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Toward a Mission Statement for Mutual Funds in Shareholder Litigation

Sean J. Griffith* & Dorothy S. Lund**

87 UNIVERSITY OF CHICAGO LAW REVIEW (forthcoming 2020)

Abstract

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

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

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

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I. Introduction

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

Reality, however, is considerably more complex. In U.S. public markets, the vast majority of company shares are held by institutional intermediaries on behalf of investors. Mutual funds are among the most common institutional owners, holding about one third of the total U.S. stock market.³ In particular, the “Big Three” fund families—BlackRock, State Street, and Vanguard—own significant blocks in virtually all publicly traded companies.⁴ This gives them considerable authority over the governance of the companies in which they invest.⁵ Yet many of these funds track the performance of an index, such as the S&P 500 or the Russell 2000,⁶ rather than actively trading into and out of companies on the basis of their performance.⁷ As a result, these funds do not have the same set of governance tools. Because they are effectively long-only, they can access only two levers of corporate governance. They can vote, and they can sue.

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

² WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 177 (5th ed 2016).

³ SEAN COLLINS ET AL., INV. COMPANY INST., 2018 INVESTMENT COMPANY FACT BOOK 40 (2018), https://www.ici.org/pdf/2018_factbook.pdf (providing data showing U.S. mutual funds held 31% of all U.S. corporate equities in 2017).

⁴ See Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-concentration Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 313–14 (2017) (finding that the Big Three own the largest stakes in at least 40% of all U.S. listed companies and in 88% of the S&P 500); Sarah Krouse et al., *Meet the New Corporate Power Brokers: Passive Investors*, WALL ST. J. (Oct. 24, 2016), <https://www.wsj.com/articles/the-new-corporate-power-brokers-passive-investors-1477320101>. Some commentators have suggested that the term ought to be the “Big Four” or the “Giant Three.” See, e.g., Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 724–25 (“Giant Three”); Leo E. Strine, *Fiduciary Blind Spot: The Failure of Institutional Investors to Prevent the Illegitimate Use of Working Americans’ Savings for Corporate Political Spending*, 97 WASH. U. L. REV. (forthcoming 2020) (“Big Four”). We will continue to use the “Big Three” terminology to refer to the largest mutual fund blockholders.

⁵ Edward Rock & Marcel Kahan, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders 1* (N.Y. Univ. Sch. of Law Law & Econ. Research Paper Series, Working Paper No. 18-39), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3295098 (“The largest institutional investors have become the presumptive ‘deciders’ of corporate law controversies.”).

⁶ Index funds and other passive funds will soon have more assets under management than active funds. See Trevor Hunnicutt, *Index Funds to Surpass Active Fund Assets in U.S. by 2024: Moody’s*, REUTERS (Feb 2, 2017), <https://www.reuters.com/article/us-funds-passive/index-funds-to-surpass-active-fund-assets-in-u-s-by-2024-moodys-idUSKBN15H1PN>. For brevity, we will refer to ETFs, index funds, and other passively managed mutual funds that seek to track the performance of an index as “index funds.”

⁷ On institutional investors’ preference for exit (selling) over voice (voting), see John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1280 n.8, 1281 (1991) (arguing that in the absence of a controlling stake institutional investors prefer liquidity to control and therefore fail to monitor).

After a long period of inactivity in corporate governance, large mutual funds have begun to establish “stewardship” groups to guide their governance activities.⁸ The Big Three are especially vocal in promoting their stewardship practices. BlackRock, for example, advertises that they “take corporate governance very seriously.”⁹ State Street explains that its stewardship program “is designed to have an impact” and that the fund family “actively engage[s] with ... portfolio companies to promote long-term value of [their] clients’ investments.”¹⁰ And Vanguard insists that it cares “deeply” about governance and is “good at it.”¹¹ However, the exclusive focus of stewardship groups has been on *voting*.¹² Mutual funds tout the number of votes in which they have participated and, increasingly, highlight their willingness to oppose management.¹³ A lively academic debate has arisen in response to these claims, with scholars also predominantly focused on voting.¹⁴ The potential for mutual funds to exert a governance role through litigation has gone almost entirely overlooked.¹⁵

⁸ See generally HORTENSE BIOY ET AL., MORNINGSTAR, PASSIVE FUND PROVIDERS TAKE AN ACTIVE APPROACH TO INVESTMENT STEWARDSHIP, MORNINGSTAR (2017), <https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Morningstar-Passive-Active-Stewardship.pdf> (discussing research on how index managers carry out their investment stewardship responsibilities).

⁹ Madison Marriage, *Passive Houses Insist They Do Care About Governance*, FINANCIAL TIMES (Feb. 4, 2017), <https://www.ft.com/content/bd77d9b8-dd9f-11e6-86ac-f253db7791c6>.

¹⁰ *Asset Stewardship*, ST. STREET GLOBAL ADVISORS, <https://www.ssga.com/about-us/asset-stewardship.html> (last visited June 14, 2019).

¹¹ Bill McNabb, *The Ultimate Long-Term Investors*, VANGUARD (July 6, 2017), <https://vanguardblog.com/2017/07/06/the-ultimate-long-term-investors/>.

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

¹³ See, e.g., BLACKROCK, INVESTMENT STEWARDSHIP REPORT 4 (2018) (noting votes at over 17,000 shareholder meetings on over 158,000 proposals from July 1, 2017 to June 30, 2018); VANGUARD, 2018 INVESTMENT STEWARDSHIP ANNUAL REPORT 8 (2018) (noting votes at over 19,000 meetings on over 168,000 proposals).

¹⁴ See, e.g., Lucian A. 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 (arguing that agency costs at mutual funds inhibit engaged stewardship); Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 95–104 (2017) (applying the agency cost problem to mutual fund intermediaries); Luca Enriques & Alessandro Romano, *Institutional Investor Voting Behavior: A Network Theory Perspective* 47–48 (ECGI Working Paper Series in Law, Working Paper N° 393/2018, 2018) (arguing that network effects may lead to engaged stewardship); Jill E. Fisch et al., *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, U. PA. L. REV. (forthcoming 2019), <http://ssrn.com/abstract=3192069> (arguing that competition between index and active funds for new investment creates an incentive for index funds improve corporate governance); Sean J. Griffith & Dorothy S. Lund, *Conflicted Mutual Fund Voting in Corporate Law*, 99 B.U. L. REV. 1151, 1172 (2019) (articulating a set of standard conflicts that may inhibit mutual funds from acting as loyal stewards); Sean J. Griffith, *Opt-in Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 Tex. L. Rev. (forthcoming 2020) (manuscript at 3), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3404298 (arguing that mutual fund have incentives and information to vote intelligently in contests but not in other corporate governance settings); Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 101, 114 (2018) (arguing that index and passive funds lack the incentive to vote intelligently); Rock & Kahan, *supra* note 5, (arguing that spillover effects allow index funds to act as engage stewards).

¹⁵ An exception is Professors Bebchuk and Hirst who observed that mutual funds tend not to serve as lead plaintiffs in securities class actions. See Bebchuk & Hirst, *supra* note 14 (manuscript at 53–55). We confirm this observation empirically. See *infra* Section III. Likewise, Professor David Webber has described how broadly diversified investors can benefit from using litigation as a form of shareholder activism. See David H. Webber, *Private Policing*

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

As “market investors” —holders of broadly diversified portfolios—mutual funds are in an ideal position to use litigation to produce benefits for shareholders and to prevent lawyers from diverting and destroying those benefits. Indeed, litigation may serve stewardship goals more effectively than voting. First, litigation can produce a direct monetary benefit to shareholders. Voting, by contrast, produces only indirect monetary benefits, as when an outside intermediary—an activist or an acquiror—submits a proposal or a bid that has the effect of increasing shareholder value. Second, shareholder litigation can immediately target and thereby deter specific bad acts of management. Voting deters mismanagement more bluntly. Proxy contests are expensive to bring, and misconduct that does not lead to an activist intervention may be undeterred by voting alone.¹⁷ Third, unlike shareholder proposals that result, at best, in a non-binding commitment to consider forming a committee to study an issue of concern, shareholder suits produce governance reforms that come with the force of a court order. If the company does not implement the reforms as promised, they are in violation of the terms of their settlement, which shareholders can then enforce judicially. Voting, in other words, is no substitute for litigation. Voting and litigation should instead be viewed as complementary corporate governance mechanisms, with litigation in many ways the stronger of the two.

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

Next, we examine the actual conduct of mutual funds in shareholder litigation. To do so, we collected data on mutual fund participation in each of the forms of shareholder litigation noted above over a ten-year time period. We found that the ten largest mutual funds, including each of

of Mergers and Acquisitions: An Empirical Assessment of Institutional Lead Plaintiffs in Transactional Class and Derivative Actions, 38 Del. J. Corp. L. 1, 23–27 (2014).

¹⁶ James D. Cox & Randall S. Thomas, *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law*, 6 EUR. COMPANY & FIN. L. REV. 164 (2009); C.N.V. Krishnan, et al., *Shareholder Litigation in Mergers and Acquisitions*, 18 J. CORP. FIN. 1248 (2012); Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 142–43 (2004).

¹⁷ Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. Fin. Econ. 610, 621 tbl.4, 625 tbl.8, 629 (2013) (reporting that the average proxy contest cost is \$10.71 million).

most vocal funds on corporate governance, *very rarely* participate in shareholder litigation. Collectively, these funds were involved in the filing of just ten traditional shareholder suits over our sample period. However, these were often the same claims: the ten suits involved only five different instances of managerial misconduct. All but one of these complaints alleged violations of the federal securities laws; we found a single appraisal suit and no instances of state law class or derivative litigation. The securities claims were typically not brought as class actions, but rather as individual actions separate from any class claims brought against the same corporate defendant. Moreover, none of our mutual funds served as lead plaintiff even a single time over our sample period.

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

This is a serious issue. Nearly half of U.S. households invest in mutual funds.¹⁸ In doing so, they entrust their governance rights to intermediaries. It is critically important that these intermediaries act to further investor interests when they make litigation decisions. What our evidence shows is that mutual funds are not discharging this obligation. Indeed, they may not be thinking about it at all. Why not?

We survey a variety of possible explanations for mutual funds' failure to participate more aggressively in shareholder litigation. None is particularly compelling. The failure cannot be explained by substantive legal barriers or structural obstacles, both of which are limited and manageable. Nor can the failure be fully explained by the "circularity" problem that arises when shareholders are on "both sides of the v," as both plaintiff and defendant.¹⁹ Although mutual funds own the market and are therefore likely to be on both sides in many suits, they may still benefit from systemic deterrence and governance benefits won through shareholder suits. Moreover, not all shareholder recoveries are funded by defendant corporations also owned by shareholder plaintiffs.

Agency costs and conflicts of interest present serious obstacles. Mutual funds likely do not want to offend the corporations that funnel them 401(k) and other advisory business by filing lawsuits against them. Furthermore, because the benefits of shareholder litigation must often be shared with a class that includes their competitors, mutual funds may see little advantage in litigating.²⁰ However, these incentives do not apply to all forms of shareholder litigation. Corporate defendants in their last period, facing bankruptcy or acquisition, are not a likely source

¹⁸ SEAN COLLINS ET AL., *INV. COMPANY INST.*, *supra* note 3, at 142 fig.7.1 (showing that 44.5% of U.S. households owned mutual funds in 2017).

¹⁹ *See infra* notes 108–113.

²⁰ These incentive problems have most often been discussed by others in the context of shareholder voting. *See, e.g.*, Bebchuk & Hirst, *supra* note 14; Lund, *supra* note 14, at 114–31. Like us, Professor David Webber has raised the specter of agency costs in the context of litigation. In his study of shareholder derivative suits and class actions filed in Delaware between 2003 and 2009, he found that mutual funds served as lead plaintiffs only seven times and posits that agency costs may explain this low number. *See* Webber, *supra* note 15 at 16–17, 34.

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

It may be that the failure to litigate reveals mutual funds' motivations in stewardship generally. Stewardship ought to involve litigation as well as voting, yet mutual funds pursue stewardship through voting only, perhaps because mutual fund voting is a subject of regulatory attention while litigation is not.²¹ But this suggests something about voting too. Take away the regulatory impetus and mutual funds might neither litigate nor vote.

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

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

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

II. Shareholder Litigation

Before we can assign a role to mutual funds in shareholder litigation, we must first develop an understanding of what shareholder litigation is for. As noted above, litigation is one of the traditional levers of corporate governance. But what can shareholders expect to accomplish by suing the companies they own? And what are typical outcomes of shareholder suits? The

²¹ Of course, the fact that mutual funds vote their shares does not necessarily mean that they vote them well, and recent scrutiny of their voting practices has led to some embarrassing revelations. *See, e.g.,* Asjlynn Loder, *Funds Don't Always Vote for Policies They Publicly Back*, WALL STREET J. (April 2, 2019, 8:00 AM), <https://www.wsj.com/articles/funds-dont-always-vote-for-policies-they-publicly-back-11554206401>. Not only that, mutual funds often fail to support their public positions by bringing shareholder proposals themselves. Bebchuk & Hirst, *supra* note 14.

answers to these questions will guide the analysis of whether and when mutual funds should instigate litigation on behalf of their investors. But answering them requires an account of shareholder litigation generally. This Part offers that account, first reviewing mainstream theories of shareholder litigation, then evaluating paradigmatic forms of shareholder suits in practice.

A. Shareholder Litigation in Theory

Shareholder suits do not exist in isolation. Rather, they are part of the broader ecosystem of corporate law as a whole, in which agency costs are a fundamental concern.²² By severing management and control, the corporate form creates incentives for manager-agents to defect from the interests of their shareholder-principals.²³ These defections range from mild (shirking) to severe (theft).²⁴ Corporate governance mechanisms are designed to contain agency costs.²⁵ Intra-corporate litigation—that is, investors’ suits to enforce their rights as such—can thus be understood as a basic tool for shareholders to use in seeking to minimize managerial agency costs.²⁶

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

²² Accord Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 738 (1997) (describing the core corporate governance problem as “how investors get the managers to give them back their money”); see also Sanjai Bhagat et al., *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1809 (2008) (“The key focus of U.S. corporate law and corporate governance systems is what is referred to as an agency problem: an organizational concern that arises when owners—in a corporation, the shareholders—are not the managers who are in control.”).

²³ 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).

²⁴ Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1662 (2001) (noting that although both shirking and theft can be understood as agency costs, only theft is illegal due to differences in enforcement costs).

