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Conflicted Mutual Fund Voting in Corporate Law

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CONFLICTED MUTUAL FUND VOTING IN CORPORATE LAW

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ABSTRACT

Recent Delaware jurisprudence establishes a disinterested vote of shareholders as the pathway out of heightened judicial scrutiny. The stated rationale for this policy is that shareholders, the real party at interest, are better protected by the ballot box than by the courtroom. As long as informed, disinterested shareholders with an economic stake in the outcome of the vote can effectively express their preferences through voting—the court need not scrutinize the underlying transaction. Rather, it can defer to the outcome under the business judgment rule.

But shareholder voting is not always as direct as this reasoning implies. Instead, voting outcomes increasingly are determined not by those holding the ultimate economic interest but rather by institutional intermediaries who buy, hold, and vote shares on behalf of someone else. In this setting, there are several predictable circumstances under which institutional voting interests will depart from those of the underlying investors.

This Article develops a typology of institutional investor conflicts of interest. We focus on mutual fund intermediaries, which are the key deciders of corporate elections and represent the interests of millions of investors when voting. We describe and document instances of Cross-Ownership Conflict (situations in which funds have interests on both sides of a transaction), Corporate Client Conflict (situations in which funds have an interest in currying favor with the managers of portfolio companies), and Uniform Policy Conflict (situations in which fund sponsors enforce a uniform voting policy irrespective of individual fund objectives).

Our account provides a basis to reevaluate corporate law's retreat from heightened judicial scrutiny. When mutual fund voting is subject to the conflicts we describe, the real parties in interest have not necessarily spoken in favor of the transaction. As such, courts should consider a broader set of conflicts when deciding whether the protection of the business judgment rule is warranted.

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INTRODUCTION

In October 2016, Elon Musk pitched a $2.6 billion merger with SolarCity to Tesla's shareholders.[1] He described rising carbon dioxide levels, global warming, and the inevitable transition to a world fueled only by sustainable energy.[2] He argued that together, Tesla and SolarCity would forge an "integrated future" for the planet.[3] The crowd cheered. Someone yelled "Save us, Elon!"[4]

What Musk failed to highlight in his fourteen-minute speech was SolarCity's dismal performance. The company's debt had reached $3.4 billion, sales growth had slowed, and it faced a liquidity crisis.[5] Without the merger, the company would have faced bankruptcy.[6] Perhaps more importantly, Musk failed to mention the pervasive conflicts of interest, both personal and financial, facing Tesla management. Musk chaired both companies and was SolarCity's largest shareholder.[7] Beyond these obvious conflicts, SolarCity was founded by Musk's two cousins, with substantial support and encouragement from Musk.[8] Musk had taken out millions of dollars in personal credit lines to buy more shares in the company, and his aerospace company, SpaceX, had purchased $165 million in bonds issued by SolarCity.[9] Six of Tesla's seven directors had close ties to SolarCity.[10]

For all of these reasons, the market panned the merger. When news of Tesla's $2.6 billion offer was disclosed, Tesla's stock dropped 10%.[11] Jim Chanos, a hedge fund manager that had shorted Tesla and SolarCity, called the acquisition a "shameful example of corporate governance at its worst" and a "bailout" of SolarCity.[12] Auto industry experts said the idea of combining the electric-car

[1] Austin Carr, *The Real Story Behind Elon Musk's $2.6 Billion Acquisition of SolarCity, and What It Means for Tesla's Future—Not to Mention the Planet's*, FAST COMPANY (June 7, 2017), https://www.fastcompany.com/40422076/the-real-story-behind-elon-musks-2-6-billion-acquisition-of-solarcity-and-what-it-means-for-teslas-future-not-to-mention-the-planets [perma.cc/NL7U-MPJ3].

[2] *Id.*

[3] *Id.*

[4] *Id.*

[5] *Id.*

[6] Plaintiffs' Answering Brief in Opposition to Defendants' Motion to Dismiss the Second Amended Complaint at 3, *In re* Tesla Motors, Inc. Stockholder Litig., No. 12711-VCS (Del. Ch. Mar. 28, 2018), 2017 WL 3316057.

[7] *Id.* at 1-2.

[8] *Id.* at 2.

[9] Carr, *supra* note 1.

[10] *Id.* ("Tesla's board includes SolarCity's former CFO, a SolarCity director, and two VCs whose firms also have seats on SolarCity's board, along with Musk's brother, Kimbal.").

[11] *Id.*

[12] *Id.*

manufacturer with a solar energy company made no strategic sense.[13] Many highlighted existing problems at Tesla as further cause for concern—Tesla was cash-strapped and struggling to meet production goals for its Model X. As expressed in the *Wall Street Journal*, "Tesla latching on to SolarCity is the equivalent of a shipwrecked man clinging to a piece of driftwood grabbing on to another man without one."[14]

Nonetheless, the merger was approved by a wide-margin—excluding the votes of Musk and his affiliates, 85% of the company's shareholders voted in favor of the transaction.[15] Accordingly, in litigation challenging the merger as the product of pervasive conflicts of interest, lawyers for Tesla contended that the transaction should receive business judgment protection.[16] Tesla relied upon *Corwin v. KKR Financial Holdings, LLC*,[17] which protects merger-and-acquisition ("M&A") transactions from judicial scrutiny when ratified by "the fully informed, uncoerced vote of the disinterested stockholders."[18] Because Tesla's shareholders had voted in favor of the merger, the defendants argued that the plaintiffs had no recourse.

The plaintiffs mounted a novel argument in response. The purportedly "disinterested" Tesla shareholders included large institutional investors who also owned SolarCity stock. The plaintiffs demonstrated that Tesla's top twenty-five institutional investors—those holding 45.7% of Tesla's stock—were standing on both sides of the transaction.[19] The plaintiffs claimed that this rendered the institutional investors "interested" and the deal ineligible for business judgment protection.[20] Although the Delaware Court of Chancery

[13] James B. Stewart, *SolarCity and Tesla: Riding on Faith*, N.Y. TIMES, Aug. 5, 2016, at B1 (noting that even if deal could lead to vertical integration "[t]hat approach has gone down in automotive history as a colossal failure").

[14] Spencer Jakab, *A Double Dose of Risk for Tesla in SolarCity Deal*, WALL STREET J. (Aug. 1, 2016, 11:59 AM), https://www.wsj.com/articles/a-double-dose-of-risk-for-tesla-in-solarcity-deal-1470067165.

[15] *See* Robert Ferris, *Tesla and SolarCity Merger Gets Approval from Shareholders*, CNBC (Nov. 17, 2016, 2:59 PM), https://www.cnbc.com/2016/11/17/solarcity-shareholders-vote-on-tesla-merger.html [https://perma.cc/TDY5-967M].

[16] *See In re* Tesla Motors, Inc. Stockholder Litig., No. 12711-VCS, 2018 WL 1560293, at *36-37 (Del. Ch. Mar. 28, 2018).

[17] 125 A.3d 304 (Del. 2015); *see In re Tesla Motors, Inc. Stockholder Litig.*, 2018 WL 1560293, at *1.

[18] *Corwin*, 125 A.3d at 308. For discussion of this case, see *infra* text accompanying notes 70-84.

[19] *In re Tesla Motors, Inc. Stockholder Litig.*, 2018 WL 1560293, at *26 n.183.

[20] *See id.*

never ruled on this claim, instead denying dismissal on other grounds,[21] the court venutred a prediction that the argument would one day resurface.[22] We agree.

That is because institutional investors, mutual fund sponsors[23] in particular, increasingly control the outcome of corporate elections. Mutual funds have been around for at least a century,[24] but it was not until 1974 that they began to be a force in governance.[25] Having been steadily growing for decades, institutional investors' share of U.S. equity markets now stands at over 80%, with mutual funds holding more than half of that amount.[26] In the past decade, investor demand for passively managed mutual funds—index funds and exchange-traded funds ("ETFs")[27]—has rendered the institutions that favor passive management

[21] The Delaware Court of Chancery refused to dismiss the plaintiffs' complaint on the grounds that Musk qualified as a controlling shareholder of Tesla and that, therefore, *Corwin* did not apply. *Id.* at *56-57. This was a somewhwat surprising outcome—Musk held only 22.1% of Tesla. *Id.* at *42. But despite his controlling less than a quarter of the company's votes, the Court of Chancery concluded there was enough evidence that Musk exerted "actual domination and control over . . . the directors" to warrant the conclusion that Musk was a controlling shareholder. *Id.* at *38, *56.

[22] *Id*. at *32 n.183 ("This issue may resurface in the event Defendants renew their ratification defense later in these proceedings.").

[23] Mutual funds tend to be externally managed by "sponsors," which develop the funds and hire portfolio managers to operate them. *See* WILLIAM A. BIRDTHISTLE, EMPIRE OF THE FUND 45-50 (2016); John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 91 (2010).

[24] The first mutual fund arrived in the United States in the 1890s, although the first modern mutual fund was created in 1924. *See The History of Mutual Funds*, INV. FUNDS INST. CAN., https://www.ific.ca/en/articles/who-we-are-history-of-mutual-funds/ [https://perma.cc/LG5Z-FTZN] (last visited Apr. 1, 2019).

[25] The passage of the Employee Retirement Income and Security Act ("ERISA"), which requires pension funds to support any promised pension with a pool of segregated assets, was a primary cause of the growth of mutual funds. *See* 26 U.S.C. § 411(a)(2)(A), (b)(1) (2012) (setting forth minimum vesting requirements for defined-benefit plans); 29 U.S.C. § 1053 (2012) (same); *id.* § 1082 (providing for minimum funding standards). To comply with ERISA, companies created retirement accounts that were invested in the capital markets, usually mutual funds. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 879-80 (2013).

[26] Charles McGrath, *80% of Equity Market Cap Held By Insitutions*, PENSIONS & INV. (Apr. 25, 2017, 11:45 AM), https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions [https://perma.cc/V44R-ERHJ]. Institutional ownership of U.S. corporations nearly doubled in the 1980s and 1990s, from 30-50%, and by 2010 institutional investors held approximately 80% of publicly traded equities in the United States. *See Mutual Funds*, STATISTA, https://www.statista.com/topics/1441/mutual-funds/ [https://perma.cc/6V6F-B6WP] (last visited Apr. 1, 2019).

[27] Indexed mutual funds and ETFs now own over 10% of U.S. equities. John C. Coates IV, *The Future of Corporate Governance Part I: The Problem of Twelve* 10 (Harv. Pub. Law Working Paper No. 19-07, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337 ("Passive, indexed U.S. mutual funds and ETFs are now widely understood to hold more than 10% of total U.S. equity markets."). Professor Coates notes that the 10% figure likely understates the extent of indexed investment in U.S. markets because institutions other than

especially powerful: BlackRock now controls 5% blocks of more than half of U.S. publicly traded companies, and Vanguard has 5% blocks in over 40% of such companies.[28] Moreover, the combined shares of BlackRock, State Street, and Vanguard—the "Big Three"—exceed the stake of the largest shareholder of 40% of all U.S. listed companies, and roughly 88% of the S&P 500.[29]

Early observers celebrated the potential of sophisticated institutional investors to use the levers of corporate governance—the power to vote, sell, and sue—to improve corporate performance.[30] Those hopes have been largely dashed, and academics now warn of the implications of this concentration of corporate ownership in the hands of institutional intermediaries in a number of areas, including antitrust policy,[31] corporate governance,[32] and political economy more broadly.[33] In this Article, we focus upon the impact of mutual fund ownership on shareholder voting.

Mutual fund voting is typically dictated by the fund's "sponsors"—the firm that assembles and markets the family of funds. A mutual fund is a pool of investment securities that issue and sell redeemable common stock and is

registered mutual funds—e.g., pension funds, insurance companies, foreign funds, and actively managed funds—also follow indexing strategies. *Id.* at 10-11.

[28] Amy Deen Westbrook & David A. Westbrook, *Unicorns, Guardians, and the Concentration of the U.S. Equity Markets*, 96 NEB. L. REV. 688, 732 (2018).

[29] Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 313 (2017).

[30] *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 817-20 (1992) [hereinafter Black, *Agents Watching Agents*] (arguing for institutional shareholder oversight); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 575-91 (1990) [hereinafter Black, *Shareholder Passivity*] (arguing that institutional shareholders could overcome collective action problems); Ronald J. Gilson & Reiner Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 865 (1991) (providing "a realistic agenda for institutional investors" to improve corporate governance of portfolio companies); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 799 (1993) (describing political conflicts of interest that impede activism of public pension funds in corporate governance).

[31] *See generally* Einer Elhauge, Essay, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016) (noting antitrust concerns that emerge when large shareholders own shares of competing companies); Fiona Scott Morton & Herbert Hovenkamp, *Horizontal Shareholding and Antitrust Policy*, 127 YALE L.J. 2026 (2018) (same).

[32] *See generally* Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, J. ECON. PERSP., Summer 2017, at 89; Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493 (2018) (describing agency problems of passive funds and proposing restriction on voting by passive funds); Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. (forthcoming 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794 (describing agency problems of passive funds and supporting evidence).

[33] Coates IV, *supra* note 27, at 2-3 (arguing that "the rise of indexing presents a sharp, general, political challenge to corporate law").

composed of a broad, diversified portfolio of debt, equity, or other investments.[34] The fund itself does not do much aside from house investor assets. The sponsor manages the fund's day-to-day operations. Most sponsors counsel multiple funds[35] and may specialize in funds of a certain type. As mentioned, the Big Three specialize in passive management and hold the bulk of their investor assets in passively managed funds.[36] Others, including Fidelity and T. Rowe Price, favor active management strategies and offer more actively managed products than passive.[37]

Although it is widely acknowledged in the literature that intermediation creates conflicts,[38] there is, to our knowledge, no systemic account of the paradigmatic types of conflict that arise when mutual fund intermediaries control corporate voting rights. In this Article, we sort these conflicts into recurrent patterns and provide a typology of three basic forms of conflicted institutional voting. As the Tesla example shows, institutions may have interests on both sides of a transaction or with industry competitors that may cause them to use their vote to benefit their investment in another company (SolarCity) to the detriment of the real parties in interest (Tesla shareholders). We call this "Cross-Ownership Conflict." The second conflict of interest we describe is even more straightforward. Mutual fund sponsors often count company management as a client for 401(k) accounts or other services. Such conflicts may cause the sponsor to cast its votes in order to appease management—the client—even when doing so is not in the investors' best interest. We call this "Corporate Client Conflict." Finally, we describe the conflict that emerges from strict adherence to a centralized, institution-wide voting policy, which many mutual fund sponsors have adopted. Because the beneficial owners of funds rarely overlap, uniform voting will often hurt some mutual fund investors and help others.[39] We call this "Uniform Policy Conflict."

