutual Funds* *3, 23 (unpublished manuscript, Mar 8, 2019), archived at https://perma.cc/3KGT-MVJJ.

272 Bebchuk and Hirst, 119 Colum L Rev at 2103 (cited in note 14); John Morley, *Too Big to Be Activist*, 92 S Cal L Rev 1407, 1413–14 (2019).

273 See Gerald F. Davis and E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J Fin Econ 552, 554 (2007) (noting Vanguard founder Jack Bogle's statement in a letter to the SEC that "[v]otes against management may jeopardize the retention of clients of 401(k) and pension accounts").

274 In theory, a fund's promise to control litigation agency costs would be desirable from management's perspective. For example, were a fund to commit ex ante to helping the company avoid meritless litigation, it could possibly attract clients, rather than alienate them. But the practical reality is that screening often requires intervening and objecting to meritless settlements—which necessitates taking an adversarial position against management.

In such cases, the decision to participate in litigation might be viewed as inevitable, rather than an opportunistic decision to challenge a particular management team warranting cutting off a business relationship.

Similarly, a company exiting the portfolio through bankruptcy will not be able to punish mutual funds for litigating against it nor will managers who, like Dennis Kozlowski, are sent to prison for committing fraud.[275] Corporate Client Conflict may therefore operate as a weaker constraint with regard to bankrupt defendants, especially when misconduct suggests the end of the managers' careers as well. Likewise, Corporate Client Conflict may not constrain funds from bringing shareholder suits against target companies that have been acquired. However, insofar as the managers of these companies do not themselves exit the market but go on to manage other firms (or continue to work at the company that acquired the defendant company), Corporate Client Conflict may still exert some deterrent effect on merger suits brought by mutual funds. Managers who are in jail or otherwise out of the C-suite are in no position to retaliate, but managers who go on to serve as managers at other firms are.

2. Collective action problems.

The reluctance of mutual funds to participate in shareholder litigation may also be related to the collective nature of lawsuit recoveries. Compensation paid in a securities class action, for example, is awarded pro rata to the class, meaning that a mutual fund that sues secures benefits according to its proportional stake in the company, but so too do mutual fund competitors whose portfolios also include the corporate defendant. Likewise, any benefits from deterrence or governance enhancements won through litigation will also be enjoyed not only by the fund bringing the lawsuit but also by every other fund (and every other investor) that also owns the underlying company. Insofar as mutual funds compete for capital inflows on the basis of their performance relative to other funds, they have little incentive to use litigation to improve performance on a pro rata basis.[276] This is

[275] See text accompanying notes 169–71.

[276] Professor Edward Rock was one of the first to draw attention to this phenomenon as a barrier to institutional investor engagement in corporate governance. See Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 Georgetown L J 445, 453–57, 461–62 (1991) (discussing the free-rider problem created by

especially true if lawsuits are costly, in which case litigious funds bear all the costs while sharing the benefits with rival funds. The collective nature of lawsuit recoveries thus inhibits mutual funds from participating in litigation to bring them about.

Several scholars have recently focused on the collective action problem arising from mutual funds' measurement of their performance on a relative basis.[277] As one of us has pointed out, this problem is most pronounced for index funds.[278] Active funds, by contrast, may be able to increase their relative performance by using the levers of corporate governance, including litigation.[279]

Our point here is not to claim that collective action problems are insurmountable, but to acknowledge their role in shaping mutual funds' incentives to litigate. In particular, collective action problems may explain the failure of mutual funds to serve as lead plaintiffs.[280] Many forms of shareholder suits seek to reduce the cost of participating as plaintiff—for example, taking attorneys' fees out of the recovery, taxing them to the corporate defendant rather than the plaintiff, and, in some cases, providing an incentive payment to lead plaintiffs to offset costs incurred in monitoring class counsel.[281] But none of these strategies addresses the problems created by the sharing of the benefit. This incentive problem is compounded by the Corporate Client Conflict

the fact that the fruits of any such efforts at disciplining management will be shared with the rest of the class, while the costs will be borne by the mutual fund alone).

277 See, for example, Bebchuk, Cohen, and Hirst, 31 J Econ Persp at 97–98 (cited in note 14); Ronald J. Gilson and Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 Colum L Rev 863, 890 (2013).

278 See Lund, 43 J Corp L at 510–11 (cited in note 14).

279 Id at 512. Others contest that passive index funds' incentives will lead to too little stewardship. Professors Jill Fisch, Assaf Hamdani, and Steven Solomon claim that index funds compete with active funds for capital inflows which may give them an incentive to engage with corporate governance. See Fisch, Hamdani, and Solomon, *The New Titans of Wall Street* at *12–20 (cited in note 14). Professors Edward Rock and Marcel Kahan, meanwhile, acknowledge that performance benefits must be shared with other investors but emphasize the direct benefits in fees that the largest index funds stand to gain from improvements in portfolio company performance. See Rock and Kahan, *Index Funds and Corporate Governance* at *26–28 (cited in note 5).

280 See Webber, 38 Del J Corp L at 940–41 (cited in note 15) ("For mutual funds that compete with one another . . . serving as a lead plaintiff means incurring costs while conferring free benefits on your competitors.").

281 See Theodore Eisenberg and Geoffrey P. Miller, *Incentive Awards to Class Action Plaintiffs: An Empirical Study*, 53 UCLA L Rev 1303, 1320 (2006) (finding that incentive fees were reported in 104 of 374 cases). The PSLRA generally bars incentive awards in securities class actions. See 15 USC § 78u-4(a)(4). However, Delaware courts have occasionally awarded incentive fees. See, for example, *Chen v Howard-Anderson*, 2017 WL 2842185, *17 (Del Chanc) (awarding $1.25 million in incentive fees to plaintiffs).

discussed above—a litigious fund may not be able to find corporate clients. Better, then, to free ride on the efforts of other investors.

Nevertheless, the collective action problem does not apply to non–pro rata recoveries. Not all shareholder suits are class actions. As noted above, mutual fund plaintiffs can and occasionally do opt out of shareholder class actions in order to bring their own claims. For example, each of the shareholder suits brought by fund families against Countrywide, Petrobras, Tyco, Valeant, and American Realty were individual actions and therefore not subject to the collective action problem.[282] Whatever funds BlackRock recovered in these claims were retained by BlackRock alone and not shared with Vanguard or State Street. The fact that the collective action problem does not apply to these claims may explain why they were brought in this way, but it does not explain why there were only five of them over a ten-year period. Likewise, the collective action problem does not apply to appraisal actions which, like individual securities suits, are not shared with a broader class that necessarily includes a funds' competitors. Therefore, the fact that funds do not bring appraisal actions cannot be attributed to collective action problems.

3. Diminished incentives due to fee structure.

Professors Lucian Bebchuk and Scott Hirst observe that mutual funds may underinvest in stewardship because they receive only a small percentage of any gains.[283] As discussed, mutual fund fees are set at a percentage of assets under management. As such, the mutual fund family will not be interested in investing in stewardship if it is unlikely to increase assets under management, and therefore, the amount of fees that the fund complex collects. The same incentive problem affects litigation decisions as much as other forms of stewardship. In other words, the problem might not be that the benefit from participating in litigation is shared, but that the benefit to the fund family is small or negligible.

However, as the examples in Part II.A demonstrate, stewardship litigation can generate many benefits for mutual fund investors. And mutual fund portfolio managers owe fiduciary duties to their investors. They are therefore obligated to pursue litigation

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[282] See Part II.A.
[283] See Bebchuk and Hirst, 119 Colum L Rev at 2052–56 (cited in note 14).

in the best interests of their investors even when it does not result in a substantial benefit to the institution itself.