²⁵ OLIVER E. WILLIAMSON, *MECHANISMS OF GOVERNANCE* (1996) (connecting “agency costs” to “opportunism” and noting that modern firms address the problem through “a governance structure that holders of equity recognize as a safeguard against expropriation and egregious mismanagement”).

²⁶ *In re Riverbed Tech., Inc. Stockholders Litig.*, C.A. No. 10484–VCG, 2015 WL 5458041, at *1 (Del. Ch. Sept. 17, 2015) (“As a bench judge in a court of equity, much of what I do involves problems of... agency: insuring that those acting for the benefit of others perform with fidelity, rather than doing what comes naturally to men and women—pursuing their own interests, sometimes in ways that conflict with the interests of their principals.”). The other two basic tools available to shareholders, as already noted, are the voting and selling of shares. See *supra* note 2 and accompanying text.

²⁷ Amanda Marie Rose, *The Shifting Raison D’Etre of the Rule 10b-5 Private Right of Action*, in RESEARCH HANDBOOK ON REPRESENTATIVE SHAREHOLDER LITIGATION, ERICKSON, GRIFFITH, WEBBER & WINSHIP, EDS., (2018).

may result in specific governance reforms designed to reduce agency costs going forward.²⁸ Shareholder suits may result in the judicial invalidation of a particular governance provision, such as a poison pill,²⁹ or they may result in settlements in which the company adopts specific governance reforms aimed at better aligning the incentives of shareholders and managers. We will refer to this objective, sometimes described as “corporate therapeutics,” as the “governance rationale” for shareholder litigation.³⁰

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

But representative actions come with costs of their own. Representative shareholder suits, like other forms of representative actions, are typically controlled by a contingency-fee lawyer serving a quasi-regulatory role with a purely nominal client.³³ Such suits invert the ordinary lawyer-client relationship, with lawyers hiring clients, rather than clients hiring lawyers.³⁴ Lawyers advertise for clients on investor websites³⁵ or cultivate client relationships with institutional investors, often pension funds.³⁶ Having found a client, the lawyers are in control.³⁷

²⁸ See, e.g., Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, 51 WM. & MARY L. REV. 1749, 1826–29 (2010).

²⁹ See, e.g., *Moran v. Household* (shareholder suit challenging adoption of poison pill); *Unocal* (shareholder suit challenging the application of takeover defenses and setting the standard for such challenges going forward); *Revlon* (shareholder suit challenging the use of takeover defenses in the context of an acquisition). More recently, shareholder suits have challenged the application of defensive tactics to activist interventions. See, e.g., *Kallick v. Sandridge Energy Inc.*, 68 A.3d 242, 261 (Del. Ch. 2013) (scrutinizing defensive tactics in the context of an activist’s proxy challenge); *Oral Argument on Defendants’ Motions to Dismiss & Rulings of the Court, Pontiac Gen. Emps. Ret. Sys. v. Ballantine*, 2014 WL 6388645 (Del. Ch. Oct. 14, 2014) (finding a breach of fiduciary duty in a board’s use of a debt covenant as a defense against activism).

³⁰ See George D. Hornstein, *Legal Therapeutics: The “Salvage” Factor in Counsel Fee Awards*, 69 HARV. L. REV. 658, 662–63 (1956) (coining the idea of a “therapeutic” settlement).

³¹ See generally RESEARCH HANDBOOK ON REPRESENTATIVE SHAREHOLDER LITIGATION, ERICKSON, GRIFFITH, WEBBER & WINSHIP, EDs., (2018) (compiling recent scholarship on representative shareholder litigation).

³² See *infra* Section II.B (discussing class fiduciary claims, private securities claims).

³³ JOHN C. COFFEE, JR., *ENTREPRENEURIAL LITIGATION 2* (2015) (“[T]he private [class action] attorney is taking on a public role and acting as a quasi-public servant. . . . [T]his attorney is a private actor, wielding a degree of public power, but motivated by powerful economic incentives, and yet subject only to limited accountability.”).

³⁴ *Id.* at 1 (“[I]n group litigation in the United States, the lawyer often appears to be hiring the client, rather than the client hiring the lawyer.”).

³⁵ Sean J. Griffith, *Innovation in Disclosure-Based Shareholder Suits*, 69 Case Western Reserve L. Rev. ____ (forthcoming 2019).

³⁶ Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors’ and Officers’ Insurance and Securities Settlements*, 157 U. Pa. L. Rev. 755, 770 (2009) (noting that “large plaintiffs’ law firms continuously monitor the portfolios of institutional investors, seeking to keep them apprised of potential claim”)

³⁷ Nicholas Politan, U.S.D.C., Dist. of N.J. (Ret.), *Mediating Securities Class Actions: A View from the Captain’s Quarters*, Speech at the Institutional Investor Forum (Oct. 20, 2005) in INSTITUTIONAL INV. ADVOC., 2005, at 1, 1 (relating a mediator’s experience in conveying a settlement offer to class counsel: “why don’t you go to the restroom, look in a mirror, talk to yourself, and come back here and tell me whether you want to accept the settlement or not”).

Individual investors are rationally indifferent to the conduct of the claim,³⁸ and institutional investor plaintiffs appear to be similarly disengaged.³⁹ These circumstances are ripe for the now-familiar phenomenon of “litigation agency costs,” in which the attorney’s personal incentives depart from those of their supposed clients, leading to claims that shareholders would prefer not to press and resolutions that benefit attorneys at the expense of the shareholders.⁴⁰

Mutual fund plaintiffs need not sue in a representative capacity. Mutual funds are the largest shareholders of most public companies and may prefer, as a result, to litigate in an individual rather than representative capacity.⁴¹ Even so, mutual funds remain subject to litigation agency costs. Because litigation is costly, in the form of both the direct costs of attorneys’ fees and the indirect costs of the time and attention necessary to evaluate and oversee the litigation effort, prospective mutual fund plaintiffs may prefer to leave it to others, free-riding on the class-wide benefits they achieve. Litigation agency costs are a relevant consideration any time mutual funds leave claims to others. Moreover, as market investors, mutual funds are affected by every representative shareholder suit, whether or not they bring their own claims. Litigation agency costs therefore affect mutual funds much as they do other investors.

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

B. Shareholder Litigation in Practice

Shareholder litigation comes in various forms, each with the potential to mitigate managerial agency costs, and each with the potential to generate litigation agency costs. This section reviews four basic forms of shareholder suits. The first two, derivative and direct suits, are different procedural means of enforcing state law fiduciary duties and, as such, are closely focused on mitigating managerial agency costs.⁴² The third, appraisal, is a narrowly

³⁸ ROBERT CHARLES CLARK, *CORPORATE LAW* 389–94 (2nd ed. 1986) (discussing phenomenon where each shareholder’s stake in the corporation is too small to justify the cost in terms of time and attention of actively engaging in corporate affairs).

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

⁴⁰ See John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 *L. & CONTEMP. PROBS.* 5, 23 (1985) (identifying the problem); Thompson & Thomas, *supra* note 16, at 135 (arguing that “just as with derivative suits and securities fraud class actions, good policy must balance the positive managerial agency cost reducing effects of these acquisition-oriented shareholder suits against their litigation agency costs”); see also Randall S. Thomas & Robert B. Thompson, *Empirical Studies of Representative Litigation*, in *RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW* 152, 154–57 (Claire A. Hill & Brett H. McDonnell eds., 2012) (summarizing recent empirical work on the scope of the problem of litigation agency costs).

⁴¹ See Fichtner et al., *supra* note 4.

⁴² Fiduciary duty is essentially connected to agency cost minimization. According to Professors Easterbrook and Fischel:

The fiduciary principle is an alternative to elaborate promises and extra-monitoring. It replaces prior supervision with deterrence, much as criminal law uses penalties for bank robbery rather than

circumscribed right under state law invoked solely to increase the price paid in mergers and acquisitions transactions. The fourth, private securities litigation, is a creature of federal rather than state law and is aimed broadly at assuring that transactions in corporate shares are not affected by fraud or misinformation. Our aim is to develop an understanding of the commonalities as well as the differences between these paradigmatic forms of claims, specifically as they affect the ability of shareholders to police managerial agency costs through litigation.

1. Derivative Suits

The derivative suit is the oldest form of representative litigation in the corporate law context.⁴³ In a derivative suit, an individual shareholder sues on behalf of the corporation to seek redress for some harm done to the corporation itself.⁴⁴ The shareholder alleges that the board is compelled by fiduciary duty to seek redress for the harm, often caused a form of managerial misfeasance or malfeasance.⁴⁵ Because the derivative suit is filed on behalf of the corporation, there are several opportunities for the corporation to regain control of the claim.⁴⁶ Provided the corporation does not retake control, however, the shareholder may press the claim on behalf of the

pat-down searches of everyone entering banks. . . . Such rules preserve the gains resulting from the separation of management from risk bearing while limiting the ability of managers to give priority to their own interests over those of investors.

Easterbrook & Fischel, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* at 92.

⁴³ Some commentators have suggested that, in addition to being old, it is obsolete. GEOFFREY PARSONS MILLER, *THE LAW OF GOVERNANCE, RISK MANAGEMENT, AND COMPLIANCE* 365 (2nd ed. 2017) (referring to the derivative suit as a “platypus”). Nevertheless, derivatives suits are still regularly filed; see Erickson, *supra* note 28, at 1760 (studying characteristics of 141 derivative suits filed in the mid-2000s).

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

⁴⁵ *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 95 (1991) (“[T]he purpose of the derivative action [is] to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of ‘faithless directors and managers’” (quoting *Cohen v. Beneficial Loan Corp.*, 337 U.S. 541, 548 (1949))); *accord Taormina v. Taormina Corp.*, 78 A.2d 473, 475 (Del. Ch. 1951) (“[W]henver a corporation possesses a cause of action which it . . . refuses to assert . . . equity will permit a stockholder to sue in his own name for the benefit of the corporation solely for the purpose of preventing injustice when it is apparent that the corporation’s rights would not be protected otherwise.”).

⁴⁶ These include, for example, the demand requirement and the formation of special litigation committees. DEL. CT. CH. R. 23.1(a) (requiring that the plaintiff “allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors . . . and the reasons for the plaintiff’s failure to obtain the action or for not making the effort”); see Minor Myers, *The Decisions of Corporate Special Litigation Committees: An Empirical Investigation*, 84 IND. L.J. 1309, 1320 tbl.1 (2009) (studying the current operation of special litigation committees and finding that committees pursue claims ten percent of the time, settle thirty percent of the time, and seek dismissal sixty percent of the time).

corporation to a resolution, in which case any monetary recovery is paid into the corporation, not directly to the shareholder.⁴⁷

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

Governance reforms are a much more likely outcome of derivative litigation than monetary relief. Empirical studies suggest that derivative suits are more than two times more likely to settle for non-pecuniary relief than they are to settle for money.⁵³ These reforms are qualitative and therefore difficult to assess empirically, but the authors of the leading studies have expressed skepticism, noting that such reforms are typically “inconsequential” or “cosmetic,”⁵⁴ frequently amounting to the rote application of a common set of governance reforms—such as increased board independence or attendance requirements at board meetings—often without any clear connection to the alleged problems that led to the litigation.⁵⁵ This is not a uniform conclusion,

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

⁴⁸ See, e.g., Frank Wood, SURVEY AND REPORT REGARDING STOCKHOLDERS’ DERIVATIVE SUITS (1944) (finding monetary recoveries in 46 of 573 public company derivative suits filed in New York state and federal courts between 1932 and 1942 and finding typical settlements amounted to less than 3 percent of damages alleged in the underlying complaint); Erickson, *supra* note 28, at 1799 (finding that 13 of 141 derivative suits sampled from the mid-2000s resulted in a monetary payment); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, (1991) (finding that only 12 out of 128 derivative suits in a sample period from the 1960s through the mid-1980s ended in monetary recovery).

⁴⁹ See Jessica Erickson, *The (Un)changing Derivative Suit*, in RESEARCH HANDBOOK ON REPRESENTATIVE SHAREHOLDER LITIGATION, *supra* note 31, at 58, 65 (citing Tom Hals, *Judge Oks Activision \$275 Mln Shareholder Settlement, \$72 Mln for Lawyers*, REUTERS (May 20, 2015, 4:51 PM), <https://www.reuters.com/article/activision-settlement/judge-oks-activision-275-mln-shareholder-settlement-72-mln-f-or-lawyers-idUSL1N0YB2SA20150520>; Jonathan Stempel, *Update 2-Freeport-McMoRan in \$137.5 Mln Settlement over Purchases*, REUTERS (Jan. 15, 2015, 9:16 AM), <https://www.reuters.com/article/freeportmcmoran-settlement/update-2-freeport-mcmoran-in-137-5-mln-settlement-over-purchases-idUSL1N0UU1FU20150115>).

⁵⁰ See, e.g., DEL. CODE ANN. tit. 8, § 145(a)-(b) (2019).

⁵¹ *Id.* § 145(g). See also Tom Baker & Sean J. Griffith, ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION (2010) (noting that although corporate payments made in connection with derivative suits may generally not be indemnified, they are typically covered under “Side A” of a D&O insurance policy).

⁵² Bernard Black et al., *Outside Director Liability: A Policy Analysis*, 162 J. INSTITUTIONAL & THEORETICAL ECON. 5 (2006).

⁵³ See Erickson, *supra* note 28, at (finding that 34 of 141 suits studied settled for non-pecuniary relief); Romano, *supra* note 48, at (finding that non-pecuniary relief two times more often than monetary relief).

⁵⁴ Romano, *supra* note 48, at.