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[34] *See* John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1234-35 (2014).

[35] For example, BlackRock offers investors the choice between nearly two hundred different funds, including a variety of index funds, ETFs, target-date funds, and actively managed funds. *See All BlackRock Funds*, MORNINGSTAR, http://quicktake.morningstar.com/fundfamily/blackrock/0C000034YC/fund-list.aspx [https://perma.cc/PR9D-NX7A] (last visited Apr. 1, 2019).

[36] For simplicity, we characterize ETFs and index funds—funds that seek to track the performance of a market index as cheaply as possible—as "passive funds."

[37] *See* Lund, *supra* note 32 at 517, 519 (noting Fidelity and T. Rowe Price had only 16% and 8.9%, respectively, of each entity's equity invested in passive funds).

[38] *See, e.g.*, Kathryn Judge, *Intermediary Influence*, 82 U. CHI. L. REV. 573, 573 (2015) (documenting agency costs of "intermediary influence" across financial markets). In two articles, Professor Ann Lipton has documented many of the mutual fund voting conflicts that we highlight. *See generally* Ann M. Lipton, Essay, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation*, 19 TRANSACTIONS: TENN. J. BUS. L. 175 (2017) [hereinafter Lipton, *Family Loyalty*]; Ann M. Lipton, *Shareholder Divorce Court*, 44 J. CORP. L. 297 (2018) [hereinafter Lipton, *Shareholder Divorce Court*].

[39] *See generally* Lipton, *Family Loyalty*, *supra* note 38.

Our analysis of the conflicts institutional intermediaries face in voting has important implications for investors, regulators, academics, and judges, but our focus here is on corporate law. Recent Delaware jurisprudence establishes a disinterested vote of shareholders as the pathway out of heightened judicial scrutiny of mergers and acquisitions. The stated rationale for this shift is that shareholders, the real party at interest, are better protected by the ballot box than by the courtroom. In many cases, however, the votes that decide the outcome are not exercised by investors with skin in the game but rather by conflicted institutional intermediaries.

We argue therefore that Delaware courts should consider these conflicts before counting the votes of institutional intermediaries as "disinterested." Specifically, if a plaintiff presents evidence of a disabling economic conflict—either Cross-Ownership Conflict or Corporate Client Conflict—the institutional investor, like conflicted management, should not qualify as disinterested. Such conflicts undermine the rationale justifying the application of a deferential standard of review—that the underlying investors have spoken in favor of the transaction. Moreover, when there is a conflict, the court lacks assurance that fiduciaries are necessarily voting to further their investors' best interests. In some cases, the conflicts may result in a vote that is aligned with investors' interests, but not always. In cases where diversified shareholders favor a vote for a value-reducing transaction, that conflict provides an additional reason for enhanced scrutiny: the shareholders are not playing the gate-keeper role—approving good transactions and vetoing the bad—that the court intended they would play.

This Article proceeds as follows. Part I analyzes how corporate law has recently adopted shareholder voting as a substitute for enhanced scrutiny of merger transactions. Part II assesses the governance and voting incentives of mutual funds and provides a typology of the conflicts that may compromise mutual fund voting. Part III offers implications of our analysis for corporate law. Part IV closes with a brief summary and conclusion.

I. DISINTERESTED SHAREHOLDER VOTING AS A SUBSTITUTE FOR HEIGHTENED JUDICIAL SCRUTINY

Corporate law has identified shareholder voting as the route of retreat from heightened judicial scrutiny of merger transactions. Emphasizing that voting allows owners with a genuine economic stake to decide the fate of the transaction, Delaware has largely retreated from judicial scrutiny in M&A cases, instead of applying the deferential standard of the business judgment rule, provided the shareholder vote in favor of the deal is informed and uncoerced.[40]

[40] Under the business judgment rule, courts abstain from second-guessing and defer to the business decisions of the board provided the decisions are not tainted by a conflict of interest, in which case the business judgment rule does not apply. *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 84 (2004) (arguing that business judgment rule is a compromise between the board's authority and the need to

Because this structure can generally be pre-arranged by the transacting parties, heightened judicial scrutiny has thus become a relic of the freewheeling 1980s.

Delaware invented heightened scrutiny to deal with recurring conflict of interest problems in both controlling shareholder mergers, in which the controller or an affiliate buys out the minority shareholders, as well as in third-party mergers, in which an unaffiliated third party buys the target company.[41] The jurisprudential standards diverged—"entire fairness" for controlling shareholder deals and "enhanced scrutiny" for third-party mergers—because the underlying conflicts differ in severity.[42] The conflict of interest in controlling shareholder deals is direct and immediate because the controller's interest in paying as little as possible for the remainder of the company plainly conflicts with the board's duty to maximize the value of the company at sale.[43] By contrast, the conflict of interest in third-party mergers is more subtle, resting instead upon the insight that when there is no controlling shareholder, target boards might be more responsive to incumbent managers' interests in retaining their perquisites and positions than to shareholders' interests in maximizing the value of the company at sale.[44] Recently, however, these two situations have been reunified in Delaware jurisprudence by the substitution of an informed, uncoerced shareholder vote in the former place of heightened judicial scrutiny.

A. *Controlling Shareholder Mergers and the Majority-of-the-Minority Vote*

The reemergence of deference began, in the context of controlling shareholder mergers, as a response to litigation patterns in controlling shareholder deals. Because entire fairness was a fact-intensive standard of review, cases could not be resolved at the motion to dismiss or summary judgment stages.[45] For defendants, this meant being forced into discovery, the costs of which created a

hold boards accountable for their decisions); Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 11-13 (2005) (describing operation of business judgment rule).

[41] These are also sometimes referred to as "squeeze-out" mergers.

[42] *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (applying tougher scrutiny in third party mergers); Weinberger v. UOP, Inc., 457 A.2d 701, 711-15 (Del. 1983) (requiring fair dealing and fair price in non-arm's length transactions).

[43] *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362 (Del. 1993) ("Classic examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally.").

[44] *See* Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 457-60 (Del. Ch. 2011) (describing range of situations to which enhanced scrutiny may apply); J. Travis Laster, Revlon *Is a Standard of Review: Why It's True and What It Means*, 19 FORDHAM J. CORP. & FIN. L. 5, 11-18 (2013) (describing possible risks in third-party mergers).

[45] *See* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994) ("[P]olicy rationale . . . mandates careful judicial scrutiny of a special committee's real bargaining power before shifting the burden of proof on the issue of entire fairness.").

strong incentive to settle.[46] Controlling shareholder cases thus began to follow a ritualized dance.[47] Defendant boards, aware of the burden placed upon them by the entire fairness standard, appointed a special negotiating committee in every case.[48] At the same time, well-advised controllers held back a portion of their reservation price so that they could later raise their offer.[49] The controller's negotiations with the special committee proceeded contemporaneously with the settlement negotiations of any shareholder litigation.[50] Both negotiations were then brought to a close when the controller raised the price slightly, allowing both the special committee and the shareholders' lawyers to demonstrate their value and, in the case of the lawyers, claim fees.[51] Yet it remained unclear, in spite of all this process, whether anything of substance had changed.

[46] *See In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 605 (Del. Ch. 2005) ("[E]ach *Lynch* case has settlement value, not necessarily because of its merits but because it cannot be dismissed.").

[47] Indeed, it was referred to by Delaware judges as a "minuet," or alternatively, a "Kabuki dance." *In re* Revlon, Inc. S'holders Litig., 990 A.2d 940, 945 (Del. Ch. 2010) (referring to "the opening steps in the *Cox Communications* Kabuki dance"); *In re* Emerging Commc'ns, Inc. S'holders Litig., No. Civ.A. 16415, 2004 WL 1305745, at *42 (Del. Ch. May 3, 2004) (referring to a "scripted minuet wherein [the Committee] would bargain for a negligible price increase . . . [creating] a credible record of 'arm's length' negotiations sufficient to survive entire fairness review").

[48] *See* Elliott J. Weiss & Lawrence J. White, *File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions*, 57 VAND. L. REV. 1797, 1803 (2004) ("[B]oards of target companies in mergers involving conflicts of interest routinely appointed special negotiating committees . . . composed of independent directors and charged those committees with responsibility for negotiating the best possible terms on behalf of the company's public shareholders.").

[49] This could be for either of two reasons: (1) the special negotiating committee has real negotiating power and uses it to extract price concessions from the buyer; or more cynically (2) both sides understand that in order to minimize liability risk, the special litigation committee must be seen to be "effective," for which the increase in price can be offered as evidence. If the latter explanation is correct, of course, the controller may merely hold back a portion of its ultimate price in the initial offer, such that the price concession extracted by the special committee is in fact illusory.

[50] The rough contemporaneity is possible because controlling shareholder transactions are often public before the merger agreement is signed. Because these transactions must be approved by a special committee, they are typically announced as proposals when the special committee is formed, thus allowing shareholder plaintiffs to challenge the proposal and thereby become a part of the negotiation with the special committee. *See In re Cox Commc'ns*, 879 A.2d at 620 ("Instead of suing once a controller actually signs up a merger agreement with a special committee of independent directors, plaintiffs sue as soon as there is a public announcement of the controller's intention to propose a merger.").

[51] *See id.* at 621 ("[T]he artistry of defense counsel is to bring the first and second tracks to the same destination at the same time. . . . When [the final] price is known but before there is a definitive deal, defense counsel . . . makes its 'final and best offer' to plaintiffs' counsel. The plaintiffs' counsel then accepts . . . .").

To address this dynamic, the Delaware Court of Chancery began to experiment, first in short-form then in long-form mergers,[52] with allowing the combination of *both* special committee approval *and* a majority of the minority shareholder vote, to shift the burden of proof and, eventually, the standard of review.[53] The shareholder vote was the critical addition here.[54] The Delaware Supreme Court ultimately adopted the committee and vote structure as a substitute for heightened scrutiny in *Kahn v. M & F Worldwide Corp*.[55]

M & F Worldwide Corp. was a standard controlling shareholder case, but the controller had adopted the committee-plus-vote structure from the beginning, conditioning the transaction on approval both of a special committee of independent directors and a majority vote of the minority shareholders.[56] Accordingly, the Court of Chancery dismissed the inevitable shareholder suit on the basis of the procedural protections,[57] underscoring the increasing role of institutional investors in deferring to the shareholder vote under the business judgment rule.[58] After the Delaware Supreme Court upheld the Court of

[52] The principal distinction between a long-form merger under Delaware law section 251, DEL. CODE. ANN. tit. 8, § 251 (2019), and a short-form merger under section 253, *id.* § 253, is whether a shareholder vote is required to consummate the transaction.

[53] *See In re Cox Commc'ns*, 879 A.2d at 607 (advocating, in dicta, "unified" standard for both long- and short-form mergers provided both procedural protections are met); *In re* Siliconix Inc. S'holders Litig., No. Civ.A. 18700, 2001 WL 716787, at *6 (Del. Ch. June 19, 2001) (applying business judgment rule rather than entire fairness to section 253 merger part of two-step transaction with other procedural protections, including special committee and majority of minority condition); *see also In re* CNX Gas Corp. S'holders Litig., 4 A.3d 397, 400 (Del. Ch. 2010) (applying entire fairness review because special committee did not recommend in favor of tender offer); *In re* John Q. Hammons Hotels Inc. S'holder Litig., No. 758-CC, 2009 WL 3165613, at *2 (Del. Ch. Oct. 2, 2009) (applying entire fairness review rather than business judgment rule because of inadqeuate shareholder protections).

[54] Under the statute, short-form mergers required no shareholder vote at all, and long-form mergers did not require the separate approval of a majority of the shares not voted by the controller. DEL. CODE ANN. tit. 8, §§ 251, 253.

[55] 88 A.3d 635, 644 (Del. 2014).

[56] *In re* MFW S'holders Litig., 67 A.3d 496, 506 (Del. Ch. 2013) (describing structure of transaction).

[57] The Delaware Court of Chancery expressly stated the structural requirements necessary to shift the standard of review: the "negotiation and approval by a special committee of independent directors fully empowered to say no" and "approval by an uncoerced, fully informed vote of a majority of the minority investors." *Id.* at 502.

[58] The Court of Chancery emphasized:

> [A] generation ago, our Supreme Court noted the prevalence of institutional investors in the target company's stockholder base in concluding that a proxy contest centering on the price of a takeover offer was viable, . . . stating that "[i]nstitutions are more likely than other shareholders to vote at all [and] more likely to vote against manager proposals." Market developments in the score of years since have made it far easier, not harder, for stockholders to protect themselves. . . . Not only that, institutional investor holdings have only grown since 1994, making it easier for a blocking position of minority investors to be assembled.

Id. at 530-31 (footnote omitted).

Chancery's holding on appeal,[59] it became clear that the doorway out of entire fairness is a transaction structure that provides for both a special negotiating committee and a majority of minority vote.[60]

B. *Third-Party Mergers and the Cleansing Vote*

The reemergence of deference in third-party mergers likewise came about as a response to settlement pathologies. The pattern in third-party merger cases was for shareholder plaintiffs to file complaints alleging defects in the merger process and the merger price and then to amend their claims, once the preliminary proxy statement was released, to allege inadequacies in the disclosures about the deal.[61] The shareholder plaintiffs would seek equitable relief—an injunction barring consummation of the transaction—and, in the meantime, expedited discovery. Because the Delaware standard—a "colorable claim and . . . a possibility of . . . irreparable injury"[62]—entitled plaintiffs to expedited discovery in essentially every case challenging the adequacy of merger disclosures,[63] which is to say every third-party merger case, defendants once again sought settlement to avoid the looming cost of discovery.[64] The vast

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[59] *M & F Worldwide Corp.*, 88 A.3d at 654.

[60] *See, e.g.*, Transcript of Oral Argument on Defendants' Motion to Dismiss and the Court's Ruling at 66, Swomley v. Schlecht, No. 9355-VCL (Del. Ch. Aug. 27, 2014), 2014 WL 4470947 (granting motion to dismiss on the basis of procedural protections and noting that "the whole point of encouraging [the *M & F Worldwide*] structure was to create a situation where defendants could effectively structure a transaction so that they could obtain a pleading-stage dismissal against breach of fiduciary duty claims").