E. A Revealed Preference on Stewardship

Finally, focusing on the parallel between voting and litigation as alternative stewardship techniques gives rise to a further possibility—that mutual funds' failure to participate in shareholder litigation reveals their actual preferences with respect to stewardship generally. According to this view, the difference between their willingness to vote in shareholder elections and their reluctance to litigate comes from the simple fact that voting is emphasized and, in some cases, required by regulators while litigation is not. Under these circumstances, the failure to engage in litigation thus can be read to suggest that if voting were not the subject of regulatory attention, mutual funds would not vote either.

Mutual funds almost always vote,[284] but this was not always so. Indeed, Jack Bogle, the inventor of the index fund, recalled a time when mutual fund managers believed that they should leave the performance of the companies in their portfolios to "the invisible hand of the marketplace."[285] But as investor dollars continued to flow into mutual funds, rendering them a powerful force in corporate governance, the SEC made their fiduciary obligations clear—at least with respect to voting. Specifically, in 2003 the SEC adopted rules stating that investment advisors are required by fiduciary duty to cast votes in the best interests of their investors and requiring mutual funds to disclose how they vote.[286]

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[284] See *2018 Proxy Season Review* *4 (ProxyPulse, Oct 2018), archived at https://perma.cc/2WPH-7X78 (reporting institutional investor voting participation at 91 percent, compared to 28 percent for retail investors). For discussion of the reasons why mutual funds are now actively voting, see Part II.B. Further, mutual funds increasingly boast about their voting. See *2018 Investment Stewardship Report* at *3 (cited in note 13) (emphasizing "four pillars" of engagement: board composition, executive compensation, oversight of risk and strategy, and governance structures); *Asset Stewardship* (cited in note 10) ("Our approach to stewardship is designed to have an impact through thought leadership, engagement, proxy voting and client disclosure."); Larry Fink, *Larry Fink's 2018 Letter to CEOs: A Sense of Purpose* (BlackRock, 2018), online at https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter (visited Feb 24, 2020) (Perma archive unavailable) (noting that "our responsibility to engage and vote is more important than ever").

[285] Krouse, Benoit, and McGinty, *Meet the New Corporate Power Brokers* (cited in note 4).

[286] See Securities and Exchange Commission, Proxy Voting by Investment Advisors, 68 Fed Reg 6585, 6586 (2003), codified at 17 CFR § 275.206(4)-6(a)–(b). See also Securities and Exchange Commission, Disclosure of Proxy Voting Policies and Proxy Voting Records

Overlaying these obligations are regulations created by the Department of Labor (DOL) that strongly encourage funds managing ERISA assets to vote.[287] Although many mutual funds do not manage ERISA assets, fund advisors may reason that given the lack of an obvious distinction between pension fund fiduciary duties and mutual fund fiduciary duties, they are likewise compelled to vote.[288] Although there are good reasons to question this legal interpretation, it may nevertheless be followed by fund managers to mitigate compliance risk.[289] As a result, funds now employ third-party proxy advisors and in-house stewardship teams to manage the voting of their massive portfolios.[290] And they do so largely because regulators have told them to.

Regulators have made no such pronouncement with regard to litigation. Neither the SEC nor the DOL has ever adopted rules suggesting that fund advisors' duties to their investors compel them to litigate. Nor are we suggesting that they should. But the obvious parallel between the benefits attainable through voting and the arguably greater benefits attainable through participating in litigation suggest that if mutual fund stewardship

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by Registered Management Investment Companies, 68 Fed Reg 6564, 6564 (2003), codified at 17 CFR §§ 239, 249, 270, 274.

287 The Department of Labor articulated its position first in a set of letter rulings. See Letter of Alan D. Lebowitz, Deputy Assistant Secretary, US Department of Labor, Feb 23, 1988, reprinted in 15 Pension Rptr (BNA) 391, 392 (1988) ("[T]he decision[s] as to how proxies should be voted . . . are fiduciary acts of plan asset management."); Letter of Alan D. Lebowitz, Deputy Assistant Secretary for Program Operations, Department of Labor, Jan 23, 1990, reprinted in 17 Pension Rptr (BNA) 244, 245 (1990) ("[T]he fiduciary act of managing plan assets which are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock."). These rulings were later reaffirmed in guidelines stating that "[t]he fiduciary act of managing plan assets that are shares of corporate stock includes the management of voting rights appurtenant to those shares of stock." Employee Benefits Security Administration, Interpretive Bulletin Relating to Exercise of Shareholder Rights, 73 Fed Reg 61731, 61732 (2008).

288 See Scott Hirst, *Social Responsibility Resolutions*, 43 J Corp L 217, 219 n 4 (2018) (noting that the effect of the DOL's ruling "has been that investment advisers to mutual funds routinely vote the shares of those mutual funds").

289 See Griffith, 98 Tex L Rev at *54 (cited in note 14) (arguing that voting is not necessarily compelled by mutual fund advisors' fiduciary duties).

290 A deeper look at mutual funds' voting records leaves much to be desired. For example, mutual fund complexes—and especially the large passive ones—support management much more often than other investors. See Bubb and Catan, *The Party Structure of Mutual Funds* at *3 (cited in note 271). They also follow their proxy voting guidelines closely, achieving impressive uniformity in voting across vastly different funds. See Griffith and Lund, 99 BU L Rev at 1179–82 (cited in note 14); Lund, 43 J Corp L at 517 (cited in note 14). Therefore, the regulatory pressure may be alleviating the symptom of the problem—the lack of voting—rather than resolving the underlying agency problems that compromise mutual fund voting.

programs were driven by the desire to secure benefits for investors, such programs would also include litigation.

What would happen if neither were required? One possibility is that mutual funds would neither vote nor litigate. This may be going too far. We have shown, after all, that mutual funds *rarely* engage in litigation, not that they *never* do. Moreover, the fact that mutual funds generally do not litigate need not imply that funds are indifferent to providing benefits for their investors but perhaps only that they are unaware of the benefits that they might provide through litigation. The question thus becomes whether and how mutual funds could create value for their investors by engaging in shareholder litigation. This is our central focus in the next Part.

IV. A MISSION STATEMENT FOR MUTUAL FUNDS IN SHAREHOLDER LITIGATION

In considering how mutual funds *should* approach shareholder litigation, we begin by recognizing the unique position that mutual funds occupy in the market. Many mutual funds are market investors. They hold a broadly diversified portfolio that puts them on both sides in many shareholder suits. Index funds in particular, by owning essentially all publicly traded equities, are paradigmatic market investors.

Adopting the market investor's perspective on shareholder litigation invokes circularity concerns, at least with respect to lawsuits seeking compensation. However, it does not render funds indifferent or hostile to shareholder litigation as a whole; market investors should be interested in pursuing extraportfolio suits, as well as suits that result in improved deterrence or governance enhancements. Furthermore, adopting the perspective of the market investor suggests an important role for mutual funds in containing litigation agency costs. Because the cost of wasteful litigation is distributed throughout the market portfolio, mutual funds have an opportunity to exert a gatekeeping role, refusing to participate in suits and objecting to settlements that fail to create meaningful benefits for shareholders.

These considerations allow us to frame a mission statement for mutual funds in shareholder litigation. In it, we elaborate four key principles to guide mutual funds in evaluating and pursuing shareholder claims. First, mutual funds should litigate extraportfolio for compensation. Second, mutual funds should litigate intraportfolio to increase deterrence or, third, to enhance corporate governance. Fourth, mutual funds should intervene to minimize litigation agency costs. We discuss each of these principles in the sections that follow and also suggest how mutual funds might overcome obstacles to implementing the mission statement—including the structural impediments and agency problems described above. As we will show, it is possible for mutual funds to implement the mission statement without unduly burdening either the institution or its investors. In fact, we argue that by adopting a few simple changes, mutual funds will be able to reap litigation benefits without substantially increasing their costs.