⁵⁵ Erickson, *supra* note 28, at 1808.

however. In a study of derivative suits filed in the Delaware Court of Chancery in 1999 and 2000, Thomas and Thompson found that although the claims often resulted in non-monetary relief, the settlements nevertheless returned “very real gains” to the corporations.⁵⁶ As a recent example, consider the derivative litigation filed against Twenty-First Century Fox in the wake of the decades-long patterns of sexual misconduct involving former CEO Roger Ailes as well as news anchor Bill O’Reilly. Rather than contesting the plaintiffs’ claims, Twenty-First Century Fox promptly entered into a settlement in which it agreed to dedicate \$90 million to improving corporate governance at the company and also establish a “Workplace Professionalism and Inclusion Council” tasked with strengthening sexual harassment reporting and training, and helping to recruit and promote the advancement of women and minorities at the company.⁵⁷ The derivative suit also proved uniquely well-suited to addressing the problem of stock-option backdating in the mid-2000s, when companies manipulated the date of the option grant to their executives in order to increase their value.⁵⁸ The derivative suits that followed in the wake of this scandal frequently resulted in the repricing of these options to benefit the corporation.⁵⁹

Nevertheless, in many cases the governance reforms and other benefits that seem to be won by derivative suit plaintiffs may in fact won by prosecutors, regulators, or other claimants. This is because derivative suits are frequently brought in the wake of other actions, a phenomenon known as the “tag-along” derivative suit.⁶⁰ For example, nearly half of all securities class actions filed between 2005 and 2008 were accompanied by a tag-along derivative suit,⁶¹ and government investigations of corporate compliance failures are also frequently followed by derivative litigation.⁶² Why do derivative plaintiffs bother filing claims when a prosecutor, regulator, or class action claimant (sometimes all three) has already targeted the same underlying misconduct? It is not because their results are better. They are worse.⁶³ It is more likely because the representative nature of the derivative suit enables another attorney to extract a fee.⁶⁴

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

⁵⁷ See Daniel Hemel & Dorothy S. Lund, *Sexual Harassment and Corporate Law*, 118 COLUM. L. REV. 1583, 1622 (2018) (citing Exhibit A to Stipulation & Agreement of Settlement, Compromise, & Release at 3, 10–11, *City of Monroe Emps.’ Ret. Sys. v. Murdoch*, No. 2017-0833-AGB (Del. Ch. filed Nov. 20, 2017)).

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

⁵⁹ Erickson, *supra* note 28, at 1802–03 (finding that 40 percent of stock option suits resulted in a financial benefit, compared to 2 percent of non-stock option suits).

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

⁶¹ Stephen J. Choi et al., *Piling On? An Empirical Study of Parallel Derivative Suits*, 14 J. EMPIRICAL LEGAL STUD. 653, (2017).

⁶² See, e.g., *In re Wal-mart Stores, Inc. Del. Derivative Litig.*, 167 A.3d 513, 513–14 (discussing derivative suit following in wake of FCPA investigation of Wal-Mart which has already resulted in substantial reform of Wal-Mart’s corporate compliance program). See generally Amy Deen Westbrook, *Double Trouble: Collateral Shareholder Litigation Following Foreign Corrupt Practices Act Investigations*, 73 OHIO ST. L.J. 1217 (2012) (examining recent shareholder litigation based on company behavior that violates the Foreign Corrupt Practices Act).

⁶³ Choi, et al., *supra* note 61 (finding that attorneys who frequently file parallel suits are more likely to obtain lower monetary recoveries for their clients and are more likely to settle for non-pecuniary relief); Erickson, *supra* note 60;

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

2. State Law Direct and Class Claims

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

Also like derivative suits, shareholder class actions can achieve compensatory, deterrence, or governance objectives. Most merger claims plead a sufficient basis for both monetary and non-monetary relief.⁶⁸ Nevertheless, the vast majority of such cases are settled for non-pecuniary relief, specifically supplemental disclosures, providing no demonstrable benefit for shareholders.⁶⁹ More recently, the pattern has been to end such suits not through settlement, but through the payment of a "mootness fee."⁷⁰ In this situation, the defendant issues corrective disclosures,

Erickson, *supra* note 49, at 63 ("[I]n the hierarchy of corporate lawsuits, shareholder derivative suits may well be at the bottom."); Westbrook, *supra* note 62, at 1228–29.

⁶⁴ Even in the absence of a settlement, lawyers may be able to claim that their litigation effort created a "corporate benefit" thereby entitling them to a fee paid by the corporation. Sean J. Griffith, *Correcting Corporate Benefit: How to Fix Shareholder Litigation by Shifting the Doctrine on Fees*, 56 B.C. L. REV. 1, 1–2 (2015); accord Erickson, *supra* note 49, at 64 ("The empirical evidence suggests that attorneys are often using derivative suits not to uncover new types of misconduct or to advance new theories of liability, but rather to obtain a share of the attorneys' fees.").

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

⁶⁶ Gatz v. Ponsoldt, 925 A.2d 1265, 1277 (Del. 2007) (holding shareholders' claim to be direct "because the Recapitalization constituted an expropriation of voting power and economic value from [the Company's] public stockholders, and a transfer of that voting power and economic value to [the defendants]").

⁶⁷ See Thompson & Thomas, *supra* note 16, at 153 (identifying frequent filings and low value settlements as key indicia of litigation agency costs).

⁶⁸ Merger class actions typically allege that process defects have led to an inadequate deal price, thus creating a basis for damages. Most merger claims also allege defects of disclosure that can be remedied by non-pecuniary relief in the form of corrective disclosures. See, e.g., Jill E. Fisch et al., *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform*, 93 TEX. L. REV. 557, 572 (2015).

⁶⁹ *Id.* at 559 (citing ROBERT M. DAINES & OLGA KOUMRIAN, CORNERSTONE RESEARCH, SHAREHOLDER LITIGATION INVOLVING MERGERS AND ACQUISITIONS 6 fig.7 (2013), <http://cornerstone.com/Publications/Reports/Shareholder-Litigation-Involving-Mergers-and-Acqui> [<http://perma.cc/TRL8-QNTK?type=pdf>]; Ann Woolner et al., *Merger Suits Often Mean Cash for Lawyers, Zero for Investors*, BLOOMBERG (Feb. 16, 2012, 10:59 AM), <https://www.bloomberg.com/news/articles/2012-02-16/lawyers-cash-in-while-investor-clients-get-nothing-in-merger-lawsuit-deals> [<http://perma.cc/32HY-A22M>]) ("[Deal litigation] lawsuits rarely result in a monetary recovery for the plaintiff class. Rather, the vast majority end in settlement or dismissal. In most settled cases, the only relief provided . . . consists of supplemental disclosures in the merger proxy statement.")

⁷⁰ Griffith, *Innovation*, *supra* note 35.

thereby mooting the claim and entitling the defendant to dismissal, but at the same time entitling the plaintiffs to a fee under the corporate benefit doctrine.⁷¹ The amount of the fee can be adjudicated, but it is more frequently agreed between plaintiff and defendant.⁷² The virtue of this procedure, from the plaintiffs' perspective, is that it allows the litigants to avoid recent rulings, in Delaware and other jurisdictions, hostile to disclosure settlements.⁷³ Because the mootness fee is not a class settlement and is not therefore binding upon absent members of the class, it need not be presented in a fairness hearing.⁷⁴ Mootness dismissals thus bypass judicial review, making it easier for the lawyers to get paid.⁷⁵

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

⁷¹ As explained by the Delaware Supreme Court:

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

Dover Historical Soc’y, Inc. v. City of Dover Planning Comm’n, 902 A.2d 1084, 1092 (2006) (accepting the further characterization of “the mootness doctrine [as] an extension of the corporate benefit exception”).

⁷² The mootness award was cited by the Court of Chancery as the “preferred method” for resolving disclosure-based claims because of the potential for adversarial fee litigation to enable the court to value the benefit on an informed basis. *See In re Trulia, Inc. Stockholder Litig.*, 129 A.3d 884, 897–98 (Del. Ch. 2016) (referring to mootness dismissals as the “preferred scenario” and noting that “[i]n the mootness fee scenario, the parties also have the option to resolve the fee application privately without obtaining Court approval”). Parties have tended to settle fee disputes in order to avoid additional adversarial process. Matthew D. Cain et. al., *The Shifting Tides of Merger Litigation*, 71 *VAND. L. REV.* 603, 627 tbl.5 (2018) (finding sharply increasing rates of mootness settlements).

⁷³ The leading case is *Trulia* 129 A.3d at 898 (“[P]racticitioners should expect that disclosure settlements are likely to be met with continued disfavor in the future unless the supplemental disclosures address a plainly material misrepresentation or omission, and the subject matter of the proposed release is narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process, if the record shows that such claims have been investigated sufficiently.”). Cases in other jurisdictions following *Trulia* include: *In re Walgreen Co. Stockholder Litigation*, 832 F.3d 718, 725 (7th Cir. 2016); *Bushansky v. Alliance Fiber Optics Products, Inc.*, No. 1-16-CV-294245, (Cal. Sup. Ct. Sept. 29, 2017) (adopting *Trulia* standard into California law); *Griffith v. Quality Distribution, Inc.*, 43 Fla. L. Weekly D 1599, (Dist. Ct. App. 2018) (adopting *Trulia* standard into Florida law); see *Vergiev v. Aguero et al.*, No. L-2276-15 6–7 (N.J. Super. Ct. Law Div. June 6, 2016), <https://margravelaw.com/wp-content/uploads/2016/08/2016-06-06-Final-Order-and-Judgment-and-Statement-of-Reasons.pdf> (rejecting settlement and adopting *Trulia* into New Jersey law).

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

⁷⁵ Mootness settlements require, at most, notice to the class. *See, e.g.*, *Swomley v. Schlecht*, No. 9355–VCL, 2015 WL 1186126, at *1–2 (Del. Ch. Mar. 12, 2015) (setting forth class notice procedure for mootness fee, after defendants mooted certain disclosure claims and successfully moved to dismiss rest of case); *In re Zalicus Inc. Stockholders Litig.*, No. 9602–CB, 2015 WL 226109, at *1–2 (Del. Ch. Jan. 16, 2015) (supporting private mootness fee resolution procedure while requiring that adequate notice be provided to stockholders); *In re Astex Pharms., Inc. Stockholders Litig.*, No. 8917–VCL, 2014 WL 4180342, at *1–2 (Del. Ch. Aug. 25, 2014) (same).

⁷⁶ By 2009, shareholder claims were brought against close to 90% of all third-party mergers, a number that held until 2016. After a brief interlude in the wake of *Trulia*, the percentage of filings has climbed again. STEFAN BOETRICH & SVETLANA STARYKH, *NERA, RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION*, at 19 (2019); CORNERSTONE RESEARCH, *SECURITIES CLASS ACTION FILINGS: 2017 YEAR IN REVIEW*, at 2 (2018) (highlighting the growth in federal class action filings involving mergers and acquisitions post-*Trulia*).

⁷⁷ Fisch et al., *supra* note 68, at 600–01.

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

3. Appraisal Claims

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

Appraisal claims are also distinguishable from other forms of shareholder litigation because they cannot be brought as class or derivative actions.⁸³ They appear to be non-representative. On closer inspection, however, this distinction breaks down.⁸⁴ Appraisal actions contain procedures for connecting dissenters and ultimately coordinating their efforts under a single lead counsel with fiduciary duties to represent the interests of dissenting shareholders as a class.⁸⁵ However, unlike class actions, there is no mechanism by which lead counsel can force all dissenting shareholders into a settlement. Settlements in appraisal actions

⁷⁸ The average plaintiffs’ attorney’s fee for disclosure settlements had recently been \$500,000. *Id.* For mootness settlements, the recent range seems to be from \$87,500 to \$450,000, with an average of \$268,750. See Exhibit 1 to Defendant’s Response to Order at , *Einhorn v. Kindred Healthcare, Inc.*, No. 18-0297-RGA, (Del. Dist. Ct. 2018).

⁷⁹ See generally Joel Eden Friedlander, *How Rural/Metro Exposes The Systemic Problem of Disclosure Settlements*, 40 DEL. J. CORP. L. 877, 905–906 (2016) (compiling a list of 15 merger cases resolved between 1998 and 2011 in which shareholder plaintiffs recovered a common fund for target shareholders in excess of \$40 million).

⁸⁰ *Paramount Comm’ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 46–47 (Del. 1994); *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1284–87 (Del. 1989); *Revlon, Inc. v. Macandrews & Forbes Holdings, Inc.* 506 A.2d 173, 182–83 (Del. 1986).

⁸¹ *Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182, 1187 (Del. 1988).

⁸² DEL. CODE ANN. tit. 8, § 262 (2019). The availability of appraisal to specific transactions varies from state to state. For scholarship debating the purpose underlying various state appraisal statutes, see, for example, Daniel R. Fischel, *The Appraisal Remedy in Corporate Law*, 1983 AM. B. FOUND. RES. J. 875, 875–84; Hideki Kanda & Saul Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L. REV. 429, 434–45 (1985).

⁸³ Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 799 (2003) (citing § 262(a)) (noting that “the Delaware corporate statute does not authorize a class appraisal procedure”).

⁸⁴ See generally Minor Myers, *Appraisal as Representative Litigation*, in RESEARCH HANDBOOK ON REPRESENTATIVE SHAREHOLDER LITIGATION, *supra* note 31, at 254 (examining the ways in which appraisal actions may be seen as a form of representative litigation).

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

must be presented to all dissenters, each of whom has the option of participating in the settlement or intervening to continue the proceeding.⁸⁶ Also unlike class actions, there is no shifting of attorneys' fees to the defendant.⁸⁷ Appraisal petitioners pay their own attorneys' fees and bear their own litigation costs, apportioning them among dissenters, but generally not shifting them to the corporation itself.⁸⁸ This distinction has important implications for the question of litigation agency costs, suggesting that appraisal actions are likely to be pursued only when the claimants determine that the benefits of an action exceed its costs, in contrast to class actions and derivative suits that may be pursued for attorneys' fees irrespective of the benefit to the putative class.⁸⁹

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

⁸⁶ *Edgerly v. Hechinger*, No. 16138-NC, 1998 WL 671241, at *4 (Del. Ch. 1998) (noting that non-settling petitions must be “given notice . . . and an opportunity to intervene” to continue to press the appraisal proceeding); *Raynor v. LTV Aerospace Corp.*, 317 A.2d 43, 47 (Del. Ch. 1974) (holding that “dissenting stockholders shall be entitled to participate equally with the plaintiffs in any settlement of this consolidated appraisal action”).

⁸⁷ *See, e.g., M.G. Bancorporation, Inc. v. Le Beau*, 737 A.2d 513, 527 (Del. 1999) (quoting *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 301 (Del. 1996)) (stating that appraisal petitioners “‘should bear the burden of paying [their] own expert witnesses and attorneys,’ unless some equitable exception applies”).

⁸⁸ *See, e.g., DEL. CODE ANN. tit. 8, § 262(j)* (2019). (“Upon application of a stockholder, the Court may order all or a portion of the expenses incurred by any stockholder in connection with the appraisal proceeding, including, without limitation, reasonable attorney’s fees and the fees and expenses of experts, to be charged pro rata against the value of all shares entitled to an appraisal.”)