[61] Delaware courts derived fiduciary duties to disclose from the statutory command that mergers be put to a shareholder vote, which is an illusory right if the board does not also provide adequate disclosure. DEL. CODE ANN. tit. 8, § 251(c) (2019) (requiring shareholder vote on mergers); Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992) (implying disclosure duties from mandatory shareholder vote); *see* Lawrence A. Hamermesh, *Calling Off the* Lynch *Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087, 1096 (1996) (describing development of duty of disclosure under Delaware corporation law).

[62] Giammargo v. Snapple Beverage Corp., No. 13845, 1994 WL 672698, at *2 (Del. Ch. Nov. 15, 1994).

[63] Shareholders can always argue that they will be irreparably injured by the failure to disclose material information prior to the shareholder vote. *See In re* BioClinica, Inc. S'holder Litig., No. 8272-VCG, 2013 WL 5631233, at *4 n.46 (Del. Ch. Oct. 16, 2013) ("The standard for a motion to expedite is 'colorability' and the standard for a motion to dismiss under Rule 12(b)(6) is 'reasonable conceivability'–in my view, a higher, although still minimal, pleading burden."); *see also* Sinchareonkul v. Fahnemann, No. 10543-VCL, 2015 WL 292314, at *1 n.1 (Del. Ch. Jan. 22, 2015) ("[T]he standard for expedition, colorability, which simply implies a non-frivolous set of issues, is even lower than the 'conceivability' standard applied on a motion to dismiss." (quoting *In re BioClinica Inc., S'holder Litig.*, 2013 WL 5631233, at *1 n.1)).

[64] *See* Sean J. Griffith & Anthony A. Rickey, *Objections to Disclosure Settlements: A "How To" Guide*, 70 OKLA. L. REV. 281, 290 (2017) (describing importance of discovery in motivating settlements and describing process whereby settling parties engage in desultory confirmatory discovery rather than serious adversarial discovery).

majority of such settlements involved no monetary relief for the shareholder class but only the addition of a small number of supplemental disclosures in the merger proxy.[65] Nevertheless, the corporate benefit doctrine was invoked to allow plaintiffs' counsel to recover fees from the company, often in the $350,000 to $700,000 range.[66]

The ease of achieving disclosure settlements and attorneys' fees served only to encourage further claims. By 2009, shareholder claims were brought against close to 90% of all third-party mergers, a number that held until 2016.[67] Delaware was widely criticized as a haven for wasteful litigation.[68] In response, the judiciary attempted to address the problem in a number of ways, generally unsuccessfully.[69] Then, in 2015, the Delaware Supreme Court decided *Corwin*.[70]

In *Corwin*, the Supreme Court affirmed an opinion of the Court of Chancery dismissing a post-closing damages claim against a third-party merger.[71] The basis for the conclusion was the shareholder vote in favor of the merger, which had the effect of cancelling enhanced scrutiny, in favor of business judgment rule review. According to the court, an "uncoerced, informed stockholder vote is outcome-determinative, even if *Revlon* applied to the merger."[72] Implicitly following the logic of *M & F Worldwide*, *Corwin* substitutes the "cleansing

[65] Jill E. Fisch, Sean J. Griffith & Steven Davidoff Solomon, *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform*, 93 TEX. L. REV. 557, 559 (2015).

[66] *See* Sean J. Griffith, *Correcting Corporate Benefit*, 56 B.C. L. REV. 1, 13-16 (2015) (describing application of corporate benefit doctrine to third-party mergers).

[67] Matthew D. Cain & Steven Davidoff Solomon, Takeover Litigation in 2015, at 2 (Jan. 14, 2016) (unpublished manuscript), http://ssrn.com/abstract=2715890 (providing empirical evidence of litigation activity and outcomes).

[68] *See, e.g.*, Stephen M. Bainbridge, *Fee-Shifting: Delaware's Self-Inflicted Wound*, 40 DEL. J. CORP. L. 851, 852 (2016) (contending that merger litigation is a "problem that has reached crisis proportions").

[69] For example, in *Lyondell Chemical Co. v. Ryan*, the Delaware Supreme Court reduced the stringency of enhanced scrutiny. 970 A.2d 235, 243 (Del. 2009); *see* Lyman Johnson & Robert Ricca, *The Dwindling of* Revlon, 71 WASH. & LEE L. REV. 167, 180-93 (2014) (documenting declining stringency of *Revlon* scrutiny). However, as long as plaintiffs could still use it to seek injunctive relief, *Revlon* continued to generate nonmeritorious claims. Likewise, in *ATP Tour, Inc. v. Deutscher Tennis Bund*, the Delaware Supreme Court suggested that fee-shifting bylaws might be introduced to deter nonmeritorious litigation. 91 A.3d 554, 560 (Del. 2014). However, the legislature quickly reversed the judiciary on fee-shifting. *See* Dan Awrey, Blanaid Clarke & Sean J. Griffith, *Resolving the Crisis in U.S. Merger Regulation: A Transatlantic Alternative to the Perpetual Litigation Machine*, 35 YALE J. ON REG. 1, 59-62 (2018) (proposing regulation as alternative to private litigation as means of protecting shareholders in mergers).

[70] Corwin v. KKR Financial Holdings, LLC, 125 A.3d 304, 314 (Del. 2015).

[71] *Id.* at 306. Although much of the dispute in the Court of Chancery was over whether the buyer should be treated as a controlling shareholder, the case was decided as if it were a third-party merger. *Id.* at 306-08.

[72] *Id.* at 308.

effect" of a shareholder vote for rigorous judicial scrutiny.[73] This logic has since been extended to two-step tender offer mergers as well.[74]

Because it speaks only to damages claims—a class of cases that received enhanced scrutiny only grudgingly, if at all[75]—*Corwin* may not seem like a major shift.[76] However, the impact of *Corwin* becomes clear when it is paired with the Delaware Supreme Court's ruling one year earlier in *C & J Energy Services, Inc. v. City of Miami General Employees' & Sanitation Employees' Retirement Trust*,[77] holding that injunctions should generally not be issued where there is no alternative bidder.[78] *C & J* follows longstanding Delaware practice in not enjoining transactions if doing so risks leaving shareholders with no deal at all,[79] but its practical effect is that there is no meaningful prospect of an injunction in most cases. Paired with *Corwin*, *C & J* creates something of a Catch-22. *Corwin* says enhanced scrutiny is now generally unavailable for damages, leaving only injunction cases. And *C & J* says enhanced scrutiny is now generally unavailable for injunctions, leaving only damages cases. Read together, the clear message is that enhanced scrutiny is now generally unavailable. The sole constraint is now the shareholder vote.

The irony is that *Corwin* is not the decision that ended the filing of the easy-money disclosure cases that had drawn Delaware into disrepute. Those practices

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[73] According to Professor Charles Korsmo, "*Corwin* follows directly from [*M & F Worldwide*]. Once you hold that the procedural trappings of an arm's-length deal entitle a majority stockholder squeeze-out to business judgment rule deference, it would be strange indeed to deny such deference to an actual arm's-length deal." Charles R. Korsmo, Delaware's Retreat from Judicial Scrutiny of Mergers 5 (Jan. 3, 2018) (unpublished manuscript) (on file with author); *see also* J. Travis Laster, *The Effect of Stockholder Approval on Enhanced Scrutiny*, 40 WM. MITCHELL L. REV. 1443, 1443 (2014) (arguing that only in absence of independent, disinterested, and sufficiently informed decision makers will the court apply stringent review). Professor Korsmo also notes, however, that this logic can be reversed. Rather than taking *M & F Worldwide* to its logical conclusion in *Corwin*, *Revlon* could be read as a correction to *M & F Worldwide*, suggesting that the right standard of review in controlling shareholder cases with procedural protections might be enhanced scrutiny rather than business judgment. *See* Korsmo, *supra*, at 19, n.101.

[74] *In re* Volcano Corp. S'holder Litig., 143 A.3d 727, 738 (Del. Ch. 2016) (applying business judgment review where "disinterested, uncoerced, fully informed stockholders tendered a majority of [target company's] outstanding shares into the Tender Offer").

[75] *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235 (Del. 2009), is an example. *See supra* text accompanying note 69.

[76] *Corwin*, 125 A.3d at 312 (arguing that enhanced scrutiny was designed for injunctions, not damages).

[77] 107 A.3d 1049 (Del. 2014).

[78] *Id.* at 1053.

[79] Delaware courts have consistently demonstrated a reluctance to enjoin a transaction in the absence of a competing bidder. *See, e.g.*, *In re* El Paso Corp. S'holder Litig., 41 A.3d 432, 439 (Del. Ch. 2012) ("Although a reasonable mind might debate the tactical choices made by the El Paso Board, these choices would provide little basis for enjoining a third-party merger approved by a board overwhelmingly comprised of independent directors, many of whom have substantial industry experience.").

were brought to an end by the Court of Chancery's 2016 holding in *In re Trulia, Inc. Stockholder Litigation*[80] that disclosure settlements provided no compensable benefit unless the supplemental disclosures corrected "a plainly material misrepresentation or omission."[81] *Trulia* changed litigation and settlement patterns in Delaware and across the nation, as nonmeritorious merger claimants fled Delaware in search of more hospitable standards in alternative state and federal courts.[82] Moreover, *Trulia* addressed the settlement pathologies of third-party merger cases without fundamentally altering substantive law. But by the time the Court of Chancery ruled on *Trulia*, *Corwin* had already been decided. And *Corwin*, in substituting the shareholder vote for judicial scrutiny, fundamentally altered substantive law.

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[80] 129 A.3d 884 (Del. Ch. 2016).

[81] *Id.* at 898 (emphasizing further that "it should not be a close call that the supplemental information is material as that term is defined under Delaware law"). Prior to the articulation of this standard in *Trulia*, numerous Court of Chancery decisions had rejected proferred settlements for providing no meaningful benefit to the shareholder class. *See In re* Aruba Networks, Inc. Stockholder Litig., No. 10765-VCL, slip op. at 73 (Del. Ch. Oct. 9, 2015) (denying settlement approval and emphasizing that representation is inadequate where counsel files litigation when "there wasn't a basis to file in the first place" but subsequently fails to aggressively litigate when discovery turns up valuable information); Acevedo v. Aeroflex Holding Corp., No. 9730-VCL, slip op. at 73 (Del. Ch. July 8, 2015) (rejecting disclosure-only settlement where plaintiffs settled for "precisely the type of nonsubstantive disclosures that routinely show up in these types of settlements"); *In re* Theragenics Corp. Stockholders Litig., No. 8790-VCL, slip op. at 69 (Del. Ch. May 5, 2014) (refusing to approve settlement and noting that "when a fiduciary action settles, I have to have some confidence that the issues in the case were adequately explored, particularly when there is going to be a global, expansive, all-encompassing release given"); Rubin v. Obagi Med. Prods., Inc., No. 8433-VCL, slip op. at 20-21 (Del. Ch. Apr. 30, 2014) (refusing to approve settlement and noting that "the type of global release that plaintiff's counsel gives in this case and routinely gives in return for disclosure settlements provides expansive protection for the defendants against a broad range of claims, virtually all of which have been completely unexplored by the plaintiffs"); *In re* Medicis Pharm. Corp. S'holders Litig., No. 7857-CS, slip op. at 24 (Del. Ch. Feb. 26, 2014) (refusing to approve settlement because "giving out releases lightly . . . is something we've got to be careful about"); *In re* Transatlantic Holdings Inc. S'holders Litig., No. 6574-CS (Del. Ch. Mar. 8, 2013) (refusing to approve settlement for lack of "any real investigation," disclosure of additional background information, and in light of the overwhelming vote in favor of the transaction); *see also In re* Riverbed Tech., Inc. Stockholders Litig., No. 10484-VCG, 2015 Del. Ch. LEXIS 241, at *20 (Del. Ch. Sept. 17, 2015) (approving settlement but noting that "[i]f it were not for the reasonable reliance of the parties on formerly settled practice in this Court . . . the interests of the Class might merit rejection of a settlement encompassing a release that goes far beyond the claims asserted and the results achieved").

[82] Disclosure claims were driven out of the state, often brought instead in federal court under federal law. *See* Sean J. Griffith, *Private Ordering Post*-Trulia*: Why No Pay Provisions Can Fix the Deal Tax and Forum Selection Provisions Can't*, *in* THE CORPORATE CONTRACT IN CHANGING TIMES (Steven Davidoff Solomon & Randall S. Thomas, eds., 2019) (detailing flight of disclosure claims from Delaware to other jurisdictions).

C. *Comparative Competencies: Shareholders Versus Judges*

The basic rationale underlying the shift away from heightened scrutiny in M&A transactions is one of institutional competence. In theory at least, voting allows owners with a genuine economic stake to decide the fate of the transaction. Judges, loathe to act as "super-directors" by substituting their judgment for that of the board and the shareholders, are therefore happy to defer to the outcome of a fair—that is, uncoerced and fully informed—vote.[83] The *Corwin* court provided a clear articulation of this rationale:

> [T]he long-standing policy of our law has been to avoid the uncertainties and costs of judicial second-guessing when the disinterested stockholders have had the free and informed chance to decide on the economic merits of a transaction for themselves. There are sound reasons for this policy. When the real parties in interest—the disinterested equity owners—can easily protect themselves at the ballot box by simply voting no, the utility of a litigation-intrusive standard of review promises more costs to stockholders in the form of litigation rents and inhibitions on risk-taking than it promises in terms of benefits to them. The reason for that is tied to the core rationale of the business judgment rule, which is that judges are poorly positioned to evaluate the wisdom of business decisions and there is little utility to having them second-guess the determination of impartial decision-makers with more information (in the case of directors) or an actual economic stake in the outcome (in the case of informed, disinterested stockholders). In circumstances, therefore, where the stockholders have had the voluntary choice to accept or reject a transaction, the business judgment rule standard of review is the presumptively correct one and best facilitates wealth creation through the corporate form.[84]

This institutional competence rationale has deep roots in Delaware corporate law. Many Delaware decisions expressly recognize informed, disinterested shareholders as capable of deciding their own fate.[85] Furthermore, many

[83] Delaware courts have long resisted the "super-director" mantle. *See* Brehm v. Eisner, 746 A.2d 244, 266 (Del. 2000) ("To rule otherwise would invite courts to become super-directors, measuring matters of degree in business decisionmaking and executive compensation."); *In re* RJR Nabisco, Inc. S'holders Litig., No. 10389, 1989 WL 7036, at *14 n.13 (Del. Ch. Jan. 31, 1989) ("To recognize in courts a residual power to review the substance of business decisions for 'fairness' or 'reasonableness' or 'rationality' where those decisions are made by truly disinterested directors in good faith and with appropriate care is to make of courts super-directors.").