A. Litigate Outside of the Portfolio for Compensation

The circularity critique suggests that it will generally be self-defeating for mutual funds to seek compensation against intraportfolio defendants because the funds will be on both sides of such cases and thus pay themselves in the event of a recovery. But as discussed, not every instance of shareholder litigation presents an intraportfolio problem. In these cases, mutual funds should litigate for compensation because any amount recovered would increase overall portfolio returns, benefitting the fund's investors. In the sections that follow, we describe examples of cases that would not present an intraportfolio problem for mutual funds and thus should be a primary focus for mutual fund litigation.

1. Exit cases.

When a company exits the mutual fund's portfolio, the mutual fund may be able to litigate for additional compensation without running into the circularity problem. In particular, when a company is acquired or goes bankrupt, the mutual fund may be able to challenge misconduct without worrying that it will fund its own recovery. We address each exit scenario in turn.

In the acquisition context, shareholders can bring derivative or securities claims challenging the merger, as well as appraisal suits, in order to increase the amount they receive in the deal. Note again that when mutual funds stand on both sides of the "v," the desirability of participating in shareholder litigation challenging the merger will often depend on the relative size of those investments.[291] From the mutual fund's perspective, litigating to increase the consideration paid in connection with the acquisition of one portfolio company by another is typically pointless and, once litigation costs are taken into account, wasteful. Such claims benefit only those mutual funds with a significantly larger stake in the target than in the acquirer.

But mutual funds should favor merger claims when the acquiring company is not in the fund's portfolio. This will typically be the case in a going-private transaction, but it may also be true in cases where the acquirer is not in the index for other reasons. In such cases, mutual funds should consider filing derivative or direct claims seeking additional consideration.

Appraisal actions are also possible, but they present a special challenge for mutual funds. Appraisal suits are a potentially powerful mechanism to increase consideration paid in acquisitions.[292] But the mechanics of appraisal suits raise the specter of destroying the deal. Because appraisal rights arise only when the shareholder has voted against the transaction,[293] a large blockholder looking to perfect its appraisal rights may cause the deal not to be approved. Additionally, even if seeking appraisal does not cause the transaction to be voted down, many acquisition agreements contain a term allowing the buyer to terminate the agreement if a sufficiently large group of shareholders seeks appraisal.[294] A large blockholder seeking appraisal may thus be enough to scuttle the deal. Mutual funds should therefore weigh the appraisal option carefully, seeking it only when there are indicia of wrongdoing—a cursory process infected with self-interest—and when their opposition will not lead to the failure of the deal or when they do not mind if it does.

Second, apart from acquisition, firms may also exit the portfolio through bankruptcy. When this occurs, shareholders may be able to bring derivative or securities law claims against managers whose misconduct caused the corporation to fail. Because the shareholders' interest is generally extinguished when firms fail, these may not seem to be a promising setting for investor

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291 See text accompanying notes 257–58.

292 But see note 198 (describing a trio of decisions from the Delaware Supreme Court recognizing the deal price as a market measure of fair value).

293 See 8 Del Code Ann § 262(a).

294 See Boone, Broughman, and Macias, 62 J L & Econ at 312–13 (cited in note 92) (discussing "appraisal out" clauses and finding that they are less common as the likelihood of appraisal rises).

compensation. However, when the firm failure is caused by fraud or mismanagement, there may often be a derivative suit or securities claim against the individual managers that perpetrated the fraud. These cases are typically funded by D&O insurance and, on occasion, by contributions from the managers themselves.[295] As a result, such claims present an opportunity for the mutual fund to secure compensation without funding the recovery through the portfolio.[296]

2. Extraportfolio defendants.

Not every lawsuit will involve a portfolio company as defendant, and mutual funds should aggressively pursue monetary recoveries in those that do not. Such claims arise in two basic contexts: (1) derivative suit recoveries funded by individual managers, and (2) securities claims against non-issuer defendants. We address each of these contexts in turn.

In a paradigmatic derivative suit, the shareholder sues on behalf of the company to force a culpable manager to pay funds back into the corporation. Because such recoveries are funded by individual managers, not the corporation itself—corporations are barred by state law from indemnifying mangers in such cases[297]—they do not present the same circularity problem as other compensation-based claims. Insurance, however, complicates this dynamic. Most D&O policies provide coverage for derivative suits.[298] As a result, derivative suit recoveries may be largely

[295] For example, the former directors of Enron contributed funds to settle the securities class actions involving that firm. See Rebecca Smith and Jonathan Weil, *Ex-Enron Directors Reach Settlement* (Wall St J, Jan 10, 2005), archived at https://perma.cc/WB56-Q489 (noting that ten former Enron executives agreed to contribute a total of $18 million to the settlement).

[296] Even when the recovery is funded wholly by insurance, because the companies are exiting the portfolio, the insurer will not be able to collect future premiums to recoup the losses. However, the fund may have to consider whether the insurer is likely to raise premiums for other companies—if so, the market investor will bear these costs across the portfolio. Further complications may be introduced into this analysis if the insurer is itself a portfolio company. But even in such cases, the structure of D&O coverage, involving multiple insurers and reinsurers, not all of which are public companies and therefore within the portfolio, suggests that at least some of this cost will fall outside of the portfolio.

[297] 8 Del Code Ann § 145(a)–(b).

[298] See Baker and Griffith, 95 Georgetown L J at 1803 (cited in note 117). Moreover, the deductibles for derivative suit recoveries are substantially lower than the deductibles for other forms of loss under most D&O policies, such as the company's indemnification obligations or its own liabilities in securities claims. Id at 1804 n 38.

funded by D&O insurance, which again raises the specter of circularity because corporations pay for D&O policies.

There is an exception, however, for cases establishing actual fraud, either through settlement or adjudication. Policies exclude actual fraud from coverage.[299] This suggests a narrow way out of the circularity problem. The market investor's incentive to bring derivative suits is strongest when the evidence suggests actual fraud, in which case recoveries will be funded by individual defendants, not by the company either directly or indirectly through insurance. Such claims will likely be rare—the cost of litigation, often funded by the corporation through the D&O policy, may often exceed the potential recovery from individual defendants. But even if they are rare, such suits may provide some compensatory benefit and, as discussed below, an even greater benefit through deterrence.

The second form of extraportfolio litigation arises in connection with securities cases against non-issuer defendants. For example, cases under § 11 of the Securities Act may be brought against a range of non-issuer defendants including individual directors and officers, underwriters, and accountants.[300] Although seeking compensation from individual directors and officers in such claims may again raise circularity problems through the D&O policy, claims against underwriters and accountants may not. Because some underwriting firms—for example, Goldman Sachs—are publicly traded and therefore present in the market investor's portfolio, compensation-based claims against such defendants do effectively suffer from a circularity problem.[301] Nevertheless, some underwriters and most accounting firms are not publicly traded and therefore not present in the market portfolio. Mutual funds might therefore pursue compensation-based claims against such defendants.

In sum, litigating for compensation will be a beneficial strategy for mutual fund plaintiffs when the defendant is exiting the funds' portfolio or is not a portfolio company. And although a mutual fund plaintiff can participate in litigation as a member of the class, opting out will likely provide additional benefits for investors: namely, the ability to litigate for higher rewards and faster payment, when appropriate. In the mutual fund suits against

299 Id at 1804–05.
300 See 15 USC § 77k(a).
301 See Rose and Squire, 105 Nw U L Rev at 1687–89 (cited in note 255).

Countrywide, Petrobras, Tyco, American Realty, and Valeant, the decision to opt out likely resulted in a higher payment, and certainly a faster one.[302] In cases where compensation is the primary goal, therefore, we imagine that opting out will be the fund's best strategy.