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

⁹⁰ *See* Charles R. Korsmo & Minor Myers, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 WASH. U. L. REV. 1551, 1585, 1603 (2015) [hereinafter Korsmo & Myers, *Appraisal Arbitrage*] (citing Charles Korsmo & Minor Myers, *The Structure of Stockholder Litigation: When Do the Merits Matter?*, 75 OHIO ST. L.J. 829, 874 (2014) [hereinafter Korsmo & Myers, *The Structure of Litigation: When Do the Merits Matter?*]); Charles R. Korsmo & Minor Myers, *The Structure of Stockholder Litigation: When Do Merits Matter?*, *supra* note 90, at 847–48.

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

⁹² *See* Audra Boone et al., *Merger Negotiations in the Shadow of Judicial Appraisal* 3 (Ind. Legal Studies, Working Research Paper No. 381, 2019) (finding that “Delaware targets receive higher acquisition premiums . . . following events that strengthen the appraisal remedy”). The authors also find that the bidding of appraisal arbitrageurs post-announcement effectively eliminates the post-announcement spread, enabling shareholders to obtain the deal price without having to wait for the transaction to close. *Id.* at 19.

transaction structures *ex ante*, providing a potential benefit to all target shareholders in the form of a higher merger price.⁹³ These results have also been confirmed by other researchers.⁹⁴

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

4. Private Securities Litigation

Finally, shareholders may bring private securities claims. Although they involve a variety of potential causes of action and a variety of potential defendants,⁹⁶ the essential basis of all such claims is misinformation—fraud, misstatements, or omissions—provided in connection with transactions in corporate securities.⁹⁷ Securities claims based on misinformation may seem distinct from corporate law claims based on misconduct, but there is an essential link between the two. When corporate managers engage in misconduct, they typically also conceal it. These misstatements or omissions thus transform what might otherwise be only a state law derivative or direct claim into a federal securities claim, making securities claims a catch-all means of targeting managerial misconduct.⁹⁸

Private securities litigation can be brought in class action form, and securities class actions make up fully half of all class actions filed in federal courts.⁹⁹ The quintessential securities class action is the 10b-5 claim, alleging a material misrepresentation (or omission) in connection with

⁹³ *Id.* at 4 (summarizing their findings as suggesting that “bidders protect themselves against threat of appraisal, not through contractual terms that would allow the bidder to walk away from the deal . . . but rather by increasing their upfront bid and improving the price-setting process”).

⁹⁴ See Scott Callahan et al., *Appraisal Arbitrage and Shareholder Value*, 3 J.L. FIN. & ACCT. 147 (2018) (manuscript at 7).

⁹⁵ On the role of appraisal arbitrage hedge funds, see Korsmo & Myers, *Appraisal Arbitrage*, *supra* note 90, at 1573 n.85.

⁹⁶ For example, private securities litigation may be brought under section 11 of the Securities Act for misstatements or omissions made in a registration statement, under section 12(a)(1) of the Securities Act for violations of the offering process, under section 12(a)(2) of the Securities Act for misstatements and omissions made in the prospectus, and under section 10 of the Exchange Act for misstatements and omissions made in securities transactions generally. Securities Act of 1933, 15 U.S.C. §§ 77j(a), 77l(a)(1)–(a)(2) (2019); Securities Exchange Act of 1934, 15 U.S.C. § 78j (2019). Potential defendants include the corporate issuers, responsible officers and directors, accountants, lawyers, and underwriters. These are statutorily defined under some causes of action. See, e.g., Securities Act of 1933 § 77j. But the same defendants are potentially vulnerable under other causes of action as well, often as aiders and abettors of the primary violation. See generally *Stoneridge Inv. Partners, LLC v. Sci.-Atlanta, Inc.*, 552 U.S. 148 (2008).

⁹⁷ LOUIS LOSS, JOEL SELIGMAN & TROY A. PAREDES, *SECURITIES REGULATION* (2018).

⁹⁸ See Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 861 (2003) (arguing that outside of the contexts of self-dealing and acquisitions, “corporate governance . . . has passed to federal law and in particular to shareholder litigation under Rule 10b-5”). For a lighter take on the same point, see Matt Levine, “Everything is Securities Fraud.”

⁹⁹ Brian T. Fitzpatrick, *An Empirical Study of Class Action Settlements and Their Fee Awards*, 7 J. EMP. LEGAL STUD. 811 (2011).

the purchase or sale of securities.¹⁰⁰ Plead as a “fraud on the market” claim, in which any person trading in the shares of a public company shares prior to the correction of a public misstatement, 10b-5 can reach effectively all forms of corporate misconduct.¹⁰¹ As a result, securities filings alleging violations of rule 10b-5 predominate other forms of private securities litigation, typically at a rate of more than 10:1.¹⁰² Furthermore, recoveries in securities class actions vastly exceed typical recoveries under state fiduciary duty claims. Average securities settlements are in the tens of millions of dollars. In 2017, for example, the average securities class action settlement was \$25 million, down from \$72 million in 2016.¹⁰³ Fiduciary duty suits, recall, most often result in no money at all (except for the lawyers).¹⁰⁴

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

¹⁰⁰ Rule 10b-5, under the Securities Exchange Act of 1934 makes it unlawful, among other things, to “make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security.” 17 C.F.R. § 240.10b-5 (2018). A private right of action does not exist in rule or statute but was judicially created first in 1946 and finally blessed by the U.S. Supreme Court in 1971. See *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 (1971) (quoting *Shell v. Hensley*, 430 F.2d 819, 827 (5th Cir. 1970)); *Kardon v. Nat’l Gypsum Co.*, 69 F. Supp. 512, 513–14 (E.D. Pa. 1946) (recognizing a private right of action under Rule 10b-5).

¹⁰¹ Matt Levine, *Everything is Securities Fraud* (compiling disparate examples of corporate misconduct plead as securities fraud class actions). The fraud on the market claim, like the private right of action, is a judicial creation. See *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258, 274–77 (2014) (recognizing the fraud on the market class action as established precedent); *Basic Inc. v. Levinson*, 485 U.S. 224, 241–42 (1988) (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160–61 (3rd Cir. 1986)) (creating the fraud on the market class action).

¹⁰² BOETRICH & STARYKH, *supra* note 76, at 5; CORNERSTONE RESEARCH, *supra* note 76, at 10. The exception to this claim is the recent proliferation of securities class actions under rule 14a, alleging defective disclosures in connection with M&A transactions. After years of amounting to no more than a small minority of all securities claims, merger objection suits increased sharply in 2016 and in 2017 outnumbered even 10b-5 claims. See BOETRICH & STARYKH, *supra* note 76, at (reporting 197 merger objection cases in 2017 compared to 191 10b-5 filings); CORNERSTONE RESEARCH, *supra* note 76, at 14. This is a direct result of the migration of merger objection suits to federal court in the wake of Delaware’s crack-down on disclosure only settlements. See Sean J. Griffith, *Private Ordering Post-Trulia: Why No Pay Provisions Can Fix the Deal Tax and Forum Selection Provisions Can’t*, in *THE CORPORATE CONTRACT IN CHANGING TIMES*, Solomon & Thomas, eds., Univ. of Chicago Press (2019).

¹⁰³ BOETRICH & STARYKH, *supra* note 76, at . These averages are strongly influenced by a small number of very large settlements. Median settlements were \$6 million in 2017 and \$9 million in 2016. *Id.*

¹⁰⁴ See *supra* Parts II.B. 1-2.

¹⁰⁵ Amanda M. Rose, *The “Reasonable Investor” of Federal Securities Law: Insights from Tort Law’s “Reasonable Person” & Suggested Reforms*, 43 J. CORP. L. 77, 81, 85–86, 93–94 (2017) (emphasizing defendants’ incentives to settle even weak cases given the unpredictability of juries combined with the uncertainty of certain liability elements).

¹⁰⁶ See BOETRICH & STARYKH, *supra* note 76, at 34.

small portion of claimed damages is often used to claim that securities class actions do not achieve their compensatory objectives.¹⁰⁷

The more profound objection to the compensation rationale, however, is that given that it is the corporation that pays, it is the shareholders themselves that fund their own settlements.¹⁰⁸ This “circularity” critique of the compensation rationale operates on two levels simultaneously.¹⁰⁹ Not only will some portion of the class—those who do not sell out of the company entirely—fund the class recovery in the lawsuit itself,¹¹⁰ but also diversified shareholders—because they as likely to be buyers as they are to be sellers—will fund the vast majority of such recoveries across their portfolio over time.¹¹¹ Shareholders will, in other words, be paying themselves.¹¹² Were it not for the amounts they must also pay plaintiffs’ and defense counsel, the result would be more or less a wash.¹¹³ Given those amounts, however, shareholders’ compensatory goals are unlikely to be well served through class action securities litigation.

But securities litigation may still serve deterrence goals. The securities class action may have a role to play in forcing managers to internalize the costs of their own misconduct.¹¹⁴ Managers who fear personal liability, of course, may hesitate to engage in misconduct. However, in this context it is worth noting that personal liability in private securities litigation is vanishingly rare.¹¹⁵ Managers are typically indemnified by the corporation for any personal liabilities arising in connection from securities suits, and corporations are typically insured under a D&O policy not only for their indemnification obligations to manager-defendants but also for any liabilities arising from having been named as a co-defendant in the suit.¹¹⁶ As a result, any deterrence effect of securities class actions depends entirely upon the D&O insurer, and studies show that although insurers seek to distinguish between good and bad insurance risks, there is not a large marginal

¹⁰⁷ Elizabeth Chamblee Burch, *Reassessing Damages in Securities Fraud Class Actions*, 66 MD. L. REV. 348, 371–72 (2007).

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

¹⁰⁹ Rose, *Raison D’Etre*, *supra* note 27, at 39, 47 (explaining that “circularity exists at the micro and macro level”).

¹¹⁰ James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 509–10 (1997)

¹¹¹ John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1546–47 & n.42 (2006).

¹¹² The circularity critique is not limited to securities class actions and may apply to state law claims, especially derivative suits as well. Indeed, concerns about circularity explain why state law forbids corporations from indemnifying directors and officers for amounts paid to resolve derivative suits. In such a case indemnification would essentially amount to a payment from the corporation to the manager to pay back an amount paid by the manager to the corporation. But state law does allow such settlements to be insured, and as a result, corporations fund their settlements largely through proceeds. *See supra* notes 50-51 and accompanying text.

¹¹³ Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 668–69 (1992).

¹¹⁴ The scholarly literature suggests, however, that damages calculations may be miscalibrated for serving this end. *See, e.g.*, Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1493 (1996); Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 643–44 (1985).

¹¹⁵ Black et al., *supra* note 52.

¹¹⁶ Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors’ & Officers’ Liability Insurer*, 95 GEO. L.J. 1795, 1802 (2007) (distinguishing between Side B coverage for corporate indemnification obligations and Side C coverage for corporate liabilities as a named defendant).

difference between the premiums paid between well and poorly governed firms.¹¹⁷ If this is so, the effect of insurance is to substantially weaken the deterrence potential of securities class actions.¹¹⁸

III. Mutual Fund Plaintiffs

Mutual funds, as already noted, hold approximately one-third of the U.S. equity market and as such, are positioned to play a major role in corporate governance.¹¹⁹ Governance power accrues to the mutual fund family – the larger entity that organizes and sells interests in individual funds – under their contracts with investors. Take, as an example, an equity mutual fund offered by Fidelity. Fidelity first assembles the portfolio by purchasing securities and then, sells fund shares to investors. Fidelity will also utilize an investment adviser to oversee the day-to-day operations of the mutual fund.¹²⁰ Pursuant to the investment contract, the right to cast the portfolio’s votes, as well as bring shareholder suits, is held by the investment adviser.¹²¹

When it comes to voting, most of the large mutual fund families require the investment adviser to follow the recommendation of the entity’s corporate governance group.¹²² But what about litigation? How and when do mutual funds pursue shareholder litigation? How does the conduct of mutual funds in shareholder litigation compare to other institutional intermediaries, such as pension and hedge funds? And how does it compare to the efforts of individual shareholder plaintiffs? These are empirical questions, and the sections which follow endeavor to answer them empirically.

A. Mutual Fund Participation in Shareholder Litigation

¹¹⁷ Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors’ & Officers’ Liability Insurance Market*, 74 U. CHI. L. REV. 487 (2007),

¹¹⁸ *Accord Coffee*, *supra* note 111, at 1536 (“[C]ompensation [is] unobtainable and deterrence [is] deeply compromised by a variety of inconsistent legal doctrines that pull the punch of private enforcement.”).

¹¹⁹ *See supra* notes 3-5 and accompanying text.

¹²⁰ *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).

¹²¹ *See Form of Investment Advisory Agreement*, L. INSIDER (July 25, 2014), <https://www.lawinsider.com/contracts/7HF5OJyY06sdG7X9BQHhkU/blackrock-funds/844779/2014-07-25>

(providing that the fund’s investment adviser “ may vote, exercise consents and exercise all other rights appertaining to such securities and other assets on behalf of the Fund”); *cf.* Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564, 6565 (Apr. 14, 2003) (codified at 17 C.F.R. pts. 239, 249, 270, 274) (describing how mutual funds are the beneficial owner of the fund’s securities, and thus the votes accrue to the investment adviser); Jonathan D. Glater, *Suits Contend Mutual Funds Fail to Collect in Settlements*, N.Y. TIMES (Jan. 19, 2005), <https://www.nytimes.com/2005/01/19/business/suits-contend-mutual-funds-fail-to-collect-in-settlements.html>

(“Individual investors in mutual funds may not file a claim for a piece of the pie from a settlement with a company whose shares the fund owns. The mutual fund owns the shares on behalf of those investors, and so the right to file a claim belongs to the fund.”); *Types of Investors*, BROADRIDGE, https://www.shareholdereducation.com/SHE-types_investors.html (last visited June 25, 2019) (“Mutual fund managers vote on behalf of all of their customers, and, as an individual investor with a limited number of shares, you can’t influence how the fund votes.”). A small fraction of institutional investors that invest in mutual funds retain their governance rights. *See* Section IV.B.

¹²² *See HORTENSE BIOY ET AL.*, *supra* note 8, at 22; Griffith & Lund, *supra* note 14, at 1170–71.