[84] Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 312-14 (Del. 2015) (footnotes omitted).

[85] *See In re* Lear Corp. S'holder Litig., 926 A.2d 94, 114-15 (Del. Ch. 2007) ("When disinterested stockholders make a mature decision about their economic self-interest, judicial second-guessing is almost completely circumscribed by the doctrine of ratification."); *In re* Netsmart Techs., Inc. S'holders Litig., 924 A.2d 171, 207 (Del. Ch. 2007) ("[D]octrines . . . operate to keep the judiciary from second-guessing transactions when disinterested stockholders have had a fair opportunity to protect themselves by voting no.");

Delaware decisions suggest that the basis for deference is enhanced when the shareholder base contains sophisticated institutional investors.[86] An opinion of the Court of Chancery notes that deference is especially appropriate when a corporate "electorate is dominated by sophisticated institutional investors well-positioned to vote in an informed manner . . . assuming adequate disclosures."[87]

Delaware's willingness to defer to the shareholder vote, especially when the shareholder base contains sophisticated institutional investors, follows corporate law scholarship's emphasis on the importance of sophisticated institutional investors.[88] Members of the judiciary, in their extrajudicial writings, have also emphasized the role of institutional investors in forcing managers to remain accountable to shareholders.[89] In a recent contribution to an edited volume, Vice Chancellor Laster emphasized "the rise of sophisticated institutional investors who have the ability to influence the direction of the corporations in which they

In re PNB Holding Co. S'holders Litig., No. 28-N, 2006 WL 2403999, at *15 (Del. Ch. Aug. 18, 2006) ("[W]hen most of the affected minority affirmatively approves the transaction, their self-interested decision to approve is sufficient proof of fairness to obviate a judicial examination of that question."); Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 901 (Del. Ch. 1999) ("In this day and age in which investors also have access to an abundance of information about corporate transactions from sources other than boards of directors, it seems presumptuous and paternalistic to assume that the court knows better in a particular instance than a fully informed corporate electorate with real money riding on the corporation's performance.").

[86] *See In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 619 (Del. Ch. 2005) ("[W]ith increasingly active institutional investors and easier information flows, stockholders have never been better positioned to make a judgment as to whether a special committee has done its job."); *In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 444 (Del. Ch. 2002) ("Adherence to the *Solomon* rubric as a general matter, moreover, is advisable in view of the increased activism of institutional investors and the greater information flows available to them.").

[87] *In re* Staples, Inc. S'holders Litig., 792 A.2d 934, 952 (Del. Ch. 2001) (noting that in such cases "this court has been rightly reluctant to interpose its own view of the business merits, thereby precluding an opportunity for the genuine stakeholders to make their own decision").

[88] *See* John Armour, Jack B. Jacobs & Curtis J. Milhaupt, *The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework*, HARV. INT'L L.J., Winter 2011, at 219, 222 (emphasizing presence of sophisticated institutional investors as distinguishing characteristic of takeover regimes); Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 1001 (2010) (emphasizing role of sophisticated institutional investors in putting pressure on incumbent managers).

[89] Jack B. Jacobs, Lecture, *Does the New Corporate Shareholder Profile Call for a New Corporate Law Paradigm?*, 18 FORDHAM J. CORP. & FIN. L. 19, 31 (2012) (noting that "the new shareholder profile [consisting of concentrated ownership by sophisticated institutional investors] is an irrefutable reality that justifies inquiring into whether courts should take that into account in formulating and applying fiduciary duty principles"); Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 14 (2010) ("The potency of the institutional investor community is easy to see. When they want something, they tend to get it.").

invest" as one of two "predominant influences" in the evolution of Delaware corporate law over the last thirty years.[90] According to Laster, "Recognizing that stockholders are empowered and capable of making their own decisions changes the role of the judiciary . . . . [W]hen stockholders can protect themselves, they do not need judges. Only when the voting process itself is undermined does a role for the judge remain."[91] Revisions to corporate law jurisprudence followed this recognition: "[V]oting by sophisticated stockholders . . . emerged as an alternative, market-based means of protecting against fiduciary overreaching."[92]

However, the *sine qua non* of judicial deference to the vote is disinterest. The excesses of controlling shareholders and unaccountable managers are only constrained by disinterested shareholder voting. Interested votes count neither in a majority of the minority vote under *M & F Worldwide* nor in a cleansing vote under *Corwin*.[93] But mutual fund sponsors have their own set of interests. Moreover, as we explore in detail in Part II, below, these interests lead the voting preferences of investment funds to conflict with those of their underlying investors. This raises the question of how corporate law courts ought to construe disinterest in light of the interests of institutional shareholders, a subject we explore in Part III, below.

II. MUTUAL FUND VOTING CONFLICTS

Mutual fund sponsors—especially the Big Three—are the key voices that ultimately dictate the outcome of proxy contests,[94] shareholder proposals,[95] and

[90] *See* J. Travis Laster, *Changing Attitudes: The Stark Results of Thirty Years of Evolution in Delaware M&A Litigation*, *in* HANDBOOK ON REPRESENTATIVE LITIGATION 202, 203 (Sean Griffith et al. eds., 2018) (describing other influence as "the system-wide failure of stockholder-led M&A litigation to generate meaningful benefits for investors").

[91] *Id.* at 222-23.

[92] *Id.* at 225.

[93] Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 306 (Del. 2015) (listing shareholder disinterest as element of vote); Kahn v. M & F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014) (constituting relevant minority shareholders as those, unlike controller, disinterested in transaction).

[94] *See, e.g.*, Michael Blanding, *Vanguard, Trian, and the Problem of "Passive" Index Funds*, HARV. BUS. SCH. WORKING KNOWLEDGE (Jan. 30, 2017), https://hbswk.hbs.edu/item/passive-index-fund-leaders-push-for-shareholder-reforms [https://perma.cc/W4KN-Y8BW] ("Trian, recognizing the growing power of index funds, tried to persuade three index investors in DuPont—Vanguard, BlackRock, and State Street—to support its management reform package. All three funds refused to go along, although the assent of just one of them would have tipped the balance in favor of Trian's plan.").

[95] Steven Mufson, *Financial Firms Lead Shareholder Rebellion Against ExxonMobil Climate Change Policies*, WASH. POST (May 31, 2017), https://www.washingtonpost.com/news/energy-environment/wp/2017/05/31/exxonmobil-is-trying-to-fend-off-a-shareholder-rebellion-over-climate-change/?utm_term=.f7e1c824faa7 (reporting that BlackRock and Vanguard owned 13% of ExxonMobil and that their votes were pivotal in passage of shareholder proposal seeking improved disclosure about effects of climate change).

say on pay.[96] Initially, observers theorized that these institutional investors—because they often hold large, concentrated stakes in companies—could overcome the rational apathy plaguing diversified shareholders and serve as active participants in governance.[97] But mutual funds largely disappointed in this respect, especially when judged by shareholder proposals.[98] At one point, their dismal voting records prompted regulatory scrutiny, which lead to a Securities and Exchange Comission ("SEC") rule requiring mutual funds to disclose all of their votes.[99] The SEC also made clear that mutual fund advisors have a fiduciary duty to vote investor proxies in the clients' best interests.[100] Fund sponsors have essentially interpreted this duty as a requirement to vote all of their portfolio company shares—an impressive feat that today requires a single sponsor to cast hundreds of thousands of votes for thousands of portfolio companies annually.[101]

To manage this task, most mutual fund sponsors generally centralize their voting and governance activities within a corporate governance team.[102] These teams are in charge of enacting the voting policy for the funds housed within the institution, regardless of the investment strategy. In most cases, they also cast all of the funds' votes. These centralized corporate governance teams tend to be

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[96] *Cf.* Miguel Antón et al., *Research: Index Funds Are Fueling Out-of-Whack CEO Pay Packages*, HARV. BUS. REV. (Oct. 18, 2016), https://hbr.org/2016/10/research-index-funds-are-fueling-out-of-whack-ceo-pay-packages (arguing that the Big Three may influence executive pay packages).

[97] *See* Black, *Agents Watching Agents*, *supra* note 30, at 815 (exploring "potential promise" of oversight by institutional investors); Black, *Shareholder Passivity*, *supra* note 30 at 575-91 (arguing "institutional shareholders *could* find it in their self-interest to take an active interest in corporate governance"); Gilson & Kraakman, *supra* note 30, at 865 (providing "realistic agenda for institutional investors" to improve corporate governance of portfolio companies).

[98] Gilson & Gordon, *supra* note 25, at 887 (noting "over the 2007 through 2009 proxy seasons, mutual funds offered only seventeen (0.9%) shareholder proposals addressed to corporate governance or performance issues"); Edward Rock, *Institutional Investors in Corporate Governance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 363, 383 (Jeffrey N. Gordon & Wolf-George Ringe eds., 2018) (explaining that institutional investors suffer from misalignment of incentives that causes them to be relatively passive when it comes to corporate governance).

[99] Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 8188, 68 Fed. Reg. 6564, 6565 (Feb. 7, 2003) (codified at 17 C.F.R. pts. 239, 249, 270, 274).

[100] *Id.* at 6564.

[101] *See* VANGUARD, INVESTMENT STEWARDSHIP ANNUAL REPORT 34 (2018), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2018_investment_stewardship_annual_report.pdf [https://perma.cc/DKX8-2HXQ] (noting that Vanguard funds cast nearly 169,000 individual votes in 2018 proxy year and 170,000 in 2017).

[102] This trend is relatively recent; a decade ago, most mutual funds relied on third party proxy advisors to cast votes. Today, some continue to do so, delegating voting decisions to proxy advisors such as Institutional Shareholder Servces ("ISS") or Glass Lewis, although most of the large sponsors have spoken out against this practice.

small—as of January 2017, Vanguard employed twenty people charged with engagement and voting at about 13,000 companies; BlackRock, about thirty-one people for 14,000 companies; and State Street, eleven people for 9,000 companies.[103] Accordingly, corporate governance groups rely on active fund managers to provide information about portfolio companies in advance of a vote.[104] By contrast, index portfolio managers are not given a say in the voting of their portfolio holdings.[105]

Most, but not all, corporate governance groups seek to achieve uniformity in voting across funds.[106] In 2017, Morningstar generated a report based on interviews with corporate governance teams that included details about the governance policies for different sponsors.[107] For some, active fund managers may give input before a vote, but they must ultimately follow the corporate governance team's recommendation even if they disagree. State Street and Vanguard, for example, give their governance teams the ultimate authority on final voting decisions.[108] Tellingly, the funds explain that this is meant to ensure "consistency and efficacy, as well as to minimize potential conflicts of interest [which] arise when views of internal portfolio managers differ between each

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[103] *See* Sarah Krouse, David Benoit & Tom McGinty, *Meet the New Corporate Power Brokers: Passive Investors*, WALL STREET J. (Oct. 24, 2016, 10:41 AM), https://www.wsj.com/articles/the-new-corporate-power-brokers-passive-investors-1477320101. For updated numbers, see Madison Marriage, *BlackRock, Vanguard and State Street Bulk Up Governance Staff*, FIN. TIMES (Jan. 28, 2017), https://www.ft.com/content/657b243c-e492-11e6-9645-c9357a75844a.

[104] *See generally* HORTENSE BIOY ET AL., MORNINGSTAR, PASSIVE FUND PROVIDERS TAKE AN ACTIVE APPROACH TO INVESTMENT STEWARDSHIP (Dec. 2017), https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Morningstar-Passive-Active-Stewardship.pdf [https://perma.cc/X7QD-B7DV]. Invesco provides a unique example: its voting platform allows active fund managers to debate in advance of a vote and that process determines the voting position for the sponsor as a whole. BONNIE SAYNAY & HENNING STEIN, INVESCO, PROXY VOTING: THE HALLMARK OF ACTIVE OWNERSHIP 8 (2017), https://www.de.invesco.com/de/dam/jcr:3c5c700c-3a3c-4449-88fb-67679b937ff4/ESG_White_paper_Proxy_voting_the_hallmark_of_active_ownership.pdf [https://perma.cc/X49U-KAVC].

[105] BIOY ET AL., *supra* note 104, at 14.

[106] *See* Stephen Choi, Jill Fisch & Marcel Kahan, *Who Calls the Shots? How Mutual Funds Vote on Director Elections*, 3 HARV. BUS. L. REV. 35, 48 (2013) (finding evidence that mutual funds tend to economize by centralizing their voting decisions when it comes to director elections); Angela Morgan et al., *Mutual Funds as Monitors: Evidence from Mutual Fund Voting*, 17 J. CORP. FIN. 914, 921 (2011) (finding forty-nine of ninety-four mutual fund families coordinate voting at family level, resulting in identical voting on 90% of proposals on average, although some fund families have much higher levels of divergence in voting); Burton Rothburg & Steven Lilien, *Mutual Funds and Proxy Voting: New Evidence on Corporate Governance*, 1 J. BUS. & TECH. L. 157, 162 (2006) (studying voting practices of top ten mutual fund families and noting that all fund families but one voted their shares in uniform block for each issue).

[107] *See generally* BIOY ET AL., *supra* note 104.