B. Ensure that Litigation Inside the Portfolio Provides Effective Deterrence

The circularity critique also does not reach the deterrence rationale for shareholder suits. The basic goal of deterrence in civil litigation is to make the wrongdoer internalize enough of the cost of her activity to induce her not to engage in socially harmful conduct.[303] By pursuing deterrence goals, mutual funds would act as "private attorneys general," policing their portfolio for misconduct.[304] There are two ways for mutual funds to serve in this role: either as lead plaintiffs, bringing claims themselves, or as overseers of shareholder suits brought by other plaintiffs, using their influence to ensure that the suits accomplish meaningful deterrence. We address each in turn.

First, mutual funds should seek to serve as lead plaintiffs for strong shareholder claims.[305] As lead plaintiffs, mutual funds would be in the best position to ensure that the lawsuit accomplished meaningful deterrence. Most obviously, mutual funds could insist on personal liability for responsible managers as a condition to resolving shareholder suits. Or, in cases of severe managerial misconduct, mutual funds could insist upon the termination of top managers and, by precommitting to vote against any board employing these managers in the future, effectively ban them from the management of publicly traded corporations.

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302 See Part II.A. See also John C. Coffee Jr, *Accountability and Competition in Securities Class Actions: Why "Exit" Works Better than "Voice"*, 30 Cardozo L Rev 407, 409 (2008) ("That 'exit' may work better than 'voice' is evidenced by the striking disparity that has recently arisen between the modest payouts to class members who remain in the class versus the much higher returns to institutional investors who opt out and sue in individual actions."); Platt, 53 UC Davis L Rev at 1488 (cited in note 15) (calculating hypothetical opt-out recoveries for Vanguard's S&P 500 fund and estimating that had the fund opted out in three cases in 2016, it could have increased investor returns by several basis points).

303 On the problem of setting sanctions to promote optimal deterrence, see Steven Shavell, *Foundations of Economic Analysis of Law* 473–91 (Harvard 2004).

304 See John C. Coffee Jr, *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 Md L Rev 215, 216, 227–30 (1983) (discussing virtues and vices of the private attorney general model in securities litigation).

305 See Weiss and Beckerman, 104 Yale L J at 2096 (cited in note 39).

Mutual funds can thus enhance deterrence by imposing a credible threat of punishment through civil litigation.

Mutual fund participation in merger litigation can also enhance deterrence. When mutual funds are on both sides of public company deals, their principal interest in merger litigation will be to deter serious misconduct in the deal process more than it will be to extract additional consideration from the buyer. By serving as the class representative in cases where misconduct may be present, mutual funds can insist that managers bear personal responsibility for the deal process, again threatening personal liability or portfolio-wide bans of managers that engage in serious misconduct. Likewise, in a derivative suit, mutual funds could pursue claims to extract genuine deterrence against specific corporate managers and refuse to settle for corporate therapeutics that offer little or no value.[306]

Serving as lead plaintiff or class representative comes at a cost. However, given the willingness of attorneys to litigate shareholder suits on a contingency fee basis, the cost will principally be one of time and attention. Furthermore, some forms of shareholder suits offer fees to offset such costs borne by lead plaintiffs and class representatives.[307] This would seem to be an ideal role for mutual fund stewards, with the availability of fees offsetting the costs of stewardship.

Still, mutual funds cannot bring every shareholder suit. The Private Securities Litigation Reform Act[308] (PSLRA) limits the number of times a single plaintiff can serve as lead plaintiff in a private securities class action to five times in three years.[309] Nor, we expect, would they want to bring every claim. As a result, even if mutual funds were to become more involved in shareholder litigation, we expect that other plaintiffs would continue to bring many suits on a class or other representative basis. Nevertheless, mutual funds retain a critical role in these suits as well. Their blockholdings put large mutual funds in an excellent position to oversee shareholder suits brought by other plaintiffs.[310] This leads

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306 On the debate over therapeutic relief in the settlement of derivative suits, see text accompanying notes 53–64.

307 See text accompanying note 281.

308 Pub L No 104-67, 109 Stat 737 (1995), codified as amended in various sections of Title 15.

309 15 USC § 78u-4(a)(3)(B)(vi).

310 Compare Rose, 108 Colum L Rev at 1354–64 (cited in note 109) (suggesting that the SEC be given oversight authority to prescreen 10b-5 complaints to protect against

us to our second point: Mutual funds should actively oversee shareholder suits brought by other plaintiffs and use their influence to ensure that these suits achieve meaningful deterrence.

In an oversight role, mutual funds can use their leverage as class members to avoid both underdeterrence and overdeterrence. If the class representative and her legal team disregarded their input, large mutual funds could mount a leadership challenge, alleging inadequacy of the class representative, seeking sanctions for inadequate representation of counsel, and offering to take control of the litigation effort. The ability of mutual funds to credibly threaten to do so in virtually every shareholder suit would have a feedback effect on the incentives of class counsel. Understanding that mutual funds will countenance intraportfolio litigation only when it produces meaningful deterrence, class counsel would pursue litigation only in appropriate cases. In sum, by actively engaging in an oversight role, mutual funds could improve the deterrence effect of shareholder suits on the whole.

Nevertheless, a major obstacle to accomplishing deterrence goals through shareholder litigation arises from D&O insurance policies that indemnify managers and the corporations they serve for losses incurred in shareholder litigation.[311] Insofar as D&O insurance holds companies and their managers harmless for the kind of conduct leading to shareholder claims, we cannot expect liability in shareholder suits to adequately deter managerial misconduct. This leads us to the third priority for mutual funds: if funds are to use shareholder litigation to create meaningful deterrence, they should first consider encouraging portfolio companies to realign their D&O policies to be consistent with deterrence objectives.

Most D&O policies include two basic types of coverage. First, individual-level coverage protects individual managers against covered losses.[312] Second, entity-level coverage protects the corporation itself from losses arising from its indemnification obligations to individual managers and from losses it incurs as a named defendant in shareholder suits.[313] The vast majority of losses

overdeterrence), with Coffee, 42 Md L Rev at 216 (cited in note 304) (noting society's reliance on private institutions to enforce certain laws).

311 See Baker and Griffith, 95 Georgetown L J at 1832–33 (cited in note 117112).

312 This is referred to as "Side A" coverage under most D&O policies. Id at 1802.

313 Losses incurred as a result of corporate indemnification obligations are covered under "Side B" of the D&O policy, and losses directly incurred by the corporation as a defendant are covered under "Side C." Id.

incurred under D&O policies are incurred under entity-level coverage.[314] Entity-level coverage effectively means that, apart from the deductible, the corporation suffers no harm from managerial misconduct provided the settlement is within the limits of the insurance policy. When corporate losses are indemnified by an insurance company, the corporation therefore has less of an incentive to police the conduct of its managers to prevent misconduct ex ante. In this way, the principal effect of entity-level coverage is to render corporations less sensitive to managerial misconduct. In prior coauthored work, one of us argued that there is no good explanation for this form of coverage, only a bad one—that is, agency costs.[315] Managers use D&O insurance to sever shareholder litigation from its deterrence function.

Mutual funds could reestablish the deterrence function of shareholder litigation by minimizing the distortions introduced by entity-level coverage. One way of doing this would be simply to eliminate entity-level D&O coverage, insisting that policies cover only individual directors' liabilities.[316] Restructuring policies in this way would protect against managerial risk aversion while at the same time leaving corporate assets exposed in shareholder suits. Corporate losses in shareholder suits would be rendered more salient. Uninsured losses would have a greater impact

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314 See id at 1803 ("Our participants confirmed that the vast majority of D&O insurance losses are incurred under Side B and C—that is, entity-level coverage. Thus, to a substantial extent, D&O insurance is corporate insurance.") (citations omitted).