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

We limited our searches to the litigation activity of the ten largest mutual funds over a ten year period: January 2009 through year-end 2018. We ranked the largest mutual fund families by the amount of assets under management invested in equity strategies.¹²³ Because we are interested in shareholder litigation, we sought to capture the litigation activity of the asset managers with the largest equity shareholdings; however, this meant that certain large mutual fund families like PIMCO which primarily offer bond funds, did not make our top ten list. We searched under various permutations of the names of the following ten mutual fund companies: Vanguard, BlackRock, State Street, Fidelity, Capital Group, T. Rowe Price, Dimensional Fund Advisors, BNY Mellon Investment Management, JP Morgan Asset Management, and Invesco. As summarized in Table 1, below, the combined assets under management of these ten mutual fund companies is a staggering \$24 trillion.

Table 1: The Top 10 U.S. Asset Managers (Equity), December 2018

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

¹²³ We collected this information from annual and quarterly reports whenever possible. For the asset managers that did not report this figure, we were often able to estimate it by summing the amount of assets in different funds (and we assumed that multi-asset funds were composed of 60% equities and 40% bonds). Some asset managers did not report even that information, and in that case, we contacted the asset manager directly.

By searching under various name permutations, we hoped to capture instances where a fund family might use alternative business names as well as situations where lawsuits are brought by individual funds rather than the entity itself—the BlackRock Global Allocation Fund, for example, rather than BlackRock Advisors. Likewise, by searching for the fund name in any party capacity, we sought to capture litigation in which the funds participated without necessarily serving as lead plaintiff. After weeding out unrelated suits—predominantly contract and employment claims—we were left with a total of 17 suits involving these funds *as investors*.

Table 2: Participation of Mutual Funds in Shareholder Suits, 2009-2018

Asset Manager	Shareholder Suits	Traditional Shareholder Suits
Vanguard	2	2
BlackRock	8	3
State Street	1	1
Fidelity	0	0
Capital Group	0	0
T. Rowe Price	4	3
Dimensional Fund Advisors	2	1
BNY Mellon Investment Management	0	0
JP Morgan Asset Management	1	0
Invesco	0	0
Total	18	10

Table Two summarizes the total number of shareholder complaints filed by our group of mutual funds over a ten-year period. The first column includes all shareholder complaints filed by the relevant funds. However, many of these cases included in the column are *not* traditional shareholder suits. For example, BlackRock brought several cases alleging misconduct in connection with the sale of residential mortgage backed securities (“RMBS”) in which the funds had invested. Although these cases were brought as derivative suits against the banks as trustees and also contained federal securities law allegations, they are not traditional shareholder suits brought against a corporation or its managers.¹²⁴ There are five such RMBS cases in the table. Excluding them reduces the total number of claims brought by BlackRock to 3.

Furthermore many of the cases in the table were brought by different funds against the same defendants. Three funds (Dimensional, State Street, and Vanguard) brought 10b-5 cases

¹²⁴ As defined above, a traditional securities suit involves an investor suing a corporate issuer for misconduct or misinformation. See *supra* note 97 and accompanying text. In the RMBS suits, investors sued the banks that packaged and securitized their mortgage loans. Because these suits do not involve a corporate issuer as the defendant, we treat them as distinct from traditional shareholder suits.

against Petrobras.¹²⁵ Two funds (BlackRock and T. Rowe Price) brought 10b-5 cases against Countrywide. Two funds (BlackRock and Vanguard) brought 10b-5 cases against American Realty/ VEREIT. Two funds (BlackRock and T. Rowe Price) brought 10b-5 cases against Valeant. Interestingly, BlackRock is also named as a plaintiff along with two other funds (J.P. Morgan and T. Rowe Price) in an earlier class action complaint against Valeant.¹²⁶ Finally, our docket search found a single appraisal action, the infamous Dell appraisal case in which T. Rowe Price petitioned for appraisal in Michael Dell's management buyout but ultimately failed to perfect its appraisal rights due to an administrative error.¹²⁷

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

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

1. Countrywide

In the wake of the financial crisis, the beleaguered mortgage issuer Countrywide Financial faced litigation from dozens of plaintiffs, which eventually included three mutual fund complexes. The vast majority of Countrywide's earnings had come from its mortgage-related operations, which included originating, purchasing, servicing, and investing in mortgages.¹³⁰ During the years leading up to the financial crisis, Countrywide had lowered its mortgage underwriting standards significantly and shifted into risky products without disclosing these business practice modifications to investors.¹³¹ Accordingly, when the crisis hit, Countrywide posted massive

¹²⁵Dimensional is also named in an earlier class action complaint against Petrobras. *See* In re: Petrobras Securities Litigation, 1:14-cv-09662 (SDNY Dec. 8, 2014).

¹²⁶ *Poetter v. Valeant Pharm. Int'l.*, 3:15-cv-07658, (D. NJ. Oc. 22, 2015).

¹²⁷ *In re Appraisal of Dell, Inc.*, No. 9322-VCL (Del. Ch. Feb. 6, 2014). We discuss this case in more detail below. *See infra* notes 186-190 and accompanying text.

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

¹²⁹ Dimensional filed a separate action after being named in the class action against Petrobras, and BlackRock filed a separate action after being named in the class action against Valeant. *See* Sections IIIA 2. And 4. However, two of the three funds named as plaintiffs in the Valeant class action (JP Morgan and T. Rowe Price) do not seem to have filed a separate complaint.

¹³⁰ *In re Countrywide Fin. Corp. Sec. Litig.*, 588 F.Supp.2d 1132, 1144 (C.D. Cal. 2008).

¹³¹ *Id.* at 1145-46, 1150, 1153-54.

losses and was hastily sold to Bank of America in early 2008.¹³² But even before the company was sold, in August 2007, investors brought a class action suit against Countrywide in the U.S. District Court for the Central District of California alleging securities law violations for false and misleading statements and omissions regarding its lending standards and the quality of its loans.¹³³ The consolidated complaint was 416 pages and contained 21 claims of securities fraud against 50 defendants.¹³⁴

Bank of America settled the class action suit in May 2010 for \$624 million.¹³⁵ But thirty-three investors, including BlackRock and T. Rowe Price, were unhappy with the settlement and opted-out so that they could file their own lawsuit.¹³⁶ By July 2011, a group of fifteen investors, including the three large mutual fund complexes, sued Bank of America and Countrywide in district court, again pursuing securities fraud claims arising out of Countrywide's mortgage lending practices.¹³⁷ Those claims were settled confidentially in November 2011.¹³⁸

2. Petrobras

Once the fifth-largest company in the world by market capitalization, Brazilian oil and gas giant Petrobras suffered a fall from grace (and a precipitous stock price decline) after the Brazilian government uncovered a complex corruption scheme in 2015.¹³⁹ In 2010, Petrobras began expanding its production capacity by acquiring and constructing new facilities. But rampant corruption and bribery within Petrobras led the company to substantially overpay for these projects.¹⁴⁰ After the government investigation uncovered details of the corruption scheme, which involved thousands of employees and cost the company at least \$28 billion,¹⁴¹ Petrobras' stock price declined precipitously. By March 2015, the company's common stock price had fallen by 80%.¹⁴²

¹³² See Laurie Kulikowski, *Countrywide Losses Mount*, THESTREET (Jan. 29, 2008) <https://www.thestreet.com/story/10400894/1/countrywide-losses-mount.html> (last updated Jan. 29, 2008, 10:37 AM) (reporting that Countrywide reported losses of \$704 million in 2007); Gretchen Morgenson & Eric Dash, *Bank of America to Buy Countrywide*, N.Y. TIMES (Jan. 11, 2008), <https://www.nytimes.com/2008/01/11/business/worldbusiness/11iht-bofa.3.9157464.html>.

¹³³ *Countrywide*, 588 F.Supp.2d at 1154–56.

¹³⁴ *Id.* at 1142.

¹³⁵ Jonathan Stempel, *BofA's Countrywide in \$624 Million Lawsuit Settlement*, REUTERS (May 7, 2010, 8:24 AM), https://www.reuters.com/article/us-bankofamerica-countrywide/bofas-countrywide-in-624-million-lawsuit-settlement-idUSTRE6464KD20100507?feedType=RSS&feedName=businessNews&utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+reuters%2FbusinessNews+%28Business+News%29.

¹³⁶ Calpers, *BlackRock, Others Reject \$600M Countrywide Settlement*, AMERICAN BANKER (Feb. 28, 2011, 12:00 AM), <https://www.americanbanker.com/news/calpers-blackrock-others-reject-600m-countrywide-settlement>. This forced the class action settlement to include a provision that would allow Countrywide to set aside \$22.5 million of the original amount to pay the investors who rejected the agreement. *Id.*

¹³⁷ Barry B. Burr, *Investors Sue Bank of America, Countrywide*, PENSIONS&INVESTMENTS (July 29, 2011, 1:00 AM), <https://www.pionline.com/article/20110729/ONLINE/110729844/investors-sue-bank-of-america-countrywide>.

¹³⁸ Evan Weinberger, *BofA Reaches Deal with Countrywide Settlement Holdouts*, LAW360 (Nov. 22, 2011, 6:31 PM), <https://www.law360.com/articles/288007/bofa-reaches-deal-with-countrywide-settlement-holdouts>.

¹³⁹ *In re Petrobras Sec. Litig.*, 116 F.Supp.3d 368, 374 (S.D.N.Y. 2015).

¹⁴⁰ *Id.*

¹⁴¹ Beagan Wilcox Volz, *More Fund Managers Sue Scandal-Hit Petrobras*, FIN. TIMES (Oct. 24, 2015), <https://www.ft.com/content/f50dacce-78bd-11e5-a95a-27d368e1ddf7>.

¹⁴² *Petrobras* 116 F.Supp.3d at 375.

By January 2015, Petrobras investors began filing suits under Section 10(b) of the Exchange Act in the Southern District of New York.¹⁴³ The plaintiffs alleged that the company's financial statements were false and misleading because recorded payments were inflated due to large bribes and overcharges. The plaintiffs also alleged that the company made false and misleading statements about the integrity of the company's management and the effectiveness of its compliance program.¹⁴⁴

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

By opting out, the mutual funds got several benefits. For one, they settled their claims and were paid much more quickly than the class action plaintiffs: Dimensional and State Street settled their lawsuits in November 2016,¹⁴⁸ and Vanguard, in June 2017.¹⁴⁹ Pursuant to the settlements, the funds recovered "hundreds of millions of dollars in direct payments."¹⁵⁰ By contrast, the class action settlement was not announced until January 2018, and claimants will have to wait years for the settlement administration process to take place before their claims are paid. And although the terms of the direct settlements are confidential, the mutual funds likely did better than they would have under the class action settlement, under which a \$2.95 billion payment is expected to result in only \$1.33 per share.¹⁵¹ For Vanguard, which as of December 2018 had only 5,759,641 Petrobras shares, that would have meant an expected recovery of approximately \$7.66 million.¹⁵² Further supporting that conclusion is the fact that Petrobras raised the financial provision allocated for

¹⁴³ *Id.* at 375–76.

¹⁴⁴ *Id.* at 375

¹⁴⁵ *Id.* at 373.

¹⁴⁶ Wilcox Volz, Beagan, Lord Abbett, Russell Funds Join Line of Petrobras Plaintiffs, Ignites (Sept. 30, 2015).

¹⁴⁷ Beagan Volz, More Fund Managers Sue Scandal-Hit Petrobras, FIN. TIMES, <https://www.ft.com/content/f50dacce-78bd-11e5-a95a-27d368e1ddf7>.

¹⁴⁸ Petrobras reaches agreement with investors, Petrobras Investor Relations Press Release (Nov. 23, 2016), <http://www.investidorpetrobras.com.br/en/press-releases/petrobras-reaches-agreement-investors-settle-eleven-individual-securities-actions-united-states>.

¹⁴⁹ Paul Kiernan, *Brazil's Petrobras Settles Lawsuit with Shareholder Vanguard*, WALL STREET J. (June 19, 2017, 6:36 PM), <https://www.wsj.com/articles/brazils-petrobras-settles-shareholder-lawsuit-with-vanguard-1497909907>.

¹⁵⁰ Marissa Parker & Joseph T. Kelleher, Funds as Plaintiffs: A New Set of Questions, MONDAQ, <http://www.mondaq.com/unitedstates/x/691386/Class+Actions/Funds+As+Plaintiffs+A+New+Set+Of+Questions> (last updated Apr. 24, 2018).

¹⁵¹ Declaration of Jeremy A. Lieberman in Support Re: 765 Motion for Settlement Notice of Unopposed Motion for Preliminary Approval of Class Action Settlement exhibit I-B-1 at 3–4, *In re Petrobras Sec. Litig.*, No. 14–cv–9662 (JSR) (S.D.N.Y. filed Feb. 1, 2018); see Brendan Pierson, *Petrobras to Pay \$2.5 Billion to Settle U.S. Corruption Lawsuit*, REUTERS (Jan. 3, 2018, 1:42 AM), <https://www.reuters.com/article/us-petrobras-classaction-idUSKBN1ES0L2> (calling the settlement smaller than expected).

¹⁵² *Petroleo Brasileiro S.A. – Petrobras Institutional Ownership*, NASDAQ, <https://www.nasdaq.com/symbol/pbr/institutional-holdings?page=2> (last updated June 26, 2019).

shareholder settlements from \$372 to \$445 million after the announcement of the settlement with Vanguard.¹⁵³

3. American Realty/VEREIT

Before 2014, American Realty Capital Properties was known for managing a \$30 billion real estate portfolio that included multiple Red Lobster locations and a large portfolio of single-tenant homes.¹⁵⁴ In April 2014, the real estate investment trust admitted to the SEC that it overstated income from its operations. Correcting the error “erased roughly a third of [American Realty’s] value at the time.”¹⁵⁵ On the same day as the announcement, three American Realty executives—including the CEO and COO—stepped down.¹⁵⁶ By October, the FBI had opened a criminal probe,¹⁵⁷ which ultimately led to an 18-month prison sentence for the REIT’s CFO.¹⁵⁸

In the wake of the scandal, the company rebranded as VEREIT and replaced its board. But this did not deter plaintiffs from filing multiple class action complaints in the U.S. District Court for the Southern District of New York in January 2015.¹⁵⁹ The plaintiffs alleged that the REIT violated federal securities laws by making false and misleading statements, by misrepresenting the company’s business prospects, and by engaging in fraud.¹⁶⁰ The complaints were consolidated and the New York City Retirement System was named lead plaintiff.¹⁶¹ However, BlackRock maintained a separate securities action in the SDNY.¹⁶² One other fund—Vanguard, which had a 13% stake in the REIT¹⁶³ and had alleged that its investors had “lost billions” due to the

¹⁵³ Paul Kiernan, *Brazil’s Petrobras Settles Lawsuit with Shareholder Vanguard*, WALL STREET J., <https://www.wsj.com/articles/brazils-petrobras-settles-shareholder-lawsuit-with-vanguard-1497909907> (last updated June 19, 2017, 6:36 PM).