[108] *Id.* at 42, 46.

other and with the stewardship team."[109] In other words, the mutual fund sponsors acknowledge that there can be divergence in views between funds, and yet the funds' votes will be cast in a direction the governance team choses. If a fund manager disagrees with the governance group's voting recommendation, the manager's only recourse is to divest.[110] As a result of this policy, both State Street and Vanguard funds have impressive uniformity in voting; in 2015, only 195 out of 100,000 (or less than 2%) of proposals at State Street featured a fund voting differently than its other funds; at Vanguard, only six per 100,000 (0.006%) proposals received differing votes.[111]

By contrast, some fund sponsors maintain a preference for consistency while allowing divergent voting. At BlackRock, for example, the active fund managers can depart from the house view if they disagree with it.[112] Nonetheless, in 2015, a BlackRock fund voted differently from all of the other funds in only eighteen per 100,000 (or 0.018%) proposals.[113] Similar to BlackRock, T. Rowe Price's fund managers have discretion to cast the funds' votes differently than the governance team recommends. However, the manager who chooses to do so must document her reasons for departing from the governance team's recommendation.[114] At the more extreme end of the spectrum is AIM/Invesco, which, in addition to allowing its funds to vote differently from each other, empowers them to promulgate and follow different voting policies.[115]

Fidelity is the sole mutual fund sponsor that delegates voting for its index funds to a sub-advisor, Geode.[116] As a result, Fidelity displays much higher levels of disagreement in its proxy voting, with funds voting differently from other funds in 3,144 per 100,000 (or 3.14%) of votes.[117] But even at Fidelity, the degree of centralization is high. And owing to their commitment to uniformity in voting, mutual fund sponsors are able to leverage their heft in ways that are often outcome determinative.

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[109] *Id.* at 14.

[110] *See id.* at 42.

[111] Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 29, at 316-17.

[112] BIOY ET AL., *supra* note 104, at 14 ("[A]t BlackRock, Amundi, and UBS, the policy is for active fund managers to vote consistently across all funds, but they retain the authority to vote differently from the house view.")

[113] Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 29, at 317.

[114] *See* Donna F. Anderson, *T. Rowe Price's Investment Philosophy on Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 18, 2018), https://corpgov.law.harvard.edu/2018/06/18/t-rowe-prices-investment-philosophy-on-shareholder-activism/ [https://perma.cc/9E98-9U39] (noting it is not uncommon for different T. Rowe funds to cast different votes for the same proxy contest).

[115] *See* Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552, 561 (2007) (noting AIM funds typically vote for certain policies while Invesco funds typically vote against those same policies).

[116] *Id.* at 560.

[117] Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 29, at 317.

Mutual fund voting is subject to serious and recurring conflicts of interest between the fund sponsor and its investors. As Professor Ann Lipton, who was among the first to explore the conflicts between funds and sponsors, put it, "Today's conflicts . . . represent a pervasive, baseline characteristic of the market, and they are growing."[118] In the Sections that follow, we provide a typology of three such conflicts. The first, Cross-Ownership Conflict, encompasses conflicts of interest that pit the institution against a company's real parties in interest. Broad diversification means that mutual funds are often empty voters, with an incentive to cast a vote to benefit other investments. Second, we explore Corporate Client Conflict, which encompasses conflicts of interest that arise from the sponsor's status as a profit-maximizing institution. Finally, we note Uniform Policy Conflict—that is, intra-institutional conflicts of interest that result when beneficial ownership differs across funds but sponsors nonetheless adhere to a centralized voting strategy. In those situations, a course of action that is likely in the best interest of one group of investors is unlikely to be wealth-maximizing for another.

A. *Cross-Ownership Conflict*

Most U.S. publicly held corporations have a one-share, one-vote structure in which voting power is proportional to a shareholder's economic ownership in the company. Economists contend that this structure promotes efficient corporate decisionmaking because the shareholders with the largest financial stakes in the company and, accordingly, the greatest incentive to maximize the corporation's wealth, will have the greatest influence.[119] However, the rise of institutional investing and broadly diversified shareholding complicates this rationale: today, the largest corporate shareholders are widely diversified mutual fund sponsors with interests elsewhere.

We are not the first to explore this problem. In their groundbreaking work, Professors Henry Hu and Bernard Black demonstrated that hedge funds could engage in "empty voting" through complex financial transactions that decouple voting rights from economic interest.[120] They showed that hedge funds can wield substantial voting power while having limited, zero, or even negative economic

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[118] Lipton, *Shareholder Divorce Court*, *supra* note 38, at 118-19; *see also* Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *Passive Investors* 2 (Eur. Corp. Governance Inst., Working Paper No. 414, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3192069 ("[T]he rise of passive investing has the potential to raise concerns about . . . conflicts of interest . . . .").

[119] *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (developing theory of optimal ownership structure of firms).

[120] *See generally* Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006). Professors Frank Partnoy and Shaun Martin were the first to identify the phenomenon of "encumbered shareholding," where shareholders use financial transactions to trade votes. *See generally* Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775.

ownership in the underlying company. In this latter situation, the empty voter would have an incentive to vote in ways that reduce the company's share price.[121]

Despite the seriousness of these conflicts, the SEC has not yet acted to contain them. This may be because the incidence of "empty" hedge fund activism is relatively low, with the exception of a few prominent examples.[122] By contrast, the problem of mutual fund empty voting is likely to be much more pervasive than hedge fund empty voting.[123]

Because mutual funds are highly diversified, they are very likely to stand on two or more sides of an issue. And as they have grown in popularity, mutual funds have not only grown their existing investments, but have also expanded into new investment opportunities. This expansion has led to an increase in significant cross-holdings.[124] In 1985, "the five largest shareholders of any given S&P 500 firm would hold 17% of that firm and 2% of another randomly selected firm in the index."[125] By 2005, those numbers had risen to 26% and 10%.[126] Put differently, share ownership has become so concentrated that "in a hypothetical conflict between two S&P 500 firms in 2005, 15% of the equity in either firm would on average be held by institutional investors that prefer the other side to win."[127] And as investor assets continue to pour into mutual funds, the incidence of significant cross-holdings grows more likely every day.

Most mutual fund sponsors admit that their centralized voting strategy requires them to aggregate all of their funds' votes and cast them uniformly in

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121 Hu & Black, *supra* note 120, at 815. The merger between Mylan Laboratories and King Pharmaceuticals provides an example. When Mylan announced that it agreed to buy King at a substantial premium, Mylan's shares dropped sharply. The hedge fund Perry, which had a substantial stake in King and wanted the deal to go through, then bought nearly 10% of Mylan, becoming its largest shareholder. But Perry hedged the market risk associated with these shares, meaning that its overall economic interest in Mylan was negative. Therefore, Perry was incentivized to use its shares in Mylan to overpay for King. *Id.* at 816.

122 *See* KATTEN MUCHIN ROSENMAN LLP, PROXY VOTE PROCESSING ISSUES: OVER-VOTING AND EMPTY VOTING 3 (Nov. 21, 2013), https://www.kattenlaw.com/files/21384_Proxy-Vote-Processing-Issues.pdf [https://perma.cc/C9SH-JLNV] ("We are not aware of any information tending to show that empty voting occurs with any frequency."); Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 652, 661-81 (2008) (listing worldwide examples of empty voting).

123 Lipton, *Shareholder Divorce Court*, *supra* note 38, at 118-19; Bernard S. Scharfman, *Mutual Fund Advisors' "Empty Voting" Raises New Governance Issues*, CLS BLUE SKY BLOG (July 3, 2017), http://clsbluesky.law.columbia.edu/2017/07/03/mutual-fund-advisors-empty-voting-raises-new-governance-issues [https://perma.cc/WY2B-3JJ4].

124 Lipton, *Shareholder Divorce Court*, *supra* note 38, at 310 (citing Jarrad Harford, Dirk Jenter & Kai Li, *Institutional Cross-Holdings and Their Effect on Acquisition Decisions*, 99 J. FIN. ECON. 27, 36 (2011)).

125 *Id.*

126 *Id.*

127 *Id.*

the way that is most likely to benefit the institution as a whole.[128] In some cases, that would require voting the shares of one company in order to benefit other investments. The clearest examples involve M&A transactions, when mutual funds stand on both sides of the transaction and there can be an obvious winner and loser.[129] Consider a stylized example: Company *A* management decides to buy Company *B*, and the merger is viewed by the market as an excellent outcome for Company *B*, which has been struggling to make interest payments on debt and has had a number of setbacks in the past year. The market is less positive about the prospect for Company *A*, which will assume many debts and liabilities from Company *B*. Nonetheless, Company *A* shareholders overwhelmingly approve the merger. They do not look back even when Company *A*'s share price falls with the announcement of the deal.

What is going on here? Company *A*'s ten largest shareholders are sophisticated institutional blockholders—why did they voluntarily agree to a merger that clearly decreased the value of their investment? The answer may be that most of the large institutional investors in Company *A* also hold large investments in Company *B* and are therefore hedged.[130] This means that their incentives to oppose the deal may be dampened or even reversed depending on the size of their investment in each company. Putting aside the question of whether this is a good outcome for the institution's investors, it is unlikely to be in the best interest of the Company *A* shareholders, who now hold less valuable stock.

This example is not merely hypothetical. Tesla's acquisition of SolarCity, as described in the introduction, is a prominent recent example. But there are others. For example, in 2003, Bank of America's plan to acquire FleetBoston Financial was overwhelmingly approved by shareholders who stood on both sides of the transaction, despite the fact that Bank of America's market capitalization decreased by $9 billion when the merger was announced; notably, FleetBoston's market capitalization increased by approximately the same amount.[131] The fact that Bank of America's ten largest shareholders—all institutional investors—alone lost more than $2 billion in the transaction did not stop them from voting to approve it—most of those losses were neutralized or even reversed because of their positions in FleetBoston.[132] Professor Ann Lipton has compiled a further series of deals in which overlapping ownership affected

[128] *See generally* BIOY ET AL., *supra* note 104.

[129] *Cf.* Lipton, *Shareholder Divorce Court*, *supra* note 38, at 298 ("The shifts are particularly visible when it comes to mergers and acquisitions, where courts have long recognized that directors face special conflicts not present in other kinds of transactions.").

[130] *Id.* at 311 (noting that when "investors stand on both sides of the deal, they are hedged; any expenses paid by the acquirer benefit them in their capacity as a holder of target stock").

[131] Gregor Matvos & Michael Ostrovsky, *Cross-Ownership, Returns, and Voting in Mergers*, 89 J. FIN. ECON. 391, 391 (2008).

[132] *Id.* (noting that this example is "by no means an exception").

transaction dynamics.[133] These include Jos. A. Bank's 2014 acquisition of Men's Wearhouse[134] and Anheuser-Busch InBev's 2016 acquisition of SABMiller.[135]

Empirical evidence further indicates that institutional investor cross-ownership is a feature and not a bug of the modern M&A environment. An analysis of M&A deals involving publicly traded companies during 1998-2004 revealed that in 41.7% of the deals, the acquiring and target firms shared some of the same owners.[136] Another study observed that, for the average merger, 18% of the acquirer's stock is held by target institutional owners and 21% of target stock is held by acquirer institutional owners.[137] And as assets continue to flood into broadly diversified passively managed funds, the prevalence of cross-ownership will only grow.

Of course, the cross-holders who voted to approve these mergers may have done so for a number of reasons, including that the deal was in the best interest of both companies. But empirical evidence suggests that cross-holders are using their voting power to approve value-destroying mergers. A 2008 study showed that institutional investors with cross-holdings were more likely to vote for mergers with negative announcement returns, while mutual fund owners without cross-holdings tended to vote against them.[138]

In sum, there is ample evidence that cross-holdings affect a mutual fund family's voting on M&A decisions, but it is likely that these conflicts also affect votes on other issues. As investors continue to flock to mutual funds, and specifically passively managed mutual funds, it is increasingly likely that the

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[133] *See* Lipton, *Shareholder Divorce Court*, *supra* note 38, at 117-18.

[134] Jos. A. Bank's offer letter emphasized the overlap in the shareholder base as a source of value for Men's Wearhouse shareholders. *See* Alex Gavrish, *Jos. A Bank and Men's Wearhouse Leave Investors Puzzled*, VALUEWALK (Jan. 2, 2014, 10:09 AM), http://www.valuewalk.com/2014/01/jos-bank-mens-wearhouse-leave-investors-puzzled/ [https://perma.cc/G8W7-KV7Q] ("The transaction can therefore provide unique benefits to shareholders of Men's Wearhouse, as they will receive a premium for their shares and at the same time will remain shareholders of the merged entity by being also shareholders of Jos. A. Bank Clothiers Inc . . . .").

[135] Shareholder approval was likely, financial advisors predicted, because many of Miller's largest shareholders held stakes in Anheuser-Busch. And indeed, in spite of opposition to the deal coming from hedge funds with concentrated stakes in Miller, the deal was ultimately approved thanks to the vote of the large institutional cross-holders. *See* Eyk Henning & Tripp Mickle, *Business News: Beer Deal Nears Reckoning—Hedge Funds May Hold Key to Approval for AB InBev's Takeover of SABMiller*, WALL STREET J., Sept. 21, 2016, at B3.

[136] *See* Maria Goranova, Ravi Dharwadkar & Pamela Brandes, *Owners on Both Sides of the Deal: Mergers and Acquisitions and Overlapping Institutional Ownership*, 31 STRAT. MGMT. J. 1114, 1115 (2010) (analyzing 2,688 M&A deals during between 1998 and 2004).

[137] Chris Brooks, Zhong Chen & Yeqin Zeng, *Institutional Cross-Ownership and Corporate Strategy: The Case of Mergers and Acquisitions*, 48 J. CORP. FIN. 187, 189 (2018) (sampling 2,604 mergers between 1984 and 2014).

[138] Matvos & Ostrovsky, *supra* note 131, at 391 (characterizing this as product of conflict of interest). *But see* Harford, Jenter & Li, *supra* note 124, at 27 (finding that investors with cross-holdings were not influential enough to impact most bids).

pivotal voters will have significant conflicts of interest as a result of cross-holdings.

B. *Corporate Client Conflict*

Mutual fund sponsors experience another more nefarious conflict of interest that often pits the institution against its own investors.[139] Mutual fund sponsors profit from fees charged to funds, which are calculated based on the fund's assets under management. Company management is a large source of 401(k) assets invested in mutual funds, as well as an actual or potential client for other services. For this reason, the fund sponsor has an incentive to cast investor proxies in favor of management—the client—even when voting with management is not in its investors' best interests.[140]

As one example, consider BlackRock, one of the world's largest asset managers with over $6 trillion assets under management ("AUM").[141] As it has grown in size, BlackRock has articulated a commitment to active involvement in corporate governance, and while one of us has voiced skepticism about the institution's incentives and capacity to follow through on this promise,[142] nobody can deny that BlackRock is extremely influential.[143] In addition,

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[139] *See* Black, *Shareholder Passivity*, *supra* note 30, at 524-25 ("These conflicts . . . may explain why many institutions vote promanager on proposals that are likely to reduce share price."); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1056 (2007) (noting that voting against management can jeopardize 401(k) clients).