315 See Baker and Griffith, 95 Georgetown L J at 1841 (cited in note 117) (citation omitted), arguing:

> In order for shareholders to benefit from entity-level D&O coverage, there must be some benefit to the coverage other than pure risk distribution, which shareholders could accomplish more efficiently through portfolio diversification. Although some plausible explanations have been suggested . . . [n]one . . . accounts for the pure risk distribution form of D&O insurance that we observed. . . .
>
> We are therefore left with only one satisfactory explanation for the form of D&O insurance that we observed: agency costs. Managers do not want insurers monitoring their decisions ex ante and they do not want them managing their defense ex post. Both monitoring and defense management would reduce managers' autonomy and, relatedly, their ability to profit at the shareholders' expense.

The authors conclude that "our research strongly suggests that the prevailing form of D&O insurance benefits management at the shareholders' expense." Id at 1842.

316 This form of coverage exists. It is referred to in the industry as "Side-A only" coverage. Side-A only coverage benefits firms by addressing the risk aversion of individual directors, thereby encouraging directors to serve without distorting their incentive to monitor. See id at 1804 n 38.

on share price and on incentive compensation packages. As a result, the corporation would likely take greater care to avoid them ex ante. Eliminating entity-level D&O coverage would thus improve the deterrent effect of shareholder litigation.

If their appeals to restructure D&O coverage fall on deaf ears, mutual funds might be able to achieve a similar effect by insisting, either as lead plaintiffs or as prospective objectors, that a significant portion of any recovery *not* be funded by insurance. Forcing the corporate defendant or, in extreme cases, individual managers, to fund losses would have the same effect as eliminating entity-level coverage but on an ad hoc basis. Another way to accomplish the same thing would be to plead actual fraud in the complaint, thereby triggering the fraud exclusion and eliminating D&O coverage from the recovery.[317] However they do it, mutual funds should work to improve the deterrent effect of shareholder litigation by limiting the role of D&O insurance.

C. Litigate to Implement Meaningful Governance Reforms

Shareholder litigation can produce governance enhancements, for example, by dismantling obstacles to acquisitions or activism and also by improving corporate compliance programs.[318] Given that mutual funds advertise their interest in improving corporate governance, it seems natural that they should consider using litigation as a tool for doing so. Furthermore, given the systemic improvement that governance enhancements promise across portfolios, it seems reasonable to expect mutual funds to litigate for improved governance much as they might litigate for improved deterrence.

But the same issue that compromises index fund voting also affects stewardship litigation—mutual funds are unlikely to know how to improve governance at a given firm in the portfolio. Although it is possible to understand the basic effect of governance terms and to know their average effect on firm performance—staggered boards, for example, make it harder to replace

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317 See id at 1804–05. Because most D&O policies exclude actual fraud from coverage, pleading actual fraud and insisting upon an admission of fraud in settling the claim would void the insurer's obligation to cover the resulting loss. Most shareholder suits are carefully pleaded to avoid triggering the fraud exclusion, thereby retaining access to insurance proceeds. However, insofar as mutual funds press shareholder claims more for their deterrence than for their compensation value, they may prefer to plead their claims intentionally to trigger the fraud exclusion.

318 See text accompanying notes 28–30.

the board of directors and may have a negative average effect on firm performance[319]—it is much harder to say what the optimal governance arrangement for a particular firm will be.[320] There is no one-size-fits-all governance arrangement.[321] Even staggered boards may enhance performance for some firms.[322] Hence, knowing what is best for a particular firm requires a high degree of company-specific information.[323]

Mutual funds are generally in a poor position to evaluate the company-specific effects of a given governance arrangement. Index funds in particular lack the incentive to invest in acquiring company-specific information because their business model is essentially to hold the market as a whole and drive down the costs of investing.[324] Active funds may have more of an incentive to invest in acquiring this information and, in such cases, may share their information with index funds in the same family of funds.[325] But information sharing of this type will not always be effective. Active funds typically hold a much narrower slice of the market than index funds.[326] They may not price the effect of governance

[319] See Lucian Arye Bebchuk, John C. Coates IV, and Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 Stan L Rev 887, 898, 939 (2002).

[320] See Miroslava Straska and H. Gregory Waller, *Antitakeover Provisions and Shareholder Wealth: A Survey of the Literature*, 49 J Fin & Quant Analysis 933, 950 (2014) (surveying the literature on the effects of antitakeover provisions on shareholders, and concluding that in spite of a large volume of studies, "the net effects of these provisions on shareholder wealth remain uncertain").

[321] See Zohar Goshen and Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 Colum L Rev 767, 826 (2017).

[322] See, for example, K.J. Martijn Cremers, Lubomir P. Litov, and Simone M. Sepe, *Staggered Boards and Long-Term Firm Value, Revisited*, 126 J Fin Econ 422, 440–41 (2017) (showing that staggered boards increase value at firms with greater research and development needs and a higher proportion of intangible assets); K.J. Martijn Cremers and Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 Stan L Rev 67, 103–04 (2016) (showing that firm value tends to increase after the adoption of a staggered board). See also Seoungpil Ahn and Keshab Shrestha, *The Differential Effects of Classified Boards on Firm Value*, 37 J Bank & Fin 3993, 4000 (2013) (finding that in complex firms the benefits of staggered boards may outweigh the costs).

[323] See Gilson and Gordon, 113 Colum L Rev at 891 (cited in note 277) ("Effective use of governance rights requires firm-specific investigation and firm-specific activism, both of which are costly and will be undersupplied by institutional investors.").

[324] See Lund, 43 J Corp L at 510–12 (cited in note 14).

[325] See Kahan and Rock, *Index Funds and Corporate Governance* at *43–44 (cited in note 5) (arguing that "spillover knowledge" of this type is what enables index funds to play a meaningful role in corporate governance).

[326] See Lund, 43 J Corp L at 496 (cited in note 14).

in their analyses of portfolio companies.[327] And they often get it wrong.[328] Free riding on the efforts of active funds will not always provide index funds with sufficient information to intelligently analyze governance arrangements.

The decision to use litigation to secure governance reforms, however, is different than relying on voting and engagement. One key difference is the involvement of a lawyer, which can be both helpful and harmful. On the one hand, a trusted attorney can seek out opportunities for governance litigation and present them to the mutual fund complex. Although the mutual fund tends to lack firm-specific information, cases involving gross misconduct may present enough red flags to justify the decision to proceed.[329] And as the suit progresses, the litigation process itself will uncover additional information that can help the attorneys and mutual fund governance staff craft a settlement that addresses the specific problem.

Consider again the examples we highlighted above. Governance litigation proved to be an effective tool in undoing the harms of the stock option backdating scandal.[330] Likewise, the CalPERS intervention at IAC successfully prevented management from solidifying its control over the company through the issuance of nonvoting stock.[331] Finally, the settlement of the derivative suit against Twenty-First Century Fox in the wake of sexual harassment claims against the company resulted in the establishment of a "Workplace Professionalism and Inclusion Council" aimed at correcting the deficiencies of the compliance program and improving the workplace environment.[332] While we take no position on whether such programs achieve their goals, we note that this governance reform emerged only after the litigation process produced

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327 See Griffith, 98 Tex L Rev at *47 (cited in note 14) (arguing that the cost of valuing governance arrangements may often exceed the benefit of doing so).

328 J.B. Heaton, N.G. Polson, and J.H. Witte, *Why Indexing Works*, 33 Applied Stochastic Models Bus & Indust 690, 693 (2017) (arguing that "the much higher cost of active management may be the inherently high chance of underperformance that comes with attempts to select stocks, since stock selection itself increases the chance of underperformance relative to the chance of overperformance in many circumstances").