¹⁵⁴ Chris Matthews, *Accounting Scandal at American Realty Capital Claims More Victims*, FORTUNE (Dec. 15, 2014), <http://fortune.com/2014/12/15/accounting-scandal-at-american-realty-capital-claims-more-victims/>.

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

¹⁵⁷ Emily Flitter, *Exclusive: American Realty Capital Facing Criminal Probe Over Accounting*, REUTERS (Oct. 31, 2014), <https://www.reuters.com/article/us-usa-arcp-investigation-exclusive/exclusive-american-realty-capital-facing-criminal-probe-over-accounting-sources-idUSKBN0IK2CR20141031>.

¹⁵⁸ Christian Bautista, VEREIT Pays \$85M to Settle Accounting Scandal Class-Action Suits, REAL DEAL (Oct. 2, 2018, 4:45 PM), <https://therealdeal.com/2018/10/02/vereit-pays-85m-to-settle-accounting-scandal-class-action-suits/>. The sentence was eventually reduced to a \$160,000 fine and a lifetime ban from the securities industry. *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ Third Amended Class Action Complaint for Violations of the Fed. Sec. Laws at 19, 47–48, *In re Am. Realty Capital Props. Inc. Litig.*, No. 1:15-mc-00040-AKH (S.D.N.Y. filed Sept. 30, 2016); *In Re American Realty Capital Properties Inc. Litigation*, COHEN MILSTEIN, <https://www.cohenmilstein.com/case-study/re-american-realty-capital-properties-inc-litigation> (last visited June 27, 2019).

¹⁶¹ Third Amended Class Action Complaint for Violations of the Fed. Sec. Laws, *supra* note 160, at 2.

¹⁶² Letter, from Scott A. Edelman, Milbank, Tweed, Hadley & McCloy, to Alvin K. Hellerstein, U.S. Dist. Judge, S. Dist. of N.Y., *American Realty*, No. 1:15-mc-00040-AKH (filed Oct. 15, 2018).

¹⁶³ Vereit Inc. (VER), Second Settlement Reached but at a Higher Price, Mizuho Securities LLC (Oct. 3, 2018), https://ireitinvestor.com/wp-content/uploads/2018/10/vereit_inc_2018-10-03.pdf.

fraud¹⁶⁴—filed a separate securities fraud complaint in the U.S. District Court of the District of Arizona.¹⁶⁵

The class action continues, but the mutual funds have since settled their suits. In June 2018, VEREIT announced that it had settled the Vanguard litigation for \$90 million.¹⁶⁶ A few months later, in October 2018, VEREIT settled with BlackRock and six other funds that together held 11% of the REIT,¹⁶⁷ for \$85 million.¹⁶⁸ These settlements exceeded analyst expectations for the class recovery.¹⁶⁹

4. Valeant

Once a large holding of hedge fund and mutual fund investors alike, the Canadian drug maker's stock lost almost all of its value after its deceptive and abusive business practices came to light. At the company's peak, investors were unaware that Valeant's business strategy relied on price gouging—by its own eventual admission, Valeant would buy a company and immediately raise prices by an average of 66%.¹⁷⁰ To implement this strategy, Valeant “created a secret network of specialty pharmacies” that would raise pharmaceutical prices and engage in other deceptive practices to defraud drug purchasers.¹⁷¹ One of these pharmacies was Philidor, which purported to be independent but was actually created and controlled by Valeant.¹⁷²

By 2015, however, Valeant's pricing strategy was under investigation by Congress, and various media outlets had exposed its deceptive practices.¹⁷³ Soon after, Valeant's true relationship with Philidor, as well as its secret network of pharmacies, was exposed. By October 2015, Philidor shut down, and by February 2016, Valeant admitted to fraudulent accounting and had announced that it was under investigation by the SEC.¹⁷⁴ As each scandal unfolded, Valeant's stock price declined precipitously.

In June 2016, Valeant investors brought a class action in the U.S. District Court for the District of New Jersey alleging violations of the Exchange Act as a result of Valeant's false and misleading statements, as well as its failure to disclose information about its true business practices.¹⁷⁵ Shortly thereafter, T. Rowe Price filed its own direct action against Valeant, on behalf of dozens of its

¹⁶⁴ Konrad Putzire, Vereit Pays Vanguard \$90M over 2014 Accounting Scandal, REAL DEAL (June 11, 2018, 12:40 PM), <https://therealdeal.com/2018/06/11/vereit-pays-vanguard-90m-over-2014-accounting-scandal/>.

¹⁶⁵ Vanguard Specialized Funds v. Vereit Inc., No. CV-15-02157-PHX-ROS, 2016 WL 5858735, at *1–2 (D. Ariz. Oct. 3, 2016).

¹⁶⁶ Putzire, *supra* note 164.

¹⁶⁷ Mizuho Securities Report, *supra* note 163.

¹⁶⁸ Bautista, *supra* note 158.

¹⁶⁹ *Id.* (explaining that the research group, along with other investors, had initially estimated a total settlement amount of \$150-\$450 million for the entire class).

¹⁷⁰ *In re* Valeant Pharm. Int'l, Inc. Sec. Litig., No. 15–7658 (MAS) (LHG), 2017 WL 1658822, at *3 (D.N.J. Apr. 28, 2017).

¹⁷¹ *Id.* (quoting Consol. Complaint for Violations of the Fed. Sec. Laws Demand for Jury Trial, *Valeant*, No. 3:15-cv-07658-MAS-LHG., 2017 WL 1658822 at 30).

¹⁷² *Id.* at *3–5.

¹⁷³ *Id.* at *4–5.

¹⁷⁴ *See id.* at *5.

¹⁷⁵ Case Summary, STAN. L. SCH. SEC. ACTION CLEARINGHOUSE, <http://securities.stanford.edu/filings-case.html?id=105679> (last visited June 28, 2019).

mutual funds, that contained similar charges. Up until April 2016, T. Rowe Price had been Valeant's third-largest shareholder¹⁷⁶ and a steadfast proponent of the company: In March 2016, even after Valeant's misconduct had come to light, T. Rowe Price's top Valeant analyst reassured investors that "many of Valeant's strengths have been overlooked."¹⁷⁷ But by May, T. Rowe had sold most of its Valeant shares, which had continued to fall in price.¹⁷⁸ And by June, T. Rowe Price had sued Valeant and six of its executives directly, alleging that Valeant had engaged in fraud and securities violations.¹⁷⁹

In January 2018—about a year and a half after T. Rowe filed its complaint—BlackRock brought a direct lawsuit against Valeant, on behalf of 80 of its mutual funds, in the U.S. District Court for the District of New Jersey.¹⁸⁰ Like T. Rowe and the class plaintiffs, BlackRock's suit alleged that the company had violated the securities laws by materially misstating or omitting material facts that caused Valeant's price to be artificially inflated.¹⁸¹ The two direct actions, as well as the class action, are still pending.

* * *

These cases demonstrate that mutual funds could participate actively in shareholder litigation if they chose to do so. Indeed, these examples are encouraging, as they demonstrate instances where mutual funds took an active approach to litigation in order to secure additional compensation for investors, as well as deterrence. But the puzzle remains as to why there are so few examples. Many other egregious instances of fraud or misconduct occurred over these past ten years and the ten largest mutual fund families ignored them. Moreover, in each of these instances of obvious misconduct that attracted lawsuits, none were pursued by more than three of the ten mutual fund families in our sample. This indicates that once again, the largest mutual funds are leaving investor money on the table.¹⁸²

B. Mutual Fund Participation in Appraisal Actions

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

¹⁷⁶ Nathan Vardi, *T. Rowe Price, Valeant's Longest Supporter, Alleges Company Committed Fraud*, FORBES (Aug. 18, 2016, 1:18 PM), <https://www.forbes.com/sites/nathanvardi/2016/08/18/t-rowe-price-valeants-longest-supporter-alleges-the-company-committed-fraud/#5a3b8f7928dc>.

¹⁷⁷ Nathan Vardi, *The Investor Who Keeps Sticking By Valeant Pharmaceuticals Longer Than Anyone Else*, FORBES (Mar. 14, 2016, 8:48 AM), <https://www.forbes.com/sites/nathanvardi/2016/03/14/the-investor-who-keeps-sticking-by-valeant-pharmaceuticals-longer-than-anyone-else/#60511edc3d32>.

¹⁷⁸ Vardi, *supra* note 176.

¹⁷⁹ *Id.*

¹⁸⁰ Jennifer Bennett, *Between BlackRock and a Hard Place: Valeant Faces Fraud Suit*, BLOOMBERG L. (Jan. 10, 2018, 2:07 PM), <https://bna.com/pharma-and-life-sciences/between-blackrock-and-a-hard-place-valeant-faces-fraud-suit?context=article-related>.

¹⁸¹ *BlackRock Glo. Allocation Fund, Inc. v. Valeant Pharm. Int'l, Inc.*, No. 18-0343 (MAS) (LHG), 2018 WL 4401727, at *1 (D.N.J. (Sept. 14, 2018)).

¹⁸² *See Cox & Thomas, supra* note 16

prosecuted on behalf of a larger group of dissenting shareholders.¹⁸³ Hence, docket searches under party names will retrieve the names of the petitioners but not the names of other dissenting shareholders. Thus, insofar as a mutual fund does not file as the appraisal petitioner but rather participates as an unnamed dissenting shareholder, their role would not have been captured by the empirical methodology employed in the prior section. Nevertheless, when an appraisal action is filed, the law requires the defendant to provide a “verified list” of all shareholders eligible for appraisal so that the petitioner can coordinate with other dissenting shareholders.¹⁸⁴ The verified list is filed in the public docket of appraisal suits and is thus the key to determining whether unnamed dissenters were involved in seeking appraisal.

In redesigning our search procedures to identify any appraisal suits in which our mutual funds may have participated as non-petitioning dissenting shareholders, we began by compiling a dataset of appraisal suits. To do so, we started with a list maintained by an appraisal arbitrage hedge fund of appraisal petitions filed in the Delaware Court of Chancery over a 10-year period, 2004-2013. The list contained a total of 189 appraisal suits. We then looked up these suits on Bloomberg Law and searched for the verified list in docket. We found the verified list for 157 appraisal suits. We then sought for any reference to our mutual funds on the verified list. We found none. Next, to make the time period of the appraisal sample match our sample of shareholder suits, 2009 through 2018, we searched in the Delaware Court of Chancery Dockets on Bloomberg Law for the term “verified list” for that time period. We found 303 total filings, many of which also appeared on the hedge fund’s list. But again, apart from the T. Rowe Price appraisal petition involving Dell, we found no reference to our mutual funds on the verified lists. This does not mean that mutual funds never engage in appraisal. It is possible that mutual funds have an alternative method of seeking appraisal. For example, perhaps they contribute their shares into a special LLC with no reference to the fund name in order to seek appraisal anonymously.¹⁸⁵ If so, their participation would have escaped our empirical methodology. Having read 10 years’ worth of verified lists, however, we can state that such anonymous entities are rarely involved. The most common dissenters are appraisal hedge funds, individuals, and family trusts. Of course, it is also possible that mutual funds invest in appraisal by investing capital with these specialized appraisal hedge funds. If so, again, they would have escaped our notice. Nevertheless, we have no reason to believe that mutual funds participate in appraisal in this way. And the hedge fund manager we spoke with on this subject noted that, in his experience, this did not occur.

However, there is the well-publicized counter-example of T. Rowe Price’s botched attempt to seek appraisal rights in Dell’s 2013 management buyout. Along with other shareholders, T. Rowe Price was a vocal opponent of the buyout, in which Michael Dell and his consortium of buyers would have paid \$13.75 per share to take the company private.¹⁸⁶ T. Rowe Price had intended to vote against the merger so that it could preserve its appraisal rights, but mistakenly voted in favor due to an administrative error.¹⁸⁷ This mistake ended up costing T. Rowe Price

¹⁸³ See *supra* Section III.B.3.

¹⁸⁴ DEL. CODE ANN. tit. 8, § 262(f) (2019)..

¹⁸⁵ Doing so would enable them to avoid conflict with management. See *infra* Section IV.D.1.

¹⁸⁶ See Guhan Subramanian, *Deal Process Design in Management Buyouts*, 130 HARV. L. REV. 590, 603, 608 (2016).

¹⁸⁷ *Id.* at 609 (citing *In re Appraisal of Dell Inc.*, 143 A.3d 20, 22–23, 32 (Del. Ch. 2016); Matt Chiappardi, *Chancery Knocks T. Rowe Price Funds Out of Dell Appraisal*, LAW360 (May 11, 2016, 5:25 PM), <http://www.law360.com/articles/794983/chancery-knowck-t-rowe-price-funds-out-of-dell-appraisal>

investors dearly. In the appraisal action, the Delaware Court of Chancery determined that the fair value of Dell’s shares was about 20% higher than the amount paid in the buyout, meaning that T. Rowe Price’s investors lost \$194 million.¹⁸⁸ To avoid the prospect of investor lawsuits (and the concomitant bad publicity), T. Rowe Price decided to pay their investors the money that they would have been eligible to receive from Dell.¹⁸⁹

This example demonstrates that mutual funds can participate in appraisal actions—at least, when the deal seems obviously bad for shareholders. In the Dell case, the price appears to have been low enough that T. Rowe Price would have been comfortable scuttling the deal—a genuine risk when a large shareholder perfects their appraisal rights. This sentiment seemed to be validated by the Delaware Court of Chancery’s conclusion that the deal price “shortchanged shareholders by more than \$6 billion.”¹⁹⁰ It seems unlikely, however, that Dell is the only bad deal in which a mutual fund owned shares.