[140] This conflict results in problems for investors in other contexts. *See* William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1401 (2006) (explaining different forms of investment management malfeasane as arising out of the fund adviser's incentive to generate fees); Tamar Frankel, *Advisory Fees: Evolving Theories*, INV. LAW., Feb. 2003, at 21, 21 (arguing that fund's aggressive sales team can increase profits more than good performance); John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 672 (2001) (arguing advisor fees are grossly inflated); Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, J. ECON. PERSP., Spring 2004, at 161, 162 (detailing alleged improper trading practices among funds resulting from conflicts of interest).

[141] *About Us*, BLACKROCK, https://www.blackrock.com/au/individual/about-blackrock [https://perma.cc/7NC6-XEC7] (last visited Apr. 1, 2019). This is especially impressive when you consider that U.S. mutual funds currently manage approximately $19 trillion in client assets. *Total Net Assets of US-Registered Mutual Funds Worldwide from 1998 to 2017 (in Trillion U.S. Dollars)*, STATISTA, https://www.statista.com/statistics/255518/mutual-fund-assets-held-by-investment-companies-in-the-united-states/ [https://perma.cc/67T6-Q94A] (last visited Apr. 1, 2019).

[142] *See* Lund, *supra* note 32, at 511 (arguing passive funds have no financial incentive to ensure portfolio companies are well run); *see also* Bebchuk, Cohen & Hirst, *supra* note 32, at 90 (arguing index funds have "especially poor incentives" to improve corporate governance).

[143] *See, e.g.*, Andrew Ross Sorkin, *BlackRock's Message: Contribute to Society, or Risk Losing Our Support*, N.Y. TIMES, Jan. 16, 2018, at B1 ("Mr. Fink has the clout to make [demands on companies]: His firm manages more than $6 trillion in investments through

BlackRock is a public company, which means that unlike Fidelity and Vanguard, it is required to file periodic reports with the SEC, making it easier to understand the adviser's business model.[144]

Here is what we know about BlackRock from its SEC filings. About 40% of BlackRock's AUM, or $2.4 trillion, come from corporate pension plans.[145] Like most large mutual fund sponsors, BlackRock offers its clients the choice between active and passive management, but most of BlackRock's invested assets are in passively managed funds—BlackRock has about $1.6 trillion in actively managed funds and $3.9 trillion in index funds and ETFs.[146] BlackRock profits from those funds as a result of the management fees it collects.

BlackRock typically calculates investment management fees as a percentage of AUM, but active fund managers charge a substantially greater percentage of AUM in fees. As a result of these higher fees, BlackRock's smaller share of active funds generates an equal amount of revenue as its passive funds—approximately $1.3 billion each quarter.[147] In total, these fees make up about 88% of BlackRock's quarterly revenue.[148]

In the past few years, however, BlackRock, like all mutual fund sponsors, has faced pressure to lower fees. This is in part because competition over fees has become more intense; investors are increasingly selecting mutual funds on the basis of fees, putting pressure on institutions to lower them.[149] Fee competition is particularly intense for passively managed mutual funds, which often highlight their low fees to lure investors.[150]

As a result, BlackRock has focused on diversifying its revenue sources, including by providing other services to corporations and other institutional clients. For an annual fee, BlackRock offers a proprietary investment system ("Aladdin"), as well as risk management, outsourcing, and advisory technology systems to clients.[151] Although these systems generate a mere $677 million

401(k) plans, exchange-traded funds and mutual funds, making it the largest investor in the world, and he has an outsize influence on whether directors are voted on and off boards.").

[144] Note that by choosing BlackRock as an example, we do not suggest that it experiences more severe conflicts than other mutual fund sponsors. These conflicts likely exist at all institutional investors.

[145] BLACKROCK, BLACKROCK 2017 ANNUAL REPORT 6 (2017), http://ir.blackrock.com/Cache/1500109547.PDF [https://perma.cc/3P48-3YU3].

[146] Chris Flood, *BlackRock's Rivers of Gold from Active Management*, FIN. TIMES (Oct. 15, 2017), https://www.ft.com/content/f62ed0c2-ada1-11e7-beba-5521c713abf4.

[147] *Id.*

[148] BLACKROCK, Q4 2017 EARNINGS: EARNING RELEASE SUPPLEMENT 6 (Jan. 12, 2018), http://ir.blackrock.com/Cache/1001230788.PDF [https://perma.cc/7RBZ-2VBA].

[149] Jason Zweig & Sarah Krouse, *Fees on Mutual Funds and ETFs Tumble Toward Zero*, WALL STREET J., Jan. 27, 2016, at A1.

[150] Fidelity has even taken the bold step of offering two index funds that charge no fees. Justin Baer, *Fidelity Eliminates Fees on Two New Index Funds*, WALL STREET J. (Aug. 1, 2018, 5:20 PM), https://www.wsj.com/articles/fidelity-index-fund-fees-tumble-to-zero-1533141096 (describing reduction as method to exert pressure on low-cost rivals).

[151] BLACKROCK, *supra* note 145, at 3.

(about 5%) in annual revenue, BlackRock hopes that these systems will account for 30% of the institution's revenue in the next five years.[152] BlackRock's CEO, Larry Fink, also views this business as an important part of BlackRock's competitive success. Indeed, in 2016, Aladdin's revenues rose 13% while BlackRock's management fees in its investment business declined slightly.[153] BlackRock is not unique in this respect—large mutual fund sponsors often provide a range of client services, including brokerage, underwriting, insurance, or banking services, to the company whose management is soliciting proxies.

In sum, like most large mutual fund sponsors, the bulk of BlackRock's revenue comes from corporate pension fund accounts. However, due to intense competition and regulatory pressure,[154] it is unlikely that BlackRock will be able to increase fees—instead, it will have to bring in new assets or sell additional services to clients to maintain its breakneck growth. And BlackRock, as well as State Street and Vanguard, likely feel this pressure more than institutional investors that primarily focus on active management.[155] Investors choose those institutions because of their passive investment vehicles, which are designed to mimic indices and thus offer investors the same performance as rival passive funds. That means that these institutional investors will have a difficult time winning new clients on the basis of fund performance. An easier way to increase

[152] *See id.* at 19 ("The sophisticated risk analytics that BlackRock provides via its technology platform to support investment advisory and *Aladdin* clients are an important element of BlackRock's competitive success.").

[153] *See id.* at 45.

[154] For example, in June 2016, the SEC's Office of Compliance Inspections and Examinations announced that SEC examiners will scrutinize whether advisors have conflicts of interest when making recommendations about share classes to their clients. OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, SEC. EXCH. COMM'N, OCIE'S 2016 SHARE CLASS INITIATIVE 1 (2016), https://www.sec.gov/ocie/announcement/ocie-risk-alert-2016-share-class-initiative.pdf [https://perma.cc/YF23-R7Y7] ("[A]n investment advisor has failed to uphold its fiduciary duty when it causes a client to purchase a more expensive share class of a fund when a less expensive class of that fund is available.").

[155] We recognize that active fund managers also have an incentive to be deferential to management, especially because access to management can help with discretionary trading decisions. *See* Lucian Bebchuk & Scott Hirst, *Are Active Mutual Funds More Active Owners than Index Funds?*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 3, 2018), https://corpgov.law.harvard.edu/2018/10/03/are-active-mutual-funds-more-active-owners-than-index-funds/ [https://perma.cc/DE4S-JQ27] (arguing stewardship of index funds is superior to that of active funds in part because of this conflict of interest). But in light of the empirical evidence showing that the mutual fund sponsors that favor passive management strategies vote with management most often, it is likely that the incentives to defer to management are greater for passively managed funds. *See* Ryan Bubb & Emiliano Catan, The Party Structure of Mutual Funds 3 (Apr. 16, 2018) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3124039 (noting that passively managed funds, including those under Big Three families, support management at much greater rates than other funds). Also, because most mutual fund voting decisions are centralized, individual fund managers might not always be able to influence voting decisions made for the institution as a whole. *See id.* at 29.

assets under management (other than slashing fees and putting pressure on the institution's margins) is to develop and maintain close relationships with the source of corporate 401(k) assets: management. These mutual fund sponsors may also hope to convince management to utilize other services provided by the sponsor.

These conflicts likely affect the institution's voting—it is in the institution's best interest to side with management on important votes, even when voting against management would be better for shareholders. Put simply, as Jack Bogle, founder of Vanguard, explained in an SEC comment letter supporting a rule requiring mutual fund vote disclosure: "Votes against management may jeopardize the retention of clients of 401(k) and pension accounts."[156]

The calculus is simple. Suppose a vote against management would be in the shareholders' best interest. Nonetheless, any gain to shareholders will benefit the institution only indirectly. If taking an anti-management stance is expected to increase the portfolio's value by $1,000, the institution's revenue will increase by $5 if management fees are 0.5% of assets under management, and $6 if fees are 0.6% (a more realistic number for passively managed funds).[157] Furthermore, the improved performance will not mean much to passive fund investors, all of whom expect the fund to replicate the performance of the index anyway. Put differently, it is highly uncertain whether a fund will attract new clients on the basis of its pro-shareholder activism. However, if the institution's activism is likely to alienate management, it will put millions of dollars of client assets at risk, potentially leading to large losses for the institution.[158]

There are a few prominent examples of Corporate Client Conflict affecting mutual fund voting. For example, in 2004, after the SEC first required mutual funds to disclose their votes, it came to light that a few large mutual fund sponsors, including Fidelity, had voted against shareholder proposals to expense employee stock options, which was viewed by many in the investment community as a more honest accounting practice than the alternative.[159] Immediately, the charge was levied that the management-friendly votes were the result of a conflict of interest. The *New York Times* noted that Fidelity voted against a shareholder proposal at Intel, where Fidelity served as the recordkeeper for Intel 401(k) accounts worth $1 billion.[160] In addition, a study of the stock option expensing proposals found evidence that institutional investors with

[156] *See* Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J FIN. ECON. 552, 554 (2007) (quoting John C. Bogle, *Mutual Fund Secrecy*, N.Y. TIMES, Dec. 14, 2002, at A35).

[157] *See id.* at 553.

[158] *See id.*

[159] Gretchen Morgensen, *A Door Opens. The View Is Ugly.*, N.Y. TIMES, Sept. 12, 2004, § 3, at 1.

[160] *Id.*

conflicts of interest were less likely to support the shareholder proposal than institutional investors with no such conflicts.[161]

Recent empirical evidence also supports the hypothesis that mutual fund, and in particular passive fund voting, is prone to conflicts of interest that result in a pro-management stance. Professors Ryan Bubb and Emilio Catan have shown that large mutual fund sponsors—including BlackRock, State Street, and Vanguard—support management at greater rates than other institutions and third-party proxy advisers Institutional Shareholder Services ("ISS") and Glass Lewis.[162] Additional evidence shows that these investors are especially unlikely to oppose management on hot-button issues that directly affect management teams; in 2017, for example, BlackRock voted for executive compensation proposals at S&P 500 companies 98.3% of the time.[163] Although 95% of say-on-pay proposals received shareholder support, BlackRock's support for executive pay packages exceeded even that high level.[164] In addition, Professors Alon Brav, Wei Jiang, Tao Li, and James Pinnington studied proxy contests spanning from 2008-2015 and found that large, passively managed mutual fund sponsors are much more likely to support management in proxy contests.[165]

Bubb and Catan's research also sheds light on the types of shareholder proposals that these large mutual fund sponsors most often support—namely, proposals to declassify the board and reduce supermajority voting requirements.[166] Nonetheless, they are *less* likely than other investors and third-party proxy advisors to support the dissident slate in a proxy contest.[167] Why do institutional investors favor proposals to make the electorate more accountable when they so rarely use their increased voting power to challenge incumbent directors? Perhaps institutional investors prefer structural arrangements that make their votes more powerful because it renders their support more meaningful to management. If BlackRock votes to support management when a majority of shareholders is all that is needed to catalyze a different course of

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161 Fabrizio Ferri, Tatiana Sandino & Garen Markarian, Stock Options Expensing: Evidence from Shareholders' Votes 1 (Oct. 17, 2005) (unpublished manuscript), https://msbfile03.usc.edu/digitalmeasures/sandino/intellcont/Paper%206%20-%20Voting%20for%20ESO%20expensing-1.pdf [https://perma.cc/R6D9-E5LX].

162 Bubb & Catan, *supra* note 155, at 3.

163 Gretchen Morgenson, *Your Fund Has Your Stay, Like It or Not*, N.Y. TIMES, Sept. 25, 2016, at BU1.

164 COMP. ADVISORY PARTNERS, SAY ON PAY VOTE RESULTS (S&P 500) 3 (2017), https://www.capartners.com/wp-content/uploads/2017/05/2017-SoP_Update_5-15-2017.pdf [https://perma.cc/5H5H-RT4A].

165 Alon Brav et al., *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests* 3 (Columbia Bus. Sch., Research Paper No. 18-16, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3101473 (finding passive funds support management up to 12% more often than active funds).

166 Bubb & Catan, *supra* note 155, at 3.

167 *See id.* at 20-22 (flagging high support for insurgents in proxy contests among active, interventionist investors).

action, management will be very grateful. Indeed, management is keenly aware that maintaining good relations with their largest investors is an essential defense to hedge fund activism.[168] It is rational for large mutual fund sponsors to want to foster the feeling of dependency.

Interestingly, Bubb and Catan also find that large mutual fund sponsors support management proposals to merge or engage in large acquisitions more often than other investors. For example, BlackRock supported such proposals 79% of the time; Fidelity, 70%; and Vanguard, 85%.[169] By contrast, ISS recommended approval in only 46% of cases; Glass Lewis, only 50%.[170] Cross-Ownership Conflict, discussed in the previous Section, could explain this difference. It could also support the theory that mutual fund sponsors cater to management—management is often heavily invested in the transaction it is proposing, meaning that the cost of opposition may be substantial. And there is at least one poignant example of a conflict of this type coloring a merger vote. In 2002, Hewlett-Packard ("H-P") founder and shareholder Walter Hewlett challenged in the Delaware Court of Chancery the contentious merger between H-P and Compaq, contending that H-P's managers used corporate assets to entice and coerce Deutsche Asset Management (a subsidiary of Deutsche Bank) into switching its votes in favor of the merger.[171] In the midst of an intense campaign for votes, H-P management secured a multibillion dollar credit facility to pay for merger costs and named Deutsche Bank as the co-arranger.[172] Deutsche Asset Management had already cast twenty-five million votes against the merger; days later, on the morning of the vote and after a thirty minute call with H-P management, Deutsche Asset Management switched seventeen million of its votes in favor of the deal. Shareholders ultimately approved the deal by a narrow margin.[173] Although the Court of Chancery ultimately granted summary judgment for H-P on the grounds that the evidence did not establish the company had engaged in improper vote buying,[174] Deutsche Asset Management's conflict of interest was readily apparent.