329 The decision to sue is similar to the decision to vote for the dissident slate in a proxy contest—for the latter, the activist hedge fund will have generated information in the campaign, reducing the likelihood of an uninformed vote. See Griffith, 98 Tex L Rev at *34–36 (cited in note 14).

330 See text accompanying note 58.

331 See text accompanying note 208.

332 See text accompanying note 57.

information concerning the specific deficiencies then existing at the company, giving the plaintiffs an opportunity to target reforms to the company's specific needs. This process might not be perfect, but it operates on better information and offers more carefully tailored solutions than the one-size-fits-all governance reforms typically offered in shareholder proposals.[333]

Nevertheless, the use of litigation to achieve governance reforms comes with the risk that attorneys will use lawsuits to push worthless reforms merely to extract fees from the defendant corporation. If the cost in fees is greater than the benefit of the reforms, then investors are harmed, not benefited, by the litigation. This suggests that mutual funds' role in policing governance litigation for indicia of litigation agency costs, a subject we address in greater detail below, may be as important as litigating to produce governance reforms. Because the critical question is whether contingency fee attorneys are tempted to litigate (and settle) when their clients would prefer that they not, mutual funds should consider using in-house counsel, whose compensation does not depend on the outcome of the claim, to evaluate whether to bring the claim and to monitor the conduct of any litigation ultimately brought. Because in-house counsel have no incentive to continue litigation beyond the point that it provides a legitimate benefit to the company (or the plaintiff class), they can be trusted to voluntarily dismiss nonmeritorious claims.

D. Intervene to Contain Litigation Agency Costs

Most shareholder suits are not brought by mutual funds but rather by others suing in a class or other representative capacity. Yet even if mutual funds are not directly involved as plaintiffs, they may still be adversely affected by the outcome of these suits. When corporations pay to settle nonmeritorious cases[334] or agree to pay attorneys' fees in settlements that produce no value for the plaintiff class,[335] all shareholders are affected. As holders of the market portfolio, mutual fund investors bear the costs of such

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333 See Griffith, 98 Tex L Rev at *46–47 (cited in note 14).

334 See Lucian Arye Bebchuk, *Suing Solely to Extract a Settlement Offer*, 17 J Legal Stud 437, 440 (1988); Avery Katz, *The Effect of Frivolous Lawsuits on the Settlement of Litigation*, 10 Intl Rev L & Econ 3, 25–26 (1990); D. Rosenberg and S. Shavell, *A Model in Which Suits Are Brought for Their Nuisance Value*, 5 Intl Rev L & Econ 3, 4–5 (1985).

335 See Coffee, 48 L & Contemp Probs at 23–26 (cited in note 40); Romano, 7 J L Econ & Org at 61 (cited in note 48).

suits. As a result, an important role for mutual funds in shareholder litigation lies in intervening to reduce litigation agency costs.

Mutual funds should oversee shareholder litigation in order to avoid both overdeterrence and underdeterrence. Part of their role in this oversight capacity is to ensure that good claims produce good results—that is, meaningful deterrence. Another part of their role, however, is to ensure that bad claims are not pursued. Because attorneys' fees fuel the filing and settlement of nonmeritorious claims, mutual funds acting in an oversight role should intervene to prevent attorneys from recovering fees for nonmeritorious claims. One way of doing this is by objecting to settlements.

Class and derivative suit settlements require a fairness hearing before they can become binding on unnamed shareholders.[336] If the judge does not approve the settlement, the settlement does not bind the class.[337] The trouble with fairness hearings, however, is that there is no adversarial interest to frame the problem for the judge.[338] Instead, "[t]he contending parties have struck a bargain, and have every interest in defending the settlement and in convincing the judge that it is in accord with the law."[339]

[336] See Rubenstein, 53 UCLA L Rev at 1467–71 (cited in note 74). At the fairness hearing:

> If class action attorneys sell out their clients, the judge should perceive that the settlement does not live up to the value of the claims and reject it accordingly. Conversely, if class action attorneys file a frivolous case, the judge should perceive that the settlement is merely a nuisance payment, reject it for that reason, and dismiss the case.

Id at 1444. See also Alexandra Lahav, *Fundamental Principles for Class Action Governance*, 37 Ind L Rev 65, 128 (2003) (advocating for an active adversarial process during fairness hearings as "a kind of trial on the merits of the settlement"); Hillary A. Sale, *Judges Who Settle*, 89 Wash U L Rev 377, 402–03 (2011) (advocating for a larger gatekeeping role for judges in settlement).

[337] Howard M. Erichson, *The Problem of Settlement Class Actions*, 82 Geo Wash L Rev 951, 968–69 (2014) ("What binds the class is not the *agreement* between the defendant and the lead plaintiffs or class counsel, but rather the court's *judgment* approving that agreement. The binding effect of a class settlement, in other words, must be understood as a function of judicial power.") (emphasis in original), citing William B. Rubenstein, Alba Conte, and Herbert B. Newberg, 1 *Newberg on Class Actions* § 1.6 (Thomson Reuters 5th ed 2011). See also Howard M. Erichson, *The Role of the Judge in Non-Class Settlements*, 90 Wash U L Rev 1015, 1020–25 (2013).

[338] See Griffith, 56 BC L Rev at 20 (cited in note 64) (emphasizing information asymmetries in the settlement hearing).

[339] Owen M. Fiss, Comment, *Against Settlement*, 93 Yale L J 1073, 1082 (1984). See also Jonathan R. Macey and Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58

Questionable assertions of fact and law are not scrutinized by opposing counsel. Experts are not cross-examined or even questioned, and opposing views are not presented. A judge who questions the value of the settlement must do so on her own, in the face of all of the evidence presented by the parties before her.[340] Given the apparent weight of the evidence before them and their otherwise crowded dockets, judges can perhaps be forgiven for generally rubber-stamping settlements to which the named parties have, after all, agreed. Settlements need, and frequently lack, a motivated gatekeeper.[341]

Mutual funds can act as gatekeepers by objecting to nonmeritorious class settlements and presenting adversarial evidence at the fairness hearing. Courts would very likely take the arguments offered by mutual fund objectors very seriously were they to appear in this role.[342] There is evidence that such objections can in fact succeed in causing judges to throw out settlements and refuse to approve fee awards.[343] Moreover, the mere potential for objection may deter the filing of nonmeritorious claims. Unlike rationally apathetic shareholders who lack the information to object to

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U Chi L Rev 1, 46 (1991) (referring to settlement hearings as "pep rallies jointly orchestrated by plaintiffs' counsel and defense counsel").

340 See *Trulia*, 129 A3d at 894 ("The lack of an adversarial process often requires that the Court become essentially a forensic examiner of proxy materials so that it can play devil's advocate in probing the value of the 'get' for stockholders in a proposed disclosure settlement.").

341 Rubenstein, 53 UCLA L Rev at 1452–67 (cited in note 74) (examining various proposals for reducing agency costs at the settlement stage).

342 Courts have said so. See, for example, *In re Riverbed Technology, Inc Stockholders Litigation*, 2015 WL 5458041, *6 (Del Chanc).