* * *

Our results reveal that mutual funds almost never participate in shareholder litigation: The mutual funds in our set—the largest mutual funds in the world, with a combined \$24 trillion in assets under management—participated in a total of 10 lawsuits, based on only distinct claims, all securities claims, over a 10-year period. To put these numbers in perspective, consider that studies find over 400 securities class actions were filed in 2018 alone, nearly half of which constituted merger claims filed under federal causes of action.¹⁹¹ Excluding merger claims, Cornerstone finds 1,538 securities class actions filed over the course of our ten year sample period.¹⁹² NERA finds 1,863.¹⁹³ Whichever denominator you choose, the 10 lawsuits pursued by mutual fund plaintiffs amount to less than 1% of the total claims available. And that is counting only securities claims, not the many state fiduciary duty and appraisal claims that could have been brought during the same period, of which mutual funds brought none. In sum, this evidence reveals that the largest and most influential mutual funds have essentially forfeited their use of a principal lever to protect investors.

C. Compared to the Litigation Efforts of Other Shareholder Plaintiffs

To put mutual fund litigation into perspective, we compare the litigation record of other shareholder plaintiffs. In the sections that follow, we first compare the litigation conduct of

[<https://perma.cc/5DQG-UQVK>]). Shares must be voted against the transaction in order to have the right to sue for appraisal. § 262(e).

¹⁸⁸ See *In re Appraisal of Dell Inc.*, No. 9322-VCL, 2016 Del. Ch. LEXIS 81, at *167 (Del. Ch.), *rev’d sub nom.*, *Dell, Inc v. Magnetar Glob. Event Driven Master Fund*, 177 A.3d 1, 5 (Del. 2017); H. Adam Prussin, *Huge Appraisal Remedy Awarded in Dell Merger Case*, POMERANTZ MONITOR, July/Aug. 2016, at 1, 2.

¹⁸⁹ Stephen Gandel, *Here’s Why This Investment Fund Had to Refund \$194 Million*, FORTUNE (June 8, 2016), <http://fortune.com/2016/06/08/t-rowe-price-dell/>.

¹⁹⁰ Liz Hoffman, *Judge Raps Dell on Buyout*, Wall St. J., June 1, 2016, at A1.

¹⁹¹ BOETRICH & STARYKH, *supra* note 76, at 2 (counting 441 securities class action filings in federal courts in 2018); CORNERSTONE RESEARCH, *supra* note 76, at 5 (counting 403 securities class action filings in federal courts in 2018).

¹⁹² CORNERSTONE RESEARCH, *supra*, at 5 (counting only “core” securities class actions, most often cases under Rule 10b-5).

¹⁹³ BOETRICH & STARYKH, *supra* note 76, at 5 fig.3 (counting all federal securities filings except merger objection claims).

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

1. Public Pension Funds

Much of the literature on institutional plaintiffs in shareholder suits focuses on pension funds, especially public pension funds and labor union funds, both of which have established reputations as especially active shareholder litigants.¹⁹⁴ The reputation is not entirely positive. Some of this literature identifies ways in which pension fund managers' incentives in shareholder suits depart from the interests of their investors.¹⁹⁵ Furthermore, studies document ways in which pension fund involvement has led to the transfer of pay-to-play emoluments between plaintiffs' lawyers and pension fund managers.¹⁹⁶ We acknowledge these problems but nevertheless ask: How does the record of pension funds in shareholder litigation compare with that of mutual funds?

We ran a series of docket searches for the ten largest pension funds by assets under management parallel to the searches we had run for the ten largest mutual funds. We searched Bloomberg Law, for a period running from January 2009 through December 2018, for all cases in federal district courts and in the Delaware Court of Chancery in which any of the ten largest public pension funds appeared as a named party. The pension funds we searched included: CalSTERS, CalPERS, New York State Common Retirement Fund, Florida SBA, Texas Teachers, New York State Teachers, State of Wisconsin Investment Board, North Carolina Retirement, and Washington State Investment Board. These funds were more active than mutual funds, bring a combined total of 31 shareholder suits—more than three times as many as the ten largest mutual fund investors—over the period, against a total of 22 defendants. That is so despite managing smaller portfolios—for example, CalPERS, the largest U.S. pension fund, manages \$326 billion in assets,¹⁹⁷ compared to BlackRock, which manages nearly \$6 trillion.¹⁹⁸ Not only that, pension fund portfolios are likely to be less diversified than mutual fund portfolios, meaning that there are fewer attractive litigation opportunities.

In addition to higher overall numbers, there was a greater diversity in the type of shareholder suits brought by pension funds. Like the mutual fund cases we found, the pension fund suits were skewed towards securities claims, and the securities claims were predominantly 10b-5 class actions. But three pension fund suits were based on state law causes of action, as compared to zero for mutual fund litigants. Many of these suits resulted in large settlement

¹⁹⁴ See DAVID H. WEBBER, *THE RISE OF THE WORKING-CLASS SHAREHOLDER* xii (2018).

¹⁹⁵ See, e.g., Roberta Romano, *Public Pension Fund Activism In Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993) (arguing that “public pension funds face distinctive investment conflicts that limit the benefits of their activism”).

¹⁹⁶ See, e.g., Stephen J. Choi, Drew T. Johnson-Skinner, & A.C. Pritchard, *The Price of Pay to Play in Securities Class Actions*, 8 J. Empir. Legal Stud. 650 (2011).

¹⁹⁷ CALPERS, CALPERS AT A GLANCE (2017), <https://www.calpers.ca.gov/docs/forms-publications/calpers-at-a-glance.pdf>.

¹⁹⁸ Christine Williamson, *BlackRock's AUM Down for the Quarter, Year*, PENSIONS & INV. (Jan. 16, 2019, 12:00 AM), <https://www.pionline.com/article/20190116/ONLINE/190119897/blackrocks-aum-down-for-the-quarter-year>.

payments,¹⁹⁹ as well as corporate governance reforms—as an example of the latter, the pension fund CalPERS successfully convinced IAC to abandon its plan to issue non-voting stock that would have solidified the controlling shareholder’s control over the company.²⁰⁰

Although we limited our analysis to the ten largest pension funds, a pension fund’s incentives to litigate may not increase with size. A pension fund’s board members are appointed by politicians or directly elected by voters.²⁰¹ Accordingly, litigation activity may provide a way for the fund’s board to demonstrate alignment with investors and politicians—regardless of the size of the pension fund’s investment in the underlying company. For these reasons, earlier studies that looked beyond the ten largest pension funds reported even starker differences in litigation patterns. For example, in a study of shareholder-derivative and class action lawsuits challenging M&A transactions filed in the Delaware Court of Chancery from November 1, 2003 to December 31, 2009, David Webber finds that public pension funds and labor union funds dominate the litigation process, while mutual funds play a minimal role.²⁰² Specifically, of the 137 claims involving an institutional lead plaintiff in his dataset, Webber found only seven in which a mutual fund served as lead plaintiff. By contrast, pension and union funds served as a lead plaintiff for 60 cases, and private non-mutual funds (which include private equity funds and hedge funds) were lead plaintiffs for the remainder. Mutual funds have more assets under management than public pension funds do, and they have substantial stakes in the transactions that were subject to litigation. They would appear to be excellent lead plaintiff candidates, but they do not apply for the job.²⁰³ Another study found similar results with regard to securities class actions. Of 1,811 securities class actions from 1996 to 2005, 97 were led by public pension funds, 61 had union pension fund lead plaintiffs, but only 12 featured mutual funds as lead plaintiffs.²⁰⁴

¹⁹⁹ As a few examples, pension fund litigants won large settlement payments in suits filed against the following companies: Big Lots, Inc. (\$3.5 million payment to the company in addition to governance and compliance reforms); Green Mountain Coffee Roasters (\$36.5 million payment); and CBOT Holdings (\$475 million in additional deal compensation). See Notice of Pendency and Proposed Settlement of Stockholder Derivative Action at 11–13, *In re Big Lots, Inc. S’holder Litig.*, Nos. 2:12-cv-445; 2:12-cv-447; 2:12-cv-590; 1:13-cv-753, 2017 U.S. Dist. LEXIS 65027 (S.D. Ohio 2017); Notice of (I) Pendency of Class Action & Class Certification; (II) Proposed Settlement; (III) Motion for an Award of Attorneys’ Fees and Reimbursement of Litig. Expenses; & (IV) Settlement Fairness Hearing at 1, *La. Mun. Police Emps.’ Ret. Sys. v. Green Mountain Coffee Roasters, Inc.*, No. 2:11-CV-00289-WKS (D. Vt. filed); *CBOT Holdings, Inc.*, Bernstein Litowitz Berger & Grossmann LLP, <https://www.blbglaw.com/cases/00016> (last visited July 1, 2019).

²⁰⁰ *In Response to CalPERS Lawsuit, IAC Abandons Plan to Issue Non-Voting Stock*, CALPERS (June 23, 2017), <https://www.calpers.ca.gov/page/newsroom/calpers-news/2017/interactivecorp-abandons-plan-non-voting-stock>.

²⁰¹ Edward B. Rock, *Institutional Investors in Corporate Governance*, in THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 363, 367 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018).

²⁰² Webber, *supra* note 15, at 26, 29 tbl.2.

²⁰³ *Id.* at 34 (noting that pension funds “are sophisticated and credible, and Delaware judges would likely be eager to appoint them if they applied. But they don’t.”); see also Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1048 (2007)(discussing the advantages and disadvantages of mutual fund monitoring, especially their size).

²⁰⁴ C.S. Cheng, et al., *Institutional Monitoring Through Shareholder Litigation*, 95 J. Fin. Econ. 356 (2010). There is also evidence that some institutional-investor lead plaintiffs in securities fraud class actions, notably public-pension funds, provide better shareholder outcomes in the form of higher settlements, lower attorneys’ fees, and improved board independence. *Id.*, at 357-58; Stephen J. Choi et al., *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 WASH. U. L.Q. 869, 895–96 (2005); James D. Cox, Randall S. Thomas & Lynn Bai, *There Are Plaintiffs and . . . There Are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*, 61 VAND. L. REV. 355, 379 (2008); Michael Perino, *Institutional Activism Through*

We ran an additional docket search for the litigation activity of the Louisiana Municipal Police Employee Retirement Fund (“LAMPERS”), which is not among the largest but is reputed to be one of the most active institutional plaintiffs. Our results confirm this reputation. LAMPERS was involved in 93 shareholder claims over the ten-year period we studied. These claims included a large number of both state law fiduciary duty claims as well as federal securities class actions, predominantly under Rule 10b-5 but also including a small number of claims brought under Sections 11, 12(a)(2), and 15 of the Securities Act as well as Section 14(a) of the Securities Exchange Act.

Why are pension funds much more active participants in litigation than their mutual fund counterparts? In addition to their political motivations, there are other factors at play. Public pension funds, unlike mutual funds, do not count on corporations as a source of revenue.²⁰⁵ Furthermore, there may be less network overlap between the boards of public pension funds—which may consist of fire-fighters, police officers, and teachers—and corporate boards of directors, which may more closely resemble mutual fund boards.²⁰⁶ Each of these factors may contribute to greater willingness, on the part of public pension funds, to pursue litigation against corporate defendants. Additionally, public pension funds do not compete with each other for cash inflows. Instead, all covered employees contribute.²⁰⁷ Because pension funds do not compete with each other for pension assets, any reluctance on the part of pension funds to engage in conduct that might also benefit their competitors—the collective action problem we describe below—is non-existent. As state-sponsored monopolists, public pension funds are free to make litigation decisions without regard to the effect on their (non-existent) competitors.

None of this is to say that public pension funds engage in the optimal amount of litigation. As discussed, they have their own agency problems, including heightened vulnerability to political influence.²⁰⁸ Our point here is simply to demonstrate the different approaches that pension funds and mutual funds take to shareholder litigation. Pension funds are far more likely to assert claims against portfolio corporations. They are more likely to assert these claims in class action form. And they are more likely to seek appointment as lead plaintiff.

2. Hedge Funds and Individual Plaintiffs

We also gathered data on the litigation record of hedge funds and individual plaintiffs. We ran the same Bloomberg docket search—January 2009 through December 2018 for all cases in federal district courts and the Delaware Court of Chancery—for the ten largest activist hedge funds (by equity assets) that had been involved in at least 25 campaigns: Icahn Associates Holding

Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions, 9 J EMPIR. LEGAL STUD. 368, 369-70 (2012).

²⁰⁵ Which is to say they are unaffected by Corporate Client Conflict, discussed *infra* Part IV.D.1. *Accord* Webber, *supra* note 15, at 36–37.

²⁰⁶ *Id.*; *see also* Rock & Kahan, *supra* note 5, at .

²⁰⁷ *See* Webber, *supra* note 15, at 35 (explaining that public pensions funds have “no true competitors” because “[i]f a fund beneficiary is unhappy with the fund's performance, the beneficiary's only option is to change jobs, not move one's retirement savings to a competitor.”).

²⁰⁸ Note that this political influence may lead to too little or too much litigation, depending on the political alignment of the politicians who appoint them. For example, politician contributions from large corporations may reduce incentives to sue, whereas contributions from the plaintiffs' bar would likely increase them. *See* CALPERS, *supra* note 196.

LLC, Elliot Management Corp., GAMCO Asset Management, Inc., ValueAct Capital Management LP, Triam Fund Management LP, Southeastern Asset Management, Inc., Third Point LLC, Pershing Square Capital Management, Carlson Capital LP, and Starboard Value LP.²⁰⁹ We also ran a similar search for the litigation activity of individuals who have repeatedly served as shareholder plaintiffs.

The hedge funds in our sample did not file a vast quantity of claims. We found 21 distinct investor suits filed by the ten hedge funds over a 10-year period.²¹⁰ But a relatively small number of intensely litigated cases is commensurate with an activist hedge fund's investment strategy—hedge funds are not broadly diversified, and instead make large, concentrated investments in a small number of companies.²¹¹ As such, we would expect that their overall litigation record would involve a much smaller number of companies than that of broadly diversified mutual funds.

In addition, the cases pursued by hedge funds are qualitatively different from the cases brought by mutual funds. For one, the hedge fund cases are more often state law fiduciary duty claims than federal securities claims. We found only five investor lawsuits filed in federal district court by the hedge funds in our sample.²¹² By contrast, recall that apart from a single appraisal claim, the mutual funds in our study exclusively brought claims under Rule 10b-5 of the federal securities laws. They did not bring a single state fiduciary duty suit.²¹³

The hedge fund cases in our sample directly related to the funds' governance interventions in portfolio companies. Four cases involved petitions for appraisal.²¹⁴ The remainder were state

²⁰⁹ See SharkWatch 50 (Key Activists), accessed May 15, 2019.