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[168] *See* PwC, THE SWINGING PENDULUM: BOARD GOVERNANCE IN THE AGE OF SHAREHOLDER EMPOWERMENT 15 (2016), http://www.lexissecuritiesmosaic.com/gateway/sec/speech/assets_pwc-2016-annual-corporate--directors--survey.pdf [https://perma.cc/LP9T-C2SY] (finding half of corporations surveyed regularly communicated with their largest shareholders to avoid shareholder activism).

[169] Bubb & Catan, *supra* note 155, at 38.

[170] *Id.* at 39.

[171] Hewlett v. Hewlett-Packard Co., No. Civ.A. 19513-NC, 2002 WL 549137, at *1 (Del. Ch. Apr. 8, 2002).

[172] *Id.* at *2-3.

[173] *Id.* at *1-3 ("[T]he margin between the votes in favor of and those against the merger was less than 1% of the shares voted . . . .").

[174] *See* Hewlett v. Hewlett-Packard Co., No. CIV.A. 19513-NC, 2002 WL 818091, at *15-16 (Del. Ch. Apr. 30, 2002).

C. *Uniform Policy Conflict*

When a mutual fund sponsor casts its portfolio shares uniformly, its corporate governance group will have the most influence. This reality helps explain why nearly all large mutual fund sponsors have a policy encouraging uniform voting, and why some refuse to allow individual fund managers any discretion to depart from it. But this preference for uniformity creates a new problem: the funds do not have identical portfolios or investors, and thus centralized voting may benefit one fund and its investors at the expense of others.[175] We provide a few illustrative examples in the Sections that follow.

1. Favoring Active

Consider Institutional Investor, a large mutual fund sponsor that offers both passive and active funds. Institutional Investor houses Fund *A*, an active fund with a large position in TargetCo, and Fund *P*, an S&P 500 index fund that owns shares in both TargetCo and BuyerCo. BuyerCo is larger and therefore Fund *P* holds a bigger position in BuyerCo than it does in TargetCo.

The corporate governance team must decide whether to vote to approve a merger between BuyerCo and TargetCo. To make this decision, they rely on Fund *A*'s managers, who support the deal because it is predicted to benefit TargetCo, which has been struggling. The Fund *A* managers lobby hard for the institution to vote all of its shares in favor of the merger. However, because BuyerCo will take on TargetCo's struggling business, as well as its large debt obligations, BuyerCo shareholders are less rosy about the merger. Nonetheless, Institutional Investor votes all of its shares in favor of the merger. BuyerCo's share price drops after the vote is announced and Fund *P* investors' portfolio values decline accordingly.[176]

This example is unlikely to be rare or uncommon: most large institutional corporate governance teams elicit information from their active fund managers, while their passive fund managers remain completely uninvolved in corporate governance.[177] And although the result may be due to an asymmetry in information flow, Institutional Investor's corporate governance team has an incentive to use its voting power to benefit its active funds, even at the expense of its passive funds. That is because active funds charge higher fees and therefore generate more revenue than passive funds.[178] Additionally, active funds are under extreme pressure to beat the market to justify their higher fees; by contrast, investors do not expect anything more than market performance from index

[175] *See* Lipton, *Family Loyalty*, *supra* note 38, at 181-83.

[176] These conflicts are likely to crop up elsewhere, too, but as discussed, they are the easiest to observe in the merger context. There, the market often views transactions as benefitting one group of shareholders more than another.

[177] *See* BIOY ET AL., *supra* note 104, at 42, 46.

[178] José-Miguel Gaspar, Massimo Massa & Pedro Matos, *Favoritism in Mutual Fund Families? Evidence on Strategic Cross-Fund Subsidization*, 61 J. FIN. 73, 74 (2006).

funds.[179] Therefore, in the simple example above, Institutional Investor would rationally use its voting power to maximize the value of active funds whenever the interests between its active fund investors and passive fund investors conflict. Such a strategy would improve the competitive position of its active funds, drawing investors into high fee accounts,[180] without seriously compromising the position of its passive funds.[181] Indeed, evidence exists that mutual fund sponsors do exactly this—they coordinate their activities to enhance the performance of the funds that are most valuable to the institution as a whole.[182]

2. Favoring Passive

A related scenario is also possible. Imagine that Institutional Investor has many more dollars invested in passive funds than active funds. Institutional Investor's active Fund *A* has taken a long position in TargetCo. Fund *P*, like most of the institution's passive funds, has a larger position in BuyerCo than TargetCo because of BuyerCo's large size.

BuyerCo proposes to buy TargetCo in a deal that is viewed by the market as value destroying for BuyerCo, but is expected to benefit TargetCo shareholders. In this scenario, Fund *A* shareholders would want the deal to go through; Fund *P* shareholders would not. If the corporate governance team evaluates the merger by asking which course of action will benefit the greatest number of investors, it will vote to approve the merger, even though Fund *A* shareholders will suffer losses as a result.

Although this scenario seems less likely to occur than the first, it is consistent with what the large institutional investors that favor passive management claim to do: evaluate whether the deal will benefit the largest group of investors, and then cast all of the institution's votes in that direction.[183] This approach may be the welfare-maximizing for the sponsor, but some of the institution's investors will be left casting votes against their interests.

3. Equity Funds with Different Investment Goals

The previous Sections discussed conflicts between active and passive funds, but conflicts may also exist between different subsets of funds within each of those categories. Vanguard alone offers 130 different mutual funds, including

[179] *See* Edward Rock & Marcel Kahan, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders* 2 (N.Y. Univ. Law & Econ. Research, Paper No. 18-39, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3295098.

[180] *See* Gaspar, Massa & Matos, *supra* note 178, at 74.

[181] *Id.* at 101 ("[N]ew inflows to 'high value' funds will more than compensate any outflows suffered by 'low value' funds.").

[182] *See id.* at 102.

[183] *See* BIOY ET AL., *supra* note 104, at 25-47 (outlining voting strategies of various large funds).

those that specialize in growth, income, and value investment strategies.[184] It also offers target-date funds that span from a retirement date beginning in 2015 to 2065. Those portfolio managers should have different preferences for governance; there is no way to adopt an institution-wide voting policy and then vote all of the institution's shares in lockstep without sacrificing the investment objectives of some funds.

Consider differences between the governance preferences of a portfolio manager at a growth fund, which targets companies with high growth prospects, and an income fund, which seeks to generate an income stream for shareholders in the form of dividends or interest payments. When asked to weigh in on a shareholder activist who wants the company to increase dividend payments to shareholders, the portfolio managers will have very different views. The governance preferences of a portfolio manager at a growth fund should also differ from those of a portfolio manager at a value fund, which seeks to invest in stocks that the market undervalues. In particular, that value fund portfolio manager should be less rosy about current management and perhaps more interested in supporting shareholder activism than her growth fund rival.

Despite these different investment theses, there is often ownership overlap across value, growth, and income funds.[185] For example, 28% of the companies appearing in the BlackRock's iShares S&P 500 Value ETF also appear in its iShares S&P 500 Growth ETF.[186] Vanguard's growth and value funds also feature 5% overlap.[187] Adherence to a centralized voting strategy for these companies may not be in the best interests of all of the institution's investors.

For target date funds that invest in individual stocks,[188] a different conflict emerges: their different time horizons may lead investment managers to have differences in opinion when asked to weigh in on governance, the advisability of shareholder activism, and M&A, among other issues. Quite obviously, a target date fund with an end point that is close in time is less likely to take a

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[184] *Vanguard Mutual Funds*, VANGUARD, https://investor.vanguard.com/mutual-funds/list#/mutual-funds/asset-class/month-end-returns [https://perma.cc/9JTY-V893] (last visited Apr. 1, 2019).

[185] Rob Silverblatt, *How to Avoid Portfolio Overlap*, U.S. NEWS & WORLD REP. (May 19, 2010, 10:49 AM), https://money.usnews.com/money/blogs/fund-observer/2010/05/19/how-to-avoid-portfolio-overlap (noting portfolio overlap is common).

[186] Ryan Vlastelica, *A Major Value Fund Mirrors a Major Growth One More Than You May Expect*, MARKETWATCH (June 19, 2017, 5:37 PM), https://www.marketwatch.com/story/a-major-value-fund-mirrors-a-major-growth-one-more-than-you-may-expect-2017-06-19 [https://perma.cc/UCR3-AR3B]; *see also* Julie Clarenbach, *Value? Growth? Both!*, MOTLEY FOOL (Jan. 2, 2009, 12:00 AM), https://www.fool.com/investing/general/2009/01/02/value-growth-both.aspx [https://perma.cc/V4YB-TYD2] (lauding diversified funds as key investment strategy).

[187] Vlastelica, *supra* note 186 (comparing overlap of various large funds).

[188] Not all target date funds invest in stocks directly; some invest in other mutual funds (and are accordingly referred to as "funds of funds").

long-term view. Nonetheless, when an institution votes its shares in lockstep to advance a long-term perspective, those investors will sometimes be worse off.

4. Favoring Debt

Consider the same scenario as above: Institutional Investor is considering whether to vote to approve a merger between BuyerCo and TargetCo, and the market views the deal as good for TargetCo and terrible for BuyerCo. This time, the institution's active and passive funds are aligned; both have a larger investment in TargetCo than they do in BuyerCo. But Fund *D*, a mezzanine debt fund, has a large debt position in BuyerCo and is concerned that if the merger is approved, BuyerCo will be in danger of defaulting on its debt, which would be a disaster for the fund. Accordingly, Fund *D*'s portfolio manager vocally opposes the deal and lobbies the corporate governance team to vote against it.[189] Again, there is no way for Institutional Investor to vote its shares uniformly without causing some of its investors to vote against their interests.

5. Favoring Vocal Investors

The next example involves conflicts between a vocal minority of investors and an apathetic majority. Imagine that Institutional Investor is considering whether to vote yes on a proposal to require Energy Company to disclose how it plans to manage environmental and safety risks. Employees of the company support additional disclosure, as they predict that it will lead to better working conditions. Management opposes the proposal, contending that it represents an incursion into their authority to manage the business and affairs of the company, will take time and money to put together the report, and is distracting to management at best and harmful to the company's competitiveness at worst. Institutional Investor believes that the majority of its shareholders are or would be opposed to the proposal. But a large and vocal investor, Public Pension Fund, is strongly in favor. Institutional Investor knows that Public Pension Fund would be likely to take its large portfolio elsewhere if the proposal fails; Pubic Pension Fund's board of governors are up for election this year and they are facing pressure to deliver results that indicate that their stewardship is benefitting employees. Institutional Investor will have an incentive to vote yes for the proposal, even if the majority of its investors opposes it, because the rational apathy of the dispersed investors is no match for the extreme preference of a client with a large portfolio.[190]

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[189] Professors William Birdthistle and Todd Henderson have explored these conflicts in the context of private equity. *See generally* William A. Birdthistle & M. Todd Henderson, *One Hat Too Many? Investment Desegregation in Private Equity*, 76 U. CHI. L. REV. 45 (2009) (discussing conflicts of interest arising from investing in both private equity and public debt).

[190] By way of example, CalPERS, the California public pension fund, uses a set of environmental, social, and governance criteria to evaluate investments and push companies to adopt certain progressive policies. Though some groups have attacked this strategy, others,

6. Favoring Something Else?

This last Section explores other considerations that may color the voting of large mutual fund sponsors. Recently, the view that companies should single-handedly focus on shareholder wealth maximization has been challenged from many directions. Perhaps most prominently, Larry Fink, the CEO of BlackRock, has written: "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."[191] Even more controversially, Fink announced that BlackRock, as one of the largest and most influential investors across 14,000 companies world-wide, would enforce this mandate with engagement and voting.[192]

This position has generated both applause as well as criticism, as has BlackRock's decision to use its voting prowess to support controversial shareholder proposals.[193] Regardless of our beliefs about the merits of these proposals, the fact remains that some BlackRock shareholders are opposed to them.[194] In theory, the corporate governance team is making a judgment call about what is in the best long-term interest of its shareholders, and although these teams are composed of experts, they too are human actors affected by conflicts of interest—the desire to keep management or other clients happy, or the desire to further their personal political goals.[195] Because governance is challenging to evaluate, it will rarely be clear whether any given vote was the product of truly disinterested evaluation.

such as BlackRock, have begun to show interest. Sunny Oh, *Think-Tank Funded by Koch Brothers Challenges CalPERS' ESG* Strategy, MARKETWATCH (Dec. 12, 2017, 1:04 PM), https://www.marketwatch.com/story/think-tank-funded-by-koch-brothers-challenges-calpers-esg-strategy-2017-12-12 [https://perma.cc/6VMZ-2FBV].

[191] Larry Fink, *2018 Letter to CEOs: A Sense of Purpose*, BLACKROCK, https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter [https://perma.cc/W9WE-L7PM] (last visited Apr. 1, 2019).

[192] *Id.* (describing BlackRock's focus on company engagement).

[193] *See, e.g.*, Matt Levine, Opinion, *Larry Fink's Warning to CEOs Rings Hollow*, BLOOMBERG (Jan. 17, 2018, 2:00 AM), https://www.bloomberg.com/opinion/articles/2018-01-17/larry-fink-s-warning-to-ceos-rings-hollow ("It's going to take more than a strongly-worded letter to create change."); Sorkin, *supra* note 143 (hailing BlackRock's move as a "watershed moment on Wall Street").

[194] *See* Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217, 234 (2018) ("Distortions in mutual fund voting may occur if the way mutual funds vote does not match the preferences of mutual fund investors.").

[195] Fund managers are more likely to vote in favor of management-sponsored proposals at locally headquartered companies, suggesting that "social networks and interactions between firm executives and fund managers impact the latter's proxy voting decisions." Praveen K. Das, *Geographical Proximity and Mutual Funds' Proxy Voting Behavior*, 32 MANAGERIAL & DECISION ECON. 425, 426 (2011) (further noting that many business decisions are impacted by decision maker's familiarity with subject).