343 One of us has been active in bringing objections to settlements and in providing testimony to judges evaluating settlements of shareholder suits. See, for example, *Bushansky v Remy International, Inc*, 262 F Supp 3d 742, 744 (SD Ind 2017) (rejecting a settlement after objection by Sean Griffith); *Stein v Blankfein*, 2018 WL 5279358, *4 (Del Chanc) (rejecting a settlement objected to by Griffith); Brief of Sean J. Griffith as Amicus Curiae, *In re Trulia, Inc Stockholders Litigation*, No 10020-CB, *1–4 (Del Chanc filed Oct 16, 2015) (opposing a settlement, ultimately rejected by the court); Letter of Sam Glasscock III, Vice Chancellor, Court of Chancery of the State of Del to Counsel, *In re Riverbed Technology, Inc Stockholders Litigation*, No 10484-VCG, *7 (Del Chanc filed Dec 2, 2015) (reducing attorneys' fees after objection by Griffith); Stipulation and (Proposed) Order of Dismissal, *In re PMFG, Inc Stockholder Litigation*, No 11223-VCS, *4 (Del Chanc filed Sept 1, 2016) (rejecting a settlement after objection by Griffith); *Griffith v Quality Distribution, Inc*, 2018 WL 3403537, *7 (Fla App) (adopting *Trulia* and reversing a settlement after objection by Griffith); *Vergiev* Statement of Reasons at *9 (cited in note 73); *Gordon v Verizon Communications, Inc*, 2014 WL 7250212, *8 (NY Sup) (rejecting a settlement after Griffith's testimony), revd, 148 AD3d 146 (NY App).

such settlements,[344] mutual fund blockholders bear the cost of such suits across their portfolio.[345] Furthermore, as market investors, funds have standing to appear in every case, threatening to object to challenge the adequacy of counsel, or even to file sanctions motions.[346] Through interventions such as these, mutual funds could calibrate the deterrent effect of shareholder suits by controlling litigation agency costs.

In sum, mutual funds should act to minimize litigation agency costs and thereby control both underdeterrence and overdeterrence. Tools at funds' disposal include interventions and objections to settlement, as well as insisting on meaningful deterrence when participating in litigation.

E. Implementing the Mission Statement

We have now identified several ways in which mutual funds could benefit their investors by engaging in shareholder litigation. Funds should view litigation as a component of stewardship. The failure to participate in shareholder suits should, in some circumstances, be considered a failure to act in the best interests of their investors.

But this leaves the questions of how the decision to litigate should be made and who should be the one to make it. We imagine that, ex ante, stewardship groups could promulgate litigation guidelines along the lines we have suggested, similar to those

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[344] See Theodore Eisenberg and Geoffrey Miller, *The Role of Opt-Outs and Objectors in Class Action Litigation: Theoretical and Empirical Issues*, 57 Vand L Rev 1529, 1548–50 & tbl 3 (2004) (showing that the objection rate is low across case types).

[345] Mutual funds can distinguish themselves from hold-up objectors by refusing to settle their objection in exchange for a fee. Compare Brian T. Fitzpatrick, *The End of Objector Blackmail?*, 62 Vand L Rev 1623, 1633–42 (2009) (highlighting concerns of objector "blackmail" and the use of quick-pay provisions used by class action counsel), with Sean J. Griffith and Anthony A. Rickey, *Objections to Disclosure Settlements: A How-to Guide*, 70 Okla L Rev 281, 315 (2017) (noting that "an objector can offer to assuage concerns on this point by providing an affidavit attesting that he or she will not sell or settle an objection without court approval").

[346] The PSLRA requires courts to make Rule 11 findings in class action securities litigation, a requirement that is often disregarded in practice. See 15 USC § 77z-1(c); M. Todd Henderson and William H.J. Hubbard, *Judicial Noncompliance with Mandatory Procedural Rules Under the Private Securities Litigation Reform Act*, 44 J Legal Stud S87, S100–01 (2015). Mutual fund class members could intervene to demand Rule 11 sanctions against attorneys who engage in misconduct or who simply pursue shareholder suits when the benefits are outweighed by their costs. The threat of Rule 11 sanctions would create an important downside from the pursuit of securities class actions and again deter unaccountable conduct in litigation.

used to guide voting and engagement decisions.[347] Authority to generate litigation consistent with the guidelines could then rest with portfolio managers (or a committee composed of portfolio managers and members of the stewardship team). Ultimately, the individuals controlling litigation should have input from the fiduciaries who control the investment decisions for the funds' investors, rather than displacing that decision by individuals who are not fiduciaries (as mostly occurs now).

In addition, the board of directors could continue to play a role in ensuring that the fund pursued only worthwhile cases. Specifically, any decision to litigate would be subject to approval from the mutual fund's board of directors, who would certify that the litigation addresses a serious issue of corporate governance, is likely to secure compensation for investors, and/or is likely to defeat a transaction adverse to investors. In addition, the fund's board could also encourage the institution to implement systems designed to bring beneficial litigation opportunities to the portfolio managers' attention. Mutual fund directors are not subject to the same conflicts of interest or collective action problems as portfolio managers and are therefore well positioned to encourage beneficial investments in litigation.

We recognize that these adjustments may somewhat increase costs for the mutual fund family. For example, the institution would likely need to bring additional lawyers in house to guide their litigation decisions, and devote some time and resources to monitoring those lawyers. In addition, participating in litigation can subject fund managers to discovery requests. For index fund portfolio managers, those costs should not be overly burdensome; however, actively managed fund portfolio managers may have more to lose.[348] In particular, active fund managers may be wary

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347 Nearly every mutual fund family promulgates voting guidelines and follows them closely. See Bioy, et al, *Passive Fund Providers* at *11 (cited in note 8). By contrast, none has adopted any policies with regard to shareholder litigation.

348 The fear of being subjected to burdensome discovery requests may explain why the Big Three mutual funds have participated somewhat more aggressively in litigation in Europe, which does not allow for pretrial discovery. See Platt, 53 UC Davis L Rev at 1503 (cited in note 15). See also Lukas Holub, *Discovery Abroad: An Overview of European Blocking Statutes and the Hague Convention on the Taking of Evidence Outside the U.S.—Part One of Two* (National Institute for Trial Advocacy), archived at https://perma.cc/3KVL-PM8E ("The use of the term 'discovery' is not appropriate, because the pre-trial discovery as understood in the U.S. practically does not exist.").

of disclosing confidential information about their trades.[349] Active fund managers will have to weigh these costs with the expected benefits when deciding whether to pursue litigation. We imagine that in many cases, these costs will be offset by the benefits provided by successful claims.[350]

In addition to bringing lawyers in house, funds could outsource the process of identifying valuable claims to a portfolio monitor—a law firm—that would track litigation and potential litigation across the portfolio, recommending cases in which the fund might participate as a plaintiff or intervene as an objector. For example, three out of the five shareholder suits that we discuss in Part II—Countrywide, American Realty, and Valeant—involved the plaintiffs' firm Bernstein Litowitz Berger & Grossman LLP.[351] Mutual funds could continue to develop relationships with repeat-play firms, communicating their guidelines in advance, and ensuring that portfolio managers, as well as the board of directors, keep a careful eye on litigation agency costs over the life of the relationship.

We leave the internal business dynamics to the funds themselves, noting only that implementing the mission statement need not be unduly burdensome or costly. But this, of course, raises another question: If stewardship litigation is not burdensome or costly, why do funds not do it already? And given that they do not, what other barriers remain in the way?

This brings us back to the problem of agency costs—in particular, Corporate Client Conflict. Insofar as mutual funds fear that participating in shareholder litigation would lead to a loss of corporate revenue, we should not expect them to challenge management in the absence of pressure from their investors—which often include other institutional investors, such as pension funds—or their board of directors, which is tasked with overseeing the management and operations of the fund on behalf of the

[349] Active fund managers may also be concerned about losing access to management that would help them glean useful trading information. However, the passage of Regulation FD, which prohibits selective disclosure of information by publicly traded companies, should ameliorate this concern. See Securities and Exchange Commission, *Fair Disclosure, Regulation FD* (Oct 27, 2014), archived at https://perma.cc/G7LB-BAMN.

[350] As an example, Vanguard's successful settlement of the American Realty litigation netted it $90 million. See Part II.A.3. A single settlement of this size each year would fund the hiring of several new litigation employees—and then some.

[351] See *Current Cases* (Bernstein Litowitz Berger & Grossman LLP), archived at https://perma.cc/82UG-587W.

fund's investors.[352] Given the potential interference of Corporate Client Conflict, mutual fund investors or directors could insist on internal separation—a "fire wall"—between litigation decisions and the sales and marketing apparatus. Alternatively, investors and directors could demand that stewardship groups refer certain litigation decisions to an outside decision-maker independent of the sales and marketing department.[353]

If mutual funds fail to redesign their approach to litigation, their investors might be able to bring fiduciary duty litigation against the funds themselves. Recall that T. Rowe Price paid its investors $194 million to avoid investor lawsuits when it accidentally forfeited their appraisal rights.[354] Mutual funds have also faced litigation for failing to collect settlement proceeds in shareholder class actions.[355] Therefore, investor suits might also be

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[352] See *Frequently Asked Questions About Mutual Fund Directors* (Investment Company Institute), archived at https://perma.cc/GUJ2-2AKX.

[353] There is a possible first-mover problem: the first fund family to adopt these changes may face backlash from their clients, and the prospect of this backlash may inhibit change. For that reason, investor advocacy and/or litigation should target multiple firms within an industry in the hopes of shifting the industry-wide default position on litigation.

[354] See text accompanying notes 193–96.

[355] See James D. Cox and Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?*, 80 Wash U L Q 855, 875–77 (2002) (showing that on average, financial institutions file claims in fewer than half of their eligible securities fraud settlements). In the wake of the Cox and Thomas study dozens of lawsuits were filed against mutual funds alleging that the failure to collect settlement proceeds was a breach of the funds' fiduciary duties. These suits were brought under state corporate law, as well as § 36 of the Investment Company Act of 1940, Pub L No 76-768, 54 Stat 789, codified as amended at 15 USC § 80a-1 et seq. To our knowledge, none of these suits has been successful, but they did provide a reason for mutual funds to focus on the problem. And we expect that under certain circumstances, the failure to make litigation decisions in investors' best interests could constitute a breach of the fund's fiduciary duty. By this, we do not mean that the failure to participate in litigation would always or even often constitute a duty breach—as discussed, most shareholder litigation does not benefit the company or its investors, and even pursuing beneficial litigation might not be worth the fund's time and resources. But perhaps a fiduciary claim would have more luck in situations where the failure to participate in litigation left real investor money on the table. In addition, if investors could show that a fund has not focused on litigation at all, that fact could support a *Caremark* claim. See Cox and Thomas, 58 Stan L Rev at 413 (cited in note 235) (discussing duties of care under *In re Caremark International Inc Derivative Litigation*, 698 A2d 959 (Del Chanc 1996)). In an analogous context, the DOL has explained that a pension plan's fiduciary duties include determining whether the plan should serve as a lead plaintiff in litigation. See Steven W. Stone and Ryan F. Helmrich, *The Role of Investment Advisers in Client Class Action Claims*, 12 Investment Lawyer 17, 19 (2005), archived at https://perma.cc/NF95-8LFM. Here, we expect that an investment manager would have a duty to consider whether to participate in litigation, rather than a blanket policy of sitting by the sidelines.

possible when mutual funds fail to exercise shareholders' litigation rights. For example, BlackRock is a Petrobras investor.[356] Yet BlackRock did not bring a direct suit against Petrobras, even though Vanguard did.[357] While we would not want to see investor litigation against mutual funds for failure to bring every claim—a safe harbor deferring to the decision of a properly constituted, independent litigation committee strikes us as appropriate—some form of investor pressure seems necessary, given the potential of Corporate Client Conflict to influence mutual fund decision-making.

The collective action problem raises a second substantial obstacle to mutual fund participation in shareholder suits. Many of the benefits we described above in producing deterrence, enhancing governance, and reducing litigation agency costs redound to the market as a whole.[358] Insofar as funds measure their performance relative to that of their rivals, they may have little incentive to expend resources to produce benefits in which their rivals will share.

A partial answer to the collective action problem is that mutual fund involvement in shareholder litigation need not cost much. Attorneys' fees can be contingency based. Moreover, in a given year, there are likely to be many fewer plausible shareholder claims, at least in comparison to the tens of thousands of elections and proposals in which stewardship groups currently participate.[359] The cost of screening litigation can be minimized by promulgating guidelines ex ante, as well as by designating outside counsel as a portfolio monitor to do much of the work in discovering potential violations and framing the case.

But containing the cost of becoming involved in litigation is only a partial solution. If mutual funds do not see the benefit due to collective action problems, they are unlikely to become involved however low the costs. It is important to emphasize, however, that the collective action problem does not occur when the mutual fund

356 *PBR/Petroleo Brasileiro SA Petrobras ADR - Institutional Ownership and Shareholders* (Fintel), archived at https://perma.cc/HM5G-PHAF.

357 See Part II.A.2.

358 Note, however, that collective action incentives do not inhibit funds from seeking compensation in nonclass suits. See Part III.D.2.

359 There were roughly four hundred securities class actions filed in 2018. See note 199 and accompanying text. Compare this number to the five hundred–plus shareholder proposals, and the tens of thousands of management elections and other proposals on which mutual funds must vote annually. See Griffith and Lund, 99 BU L Rev at 1169–71 & n 101 (cited in note 14).

opts out of class action litigation and pursues compensation on its own. In such a case, the mutual fund can secure an outsized benefit that does not accrue to rival funds. In other situations, where the collective action problem distorts litigation decisions, the possibility of investor lawsuits alleging that the failure to litigate was a breach of the fund's fiduciary duty to investors could provide an incentive to act. And here again, lest such claims overwhelm mutual funds, we recommend a clear safe harbor, based on the insights of the mission statement, and implemented by a properly constituted, independent litigation committee.

Our hope is that these changes can be implemented through pressure brought to bear by mutual fund directors, as well as investors once they know what to ask for. Investors should insist upon a source of authority within the fund family that makes litigation decisions independent of the institution's own incentives, based upon the considerations outlined in the mission statement. Funds that implement such a structure in good faith should receive deference in any subsequent fiduciary duty claims relating to the choices they make in bringing (or not bringing) shareholder suits. Funds that fail to implement such a structure should not receive such deference and thus remain vulnerable to investor fiduciary duty claims. Although these changes can be implemented through private ordering, we observe that the failure to implement such structures may also render the industry subject to greater risk of regulation. Implementing the mission statement would allow mutual funds to avoid these consequences by demonstrating that they are in fact using all available levers of corporate governance in the best interests of their investors.

CONCLUSION

Nearly half of US households invest in mutual funds, and mutual funds have become one of the most significant players in corporate governance. Scholars have started to identify substantial limitations in the way that mutual funds engage in corporate governance, but the principal focus of this literature to date has been on how mutual funds vote. We focus instead on how they sue.

Our empirical study of the largest mutual funds' conduct in shareholder litigation leaves little doubt that mutual funds are not using litigation as a tool to create value for investors. Mutual funds' dismal litigation record sheds light on the broader debate over mutual funds' stewardship incentives. To the extent that mutual funds take governance seriously, as many claim they do, mutual funds must reform their approach to shareholder litigation.

This Article shows them how. It articulates a mission statement for mutual funds in shareholder litigation that would prioritize the interests of mutual fund investors. Our mission statement embraces the market investor perspective on shareholder litigation and, we argue, could be implemented through minor reforms to existing stewardship programs. Indeed, the principal change is for funds to see shareholder litigation for what it is: a pillar of corporate governance that can create real value for investors.

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