III. CONFLICTED MUTUAL FUND VOTES SHOULD NOT COUNT AS DISINTERESTED

When is a vote worthy of deference? Delaware courts have emphasized that deference doctrines espoused in *M & F Worldwide* and *Corwin* are only applicable when the vote is by disinterested decision makers. We contend that Delaware should read this requirement to exclude mutual fund votes that are prone to conflicts of interest, and specifically, those that may be the product of Cross-Ownership Conflict or Corporate Client Conflict.[196] In thoses situations, the court has reason to be skeptical that the outcome of the vote is one that the company's undiversified investors would necessarily embrace.

We focus on mutual fund voting for several reasons. For one, the mutual fund conflicts that we describe are relatively easy for courts to observe and measure. In addition, mutual funds are unique in experiencing these recurring and predictable conflicts: for example, pension funds, hedge funds, and retail investors are not subject to the Corporate Client Conflict. Mutual funds are also broadly diversified and generally adhere to a centralized governance model, making the Cross-Ownership Conflict especially pronounced. Perhaps most importantly, mutual funds are now the key decision makers in corporate votes—they dictate the outcomes in M&A decisions as well as proxy contests and other contested matters. And when the largest shareholders suffer from recurring conflicts that pit them against the real parties in interest, the justification for deferring to their decisions becomes increasingly tenuous.[197]

To be clear, we do not believe that the refusal to defer to conflicted votes will necessarily reduce the influence of these conflicts in governance (and future research should consider whether government regulation is necessary to ensure

[196] We include the Uniform Policy Conflict in our typology for the sake of completeness, but do not advocate that courts make an inquiry into this conflict as well. Most important, it would be administratively difficult for courts to determine whether an investor's votes were being cast to benefit some other group of investors within the institution. Future research should determine whether fund sponsors are doing enough to minimize the prevalence of this conflict in voting. *Compare* Rock & Kahan, *supra* note 179, at 49 (contending that these conflicts can be handled on case-by-case basis when they arise), *with* Lipton, *Family Loyalty*, *supra* note 38, at 175 (contending that mutual fund boards should develop procedures to ensure that fund shares are voted with view toward advancing best interests of that particular fund).

[197] This is not to say that hedge funds and pension funds do not suffer from conflicts of interest as a result of intermediation—there is a large literature documenting these. We do not address them here, however, for a few reasons. For one, these conflicts would be more difficult for courts to observe. For example, public pension funds are appointed by politicians or directly elected by voters and so may be especially sensitive to political pressure. *See* Edward B. Rock, *supra* note 98, at 365. But determining whether a pension fund's vote was affected by political interests would be challenging and invite speculative arguments. In addition, mutual fund conflicts are not only observable, they are pervasive. Recall the evidence that mutual fund empty voting occurs with regularity; hedge fund empty voting, despite its extensive treatment in the literature, is much rarer. *See supra* notes 120-23 and accompanying text.

that mutual fund fiduciaries use their governance rights to further their investors' best interests).[198] Instead, interpreting "disinterested" to exclude economic conflicts will ensure that business judgment deference applies only when the parties in interest have clearly spoken in favor of the transaction.

Although Delaware courts generally police conflicts at the director level, considering conflicts at the shareholder level is not foreign to Delaware law. For example, in *In re CNX Gas*,[199] the Court of Chancery considered evidence of Cross-Ownership Conflict in determining whether a large shareholder's vote could be counted for majority-of-the-minority approval of a tender offer.[200] In that case, Consol, a publicly traded company, was the majority shareholder of CNX Gas and planned to buy out the public shareholders using a tender offer. Like most companies, the vast majority of the public float was held by institutional investors, and the largest minority shareholder was the mutual fund sponsor T. Rowe Price. Accordingly, Consol approached T. Rowe Price and negotiated an agreement for T. Rowe to sell all of its shares before proposing a tender offer to the other minority shareholders.[201]

But T. Rowe also had a substantial minority stake in Consol, and one of its funds held a significant amount of Consol debt.[202] As such, T. Rowe stood on both sides of the transaction—the incentive for Consol to pay top dollar was dampened as a result of these cross-holdings. When the terms of the deal were challenged by the other minority shareholders, the Court of Chancery determined that the conflict rendered T. Rowe interested; T. Rowe was "fully hedged and indifferent to the allocation of value between Consol and CNX Gas."[203] As such, T. Rowe could not be counted for purposes of a majority-of-minority vote necessary to avoid a showing that the tender offer price was fair.[204]

In reaching this decision, the Court of Chancery recognized that it did not intend to encourage "generalized fishing expeditions" into shareholder motives.[205] We likewise recognize that all shareholders hold private interests that may cause their preferences to diverge from those of other shareholders. Our aim is not to open the floodgates to litigation over all kinds of shareholder interests, but rather to those that create a clear economic conflict of interest and

[198] For example, Professor Lipton has proposed that one way to alleviate the Cross-Holding Conflict would be to expand the right of appraisal for shareholders that have different preferences. Lipton, *Shareholder Divorce Court*, *supra* note 38, at 140 ("Appraisal provides a mechanism for satisfying the entire shareholder base."). For a discussion of the existing law regulating mutual fund conflicts of interest, see Lipton, *Family Loyalty*, *supra* note 37, at 178-83.

[199] 4 A.3d 397 (Del. Ch. 2010).

[200] *Id.* at 420.

[201] *Id.* at 401-02.

[202] *Id.* at 402 (noting T. Rowe Price owned 6.3% of Consol's outstanding stock).

[203] *Id.* at 416.

[204] *Id.* ("T. Rowe Price[] has materially different incentives than a holder of CNX Gas common stock . . . .").

[205] *Id.* at 417.

that are easily observable by courts. As the Court of Chancery found, the conflict facing T. Rowe put it in a very different position than the other shareholders. And including T. Rowe as part of the "minority" would weaken the bargaining position of the other minority shareholders.[206]

Although *CNX Gas* involved a tender offer, the logic applies to third-party mergers and controlling shareholder transactions as well. And the argument is likely to surface again in that context. When it does, courts should take into account those conflicts before applying the deference doctrines espoused in *M & F Worldwide* and *Corwin*. That is not to say that these deference doctrines, which have done much good by screening out meritless litigation, should be eliminated. Instead, we propose an analytical refinement that would take major mutual fund shareholder conflicts into consideration before deference doctrines are applied. First, drawing on *CNX Gas*, we provide a framework to guide plaintiffs who wish to rebut *M & F Worldwide* or *Corwin* (and the courts who must evaluate those arguments). Second, we describe how this approach would benefit investors without unduly burdening transactional planners or leading to meritless litigation.

We propose that if plaintiffs can present evidence (on the basis of a section 220 request or other public information) that either (1) the target or acquirer company is a client of the fund family, or (2) the fund family has significant cross-holdings in both the target or acquirer, then any shares voted subject to such conflicts should not be treated as disinterested. The court's inquiry could end with this finding. The court need not evaluate evidence about the fund family's actual motives for voting—the presence of the economic conflict would simply render those votes excluded from the *Corwin/M & F Worldwide* calculus.[207]

Although section 220 requests may take time and generate litigation of their own, the procedural posture of post-closing damages actions means that litigants will have time for the section 220 process to play out. In addition, the discovery burdens should be relatively easy for the company to manage. Information about Corporate Client Conflict can generally be found in public company filings, as can information about major shareholder cross-holdings. For information that is not publicly available, the information sought is akin to a shareholder list. All of this information is documentary. There is no need for depositions, expert reports, or anything else that would drive up costs and create leverage on the plaintiffs' side.

Had the Court of Chancery followed this approach in the Tesla litigation, it is likely that 45.7% of the supposedly disinterested shareholders that voted to

[206] *Id.*

[207] Delaware courts would need to consider what to do in cases where excluding conflicted votes leaves only a small number of minority shareholders. In those cases, a very small shareholder could nonetheless wield substantial influence over the vote, increasing the potential for distortions and hold outs.

approve the transaction would not have been counted.[208] Tesla's largest institutional shareholder—Fidelity—would have also been excluded because it had Corporate Client Conflict: Fidelity is the main recordholder of Tesla's 401(k) accounts.[209] And if these "yes" votes had been excluded, then the transaction would have received approval from less than 40% of the disinterested stockholders[210]—not enough to render it eligible for business judgment rule protection. In other words, this approach would have permitted litigaton to proceed without requiring the court to designate Musk—who had only a 22% stake in Tesla—as a controlling shareholder.

This approach is also consistent with the rationale used by courts that apply deferential business judgment protection to transactions approved by disinterested shareholders: when the parties in interest have spoken, courts should not second guess their choices. When there is clear evidence indicating that the parties in interest did *not* speak in favor of the transaction, and those who did had a reason to vote against their interests, it is especially important to preserve an opportunity for judicial review. If, for example, the largest shareholders may be inclined to follow management in order to preserve access or to benefit another investment, we can be less certain that the underlying transaction will benefit the ultimate investors. As we saw in the Tesla-SolarCity merger, conflicted shareholders may be quick to say yes even when the transaction's undesirable features are visible to everyone that is looking.

Additionally, a key benefit of a minority-of-the-majority voting requirement is that it operates to protect minority shareholders ex ante. If management wants the deal to be accepted without litigation risk, it will need to ensure that the transaction is desirable for the disinterested minority. However, when conflicted voters can drown out the disinterested minority, management will have to worry less about negotiating a deal that will secure their approval. Recall that nearly 46% of Tesla's "disinterested" shareholders were also SolarCity investors. Although management could not be certain that those cross-holders would vote yes for that reason, the conflict made disinterested shareholder approval more likely, despite (and perhaps because of) the obvious fact that the deal was a rotten one for Tesla. Indeed, Tesla's four largest stockholders stood to lose over half a

208 *See In re* Tesla Motors, Inc. Stockholder Litig., No. 12711-VCS, 2018 WL 1560293, at *10 (Del. Ch. Mar. 28, 2018) (noting that Tesla executives owning stock in both Tesla and SolarCity were not excluded from voting).

209 *Tesla Motors, Inc. 401k Plan*, BRIGHTSCOPE, https://www.brightscope.com/form-5500/basic-info/403609/Tesla-Inc/408890/Tesla-Motors-Inc-401k-Plan/2017/ [https://perma.cc/YA8A-WQSQ] (last visited Apr. 1, 2019).

210 Plaintiffs' Answering Brief in Opposition to Defendants' Motion to Dismiss the Second Amended Complaint, *supra* note 6, at 34 ("[O]nly 38.7% of eligible Tesla stockholders voted to approve the Acquisition.").

billion dollars in the event of a SolarCity bankruptcy.[211] And as discussed, Tesla is not an isolated example.[212]

Interpreting *M & F Worldwide* and *Corwin* to exclude shareholders with economic conflicts of interest means that management will have to work harder to ensure that the transaction is fair to the real parties in interest if it wants to avoid judicial review. In addition, excluding conflicted shareholders improves the bargaining position of minority shareholders who may have concerns about the merger. The result: better M&A outcomes for minority shareholders. That is so even if management responds to this doctrinal shift by utilizing a majority-of-the-minority vote less often. In such cases, minority shareholders will have another source of protection—the Delaware courts, who will consider whether the transaction was entirely fair to them.

We recognize that *M & F Worldwide* and *Corwin* arose out of concerns about a rapid increase in nonmeritorious litigation over M&A transactions—litigation that benefitted plaintiffs' lawyers at the expense of investors and taxpayers. But we think that considering conflicts at the large shareholder level would not dramatically change the operation of those doctrines. As discussed, a 2010 study analyzing M&A deals involving publicly traded companies during 1998-2004 revealed that in 41.7% of the deals, the acquiring and target firms shared some of the same owners.[213] This means that the majority of mergers do not involve Cross-Ownership Conflict, and therefore, in the majority of cases, the deference doctrines espoused in *M & F Worldwide* and *Corwin* would apply without change. Furthermore, the study revealed that when cross-holdings existed, the cross-holders made up 18.9% of the company's shareholders on average.[214] In many cases, therefore, excluding the cross-holders would not likely change the outcome of the vote. Of course, plaintiffs can also look for evidence of client relationships as a source of conflict between the institutional investor and the merger. However, companies generally only use a single mutual fund family to manage their 401(k) assets—therefore, that conflict would only affect, at most, two mutual fund sponsors in any given deal. In sum, even though the incidence of Cross-Ownership and Corporate Client Conflicts is substantial, considering these conflicts will not neuter the operation of the deference doctrines that have done much to control abusive litigation. Instead, our proposed approach would ensure that the use of these doctrines is limited to the situations where they are likely to do the most good.

Likewise, the prospect of discovery on shareholder conflicts is unlikely to change the bargaining position of litigants and create pressure for defendants to

211 Amended Verified Derivative Complaint at 16-17, *In re* Tesla Motors, Inc. Stockholder Litig., No. 12711-VCS, 2018 WL 1560293 (Del. Ch. Oct. 4, 2016).

212 *See supra* text accompanying notes 161-165 (discussing various sitiuations in which institutional investors vote against shareholder interests).

213 *See* Goranova, Dharwadkar & Brandes, *supra* note 136, at 1115.

214 *Id.* (noting that investor overlap is increasingly common as institutional investors supplant individual and family owners).

settle. As discussed, information about Corporate Client and Cross-Ownership Conflict is easy to find in public documents; anything that is not publicly available could be produced in a section 220 request. In addition, transactional planners will be able to easily respond by accounting for conflicts ex ante, when they are structuring the transaction.

In sum, considering these economic conflicts would preserve judicial scrutiny of mergers in situations where conflicts likely influenced the outcome of the vote without undoing the benefits that *M & F Worldwide* and *Corwin* provide transactional planners and shareholders.

CONCLUSION

This Article has analyzed the impact of mutual fund conflicts of interest on shareholder voting. It has described typical conflicts arising from intermediated mutual fund ownership. It has also argued that honest acknowledgment of these conflicts requires specific changes to Delaware corporate law. Doing so would serve to realign institutional voting with investor interests, thereby alleviating the potential inefficiencies created by the spread of intermediary shareholding.

Of course, this Article only scratches the surface in analyzing how conflicts of interest affect mutual fund voting. Although conflicts likely affect decisions on other issues, we have here confined ourselves to issues arising in M&A transactions. In addition, we focused on Delaware corporate law remedies, rather than suggesting broader regulatory reform. We leave those projects for another day.