²¹⁰ This number represents distinct causes of action, not necessarily distinct claims. For example, funds controlled by Third Point filed six separate appraisal claims involving Petsmart, which were later consolidated into a single action. See *In re Appraisal of Petsmart, Inc.*, No. 10782-VCN (Del. Ch. Apr. 30, 2015). Likewise, Icahn Partners filed two different fiduciary duty suits involving Amylin Pharmaceuticals, one seeking books and records, and another for breach of fiduciary duty relating to board conduct in connection with an acquisition offer. See *Icahn Partners LP v. Amylin Pharmaceuticals, Inc.*, No. 7418-CS, (Del. Ch. Apr. 12, 2012) (books and records); *Icahn Partners LP v. Amylin Pharm. Inc.*, No. 7404-VCN, 2012 Del. Ch. LEXIS 85 at *1–2 (Del. Ch. Apr. 9, 2012) (breach of fiduciary duty). We counted these claims as one and counted all claims involving the same plaintiff against the same defendant for the same underlying conduct a single time. Two fiduciary duty claims brought by Icahn Enterprises against Dell for different underlying conduct were counted separately. See *High River Limited Partnership v. Dell Technologies Inc.*, 2018-0790-AGB (Del. Ch., Oct. 31, 2018) (requesting inspection of corporate books and records); *High River Limited Partnership et al vs Dell Inc et al.*, 8762-CS (Del. Ch. Aug. 1, 2013) (suit alleging breach of fiduciary duty in connection with Michael Dell's management buyout).

²¹¹ Kahan & Rock, *supra* note 203, at 1062.

²¹² Three of these were 10b-5 cases filed as individual actions (two by Elliott, one by GAMCO). See *Elliott Assocs., L.P. v. AbbVie Inc.*, No. 1:17-cv-03494 (N.D. Ill. May 09, 2017); *Elliott Assocs., L.P. v. Porsche Automobil Holding SE*, 759 F. Supp. 2d 469, 470 (S.D.N.Y. 2010); *Gamco Glob. Series Funds, Inc. v. Vivendi S.A.*, No. 1:09-cv-07962 (S.D.N.Y. Sept 16, 2009). One was a 10b-5 class action filed by GAMCO. *In re Akorn, Inc. Data Integrity Sec. Litig.*, No. 1:18-cv-01713 (N.D. Ill. Mar 08, 2018). The fifth case was a federal court case brought by Pershing Square in the wake of the financial crisis claim alleging that the U.S. Treasury Department illegally deprived them of the value of their investment in Fannie Mae and Freddie Mac. See *Rafter v. Dep't of the Treasury*, No. 1:14-cv-01404-RCL (Dist. Colum. Aug 15, 2014).

²¹³ See *supra* notes 127-128 and accompanying text.

²¹⁴ *In re Appraisal of Petsmart, Inc.*, No. 10782-VCN (Del. Ch. Apr. 30, 2015). The other three appraisal cases were all brought by GAMCO. See *Gabelli Small Cap Growth, Gabelli ABC Fund, v. Federal-Mogul Holdings LLC f/k/a Federal-Mogul Holdings Corp.*, No. 2017-0330 (Del. Ch. May 01, 2017); *Gabelli Securities, Inc., v. Crown Media Holdings, Inc.*, No. 12680 (Del. Ch. Aug 23, 2016); *In re Zale Corp. Appraisal Litig.*, No. 9731 (Del. Ch. 2014).

corporate law claims relating directly to activist interventions. Several of the suits in our sample involve books and records requests, seeking information that will either help the activists challenge management or simply provide access to the shareholder list so that the activist can lobby shareholders directly.²¹⁵ Several claims seek to compel shareholder meetings in connections with proxy fights.²¹⁶ Other suits allege breaches of fiduciary duty in connection with specific transactions.²¹⁷ With the exception of Pershing Square's claim against the Treasury Department and Third Point's appraisal claim, all of the hedge fund claims we found were motivated by deterrence or governance objectives, not the desire to win compensation in the lawsuit itself. Hedge funds litigate for leverage to support their interventions. To paraphrase von Clausewitz, their lawsuits are governance by other means.²¹⁸

Finally, it is worth noting that the hedge funds' claims were generally not brought in a class or other representative capacity. Third Point's breach of fiduciary duty claim to invalidate Sotheby's poison pill was ultimately joined by class action plaintiffs (two pension funds: LAMPERS and the Employees Retirement System of the City of St. Louis) and consolidated into a single action.²¹⁹ None of the other hedge fund cases we found was litigated as a class action. Instead, all were direct actions filed by the hedge fund as named plaintiff.

As a final comparison, we examined the litigation patterns of repeat-play individual plaintiffs. One of us has recently studied litigation filed by seven individuals who regularly appear as named plaintiffs in shareholder suits—Robert Berg, Stephen Bushansky, Natalie Gordon, Paul Parshall, Matthew Sciabacucci, John Solak, and Shiva Stein.²²⁰ Over a five year period, from 2014 through 2018, half the time period of our mutual fund study, these seven plaintiffs filed 281 shareholder suits. The vast majority of these lawsuits (76%) involve challenges to mergers and acquisition transactions, which are typically settled for non-pecuniary relief or for mootness fees.²²¹

²¹⁵ See, e.g., *High River Ltd. P'ship v. Dell Techs. Inc.*, No. 2018-0790-AGB, (Del. Ch. Oct. 31, 2018); *High River Ltd. P'ship v. Forest Labs., Inc.*, No. 7663-ML, 2013 Del. Ch. LEXIS 40, at *1–2 (Del. Ch. June 28, 2012); *Icahn Partners LP v. Amylin Pharm. Inc.*, No. 7418-CS (Del. Ch. Apr. 12, 2012); Verified Complaint Pursuant to 8 *Del. C. §220* at 13, *High River Ltd. P'ship v. Forest Labs., Inc.*, No. 6614-CS, 2011 WL 3528152 (Del. Ch. filed June 28, 2011).

²¹⁶ See, e.g., *High River Ltd. P'ship v. Biogen Idec Inc.*, No. 4642-VCS (Del. Ch. June 3, 2009); *P S Fund 1 LLC v. Allergan Inc.*, No. 9760-CB (Del. Ch. June 13, 2014); *Starboard Value and Opportunity Master Fund Ltd. v. comScore, Inc.*, 2017-0533-AGB, Del. Ch. July 27, 2017; *Starboard Value and Opportunity Master Fund Ltd. v. Office Depot, Inc.*, No. 8640-VCL (Del. Ch. June 12, 2013).

²¹⁷ See, e.g., *Emps. Ret. Sys. of of St. Louis v. Sotheby's*, No. 9497-VCP (Del. Ch. Apr. 1, 2014); *Icahn Partners, LP, v. Barry D. Zyskind*, No. 2018-0358-AGB (Del. Ch. 2018); *High River Ltd. P'ship v. Dell, Inc.*, 8762-CS (Del. Ch. Aug. 1, 2013); *Icahn Partners LP v. Amylin Pharm. Inc.*, No. 7404-VCN, 2012 Del. Ch. LEXIS 85 at *1–2 (Del. Ch. April 20, 2012).

Icahn brought cases against Dell (books & records and breach of FD), AmTrust Financial (to halt IPO),

²¹⁸ CARL VON CLAUSEWITZ, ON WAR, HOWARD & PARET EDS., 87 (1983) ("War is the continuation of politics by other means.").

²¹⁹ *Third Point LLC v. Ruprecht*, Nos. 9469-VCP, 9497-VCP, 9508-VCP, 2014 WL 1922029, at (Del. Ch. May 2, 2014).

²²⁰ Sean J. Griffith, *Class Action Nuisance Suits: Evidence from Frequent Filer Shareholder Plaintiffs*, in CAMBRIDGE INTERNATIONAL HANDBOOK OF CLASS ACTIONS, FITZPATRICK & THOMAS, EDS. (forthcoming 2020), available at [SSRN CITE].

²²¹ *Id.*, at 7.

Initially, these plaintiffs filed the bulk of their lawsuits in state court, but this trend has now reversed, with most of their claims now being filed in federal court. The transformation took place over our collection period. In 2014, 82% of these plaintiffs' claims were brought in state courts. In 2015, the percentage of their claims brought in state court fell to 68%, then fell even more dramatically in 2016 to 41%. By 2017 and 2018, the relationship had flipped completely, with 96% and 87% of their claims being brought in federal rather than state court.²²² This reversal is likely a direct response to the Delaware Court of Chancery's *Trulia* opinion, which made it more difficult to settle merger cases for non-pecuniary relief.²²³ Such cases are the bread and butter claims of these plaintiffs. Rather than dropping them claims, these plaintiffs merely shifted them to federal court, bringing them under Section 14a of the Exchange Act, to which *Trulia* does not apply.²²⁴

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

IV. Why Don't Mutual Funds Participate in Shareholder Litigation?

The most striking outcome of the empirical analysis above is the simple finding that mutual funds generally do not participate in shareholder litigation. Over the ten-year time period we studied, mutual funds rarely pursued securities claims, filed a single appraisal case and never participated in state law fiduciary duty suits. By contrast, pension funds litigated frequently across a variety of claims; hedge funds used state fiduciary duty suits as leverage in activist interventions; and repeat-play individual claimants filed a mass of claims. While we do not mean to suggest that all of these suits would have benefitted mutual fund investors if pursued, there are many examples of missed opportunities. Most obviously, the claims against Valeant, Countrywide, Petrobras, and American Realty only attracted the attention of a few funds in our sample; other funds with standing to sue missed out on large settlement payments.

Nor do the data suggest that mutual funds are merely free-riding, letting others do the hard work of litigation, while they stand to collect the benefits. Mutual funds often fail to claim settlement proceeds at the end of class action cases.²²⁵ Furthermore, mutual funds exert no

²²² *Id.*, at 9-10.

²²³ See *supra* Section II.B.2.

²²⁴ Griffith, *supra* note 102.

²²⁵ See James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 424 (2005) (finding that only 28% of institutional investors filed claims to collect settlement proceeds, effectively leaving substantial sums of money unclaimed); see also Glater, *supra* note 121 (noting lawsuits filed in the wake of this discovery). More recent work suggests not much has changed in this regard. See *10 Years Removed from Cox & Thomas: A Survey of the Claims Filing Landscape for U.S. and Non-U.S. Securities Litigation Recoveries*, KESSLER TOPAZ MESLITZER CHECK LLP (Nov. 5, 2015), <https://www.ktmc.com/news/10-years-removed-from-cox-thomas-a-survey> (estimating that 35% of eligible

apparent effort to channel the conduct of such litigation or to prevent litigation agency costs from wasting corporate assets. In other words, with rare exceptions, mutual funds participated in shareholder litigation in essentially the same way as rationally apathetic shareholders—by staying out of it.²²⁶

These results are surprising given the large blocks held by the mutual funds in our sample. For example, Vanguard has at least a 5% stake in nearly every S&P 500 company.²²⁷ A stake of that size should provide a powerful incentive to participate in litigation that might lead to shareholder compensation. It would also provide the fund with the ability to shape litigation outcomes and contain litigation agency costs if it was interested in doing so.

Furthermore, mutual funds tend to be diversified across the market, which makes them repeat players in litigation and governance. Because they can anticipate that similar issues will recur again and again in their portfolio, they ought to have strong incentives to use litigation to achieve market-wide deterrence and governance benefits. If a shareholder lawsuit will deter bad behavior, the mutual fund will accrue benefits across their broad portfolio. Additionally, mutual funds' limited exit options should increase the desirability of using litigation to implement deterrence and governance reform. This is especially true for the large index fund providers: As Bill McNabb, the former CEO of Vanguard put it: “Index fund managers must care as much as—if not more than—anybody else. We essentially own stocks forever, because we can't sell out of a stock listed on an index.”²²⁸

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

A. Legal Barriers

It is possible that some kinds of shareholder claims present substantive legal barriers that prevent mutual funds from taking a leading role. For example, 10b-5 claims require both that the claimant be a “purchaser or seller” of the underlying security and that the claimant relied upon the defendant's misrepresentation in transacting in the security, both of which may present difficulties for index funds in particular.²²⁹ As long-term investors, most of an index fund's investment in the relevant company will have been acquired prior to the defendant's false statements and held through to the revelation of truth. Index funds, in other words, will generally be holders, not buyers or sellers, and the bulk of their portfolio may thus be ineligible to bring a 10b-5 claim.

institutional investors claim settlement proceeds); *see also* Jessica Erickson, *Automating Securities Class Action Settlements*, VAND. L. REV. (forthcoming 2019) (reporting conversations with claims administrators who estimate that “approximately 20 to 25 percent of eligible shares will file claims”)

²²⁶ John C. Coffee, Jr., *Litigation Governance: Taking Accountability Seriously*, 110 COLUM. L. REV. 288, 304 (2010) (stating that “the same apathy that confounds the opt-in class action at the outset also arises at the back end of the opt-out class action when claims must be filed”).

²²⁷ Fichtner et al., *supra* note 4, at 311.

²²⁸ McNabb, *supra* note 11.

²²⁹ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 738 (1975).

Nevertheless, even index funds engage in significant trading activity.²³⁰ Index funds trade each time an investor buys into or sells out of the fund. Furthermore, index funds trade in order to bring their portfolio holdings in line with the index they track. As a result, although a large portion of their assets under management may not trade during the relevant period, it is highly likely that large index funds will engage in at least some trading during the period. As a result, index funds likely have standing to be involved in virtually every claim.

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

While we acknowledge that this argument renders reliance contestable, we also think index funds have a powerful reply, based upon the dynamics of fraud on the market.²³¹ The price of a portfolio company's shares determines its proportional representation in an index.²³² As a result, if fraud inflates prices, it will also lead to a security's over-representation in the index. Hence, in buying shares based upon a security's proportional representation in an index, the fund buys more (or less) of the security than it otherwise would as a result of the fraudulent inflation (or deflation) of the security's price. This is just a further link in the chain of reliance. Funds may not trade in direct reliance on price, but they do buy in reliance on the security's proportional representation in the index, which is determined by price. Fraud thus affects an index fund's investment much as it does an active investor who trades based on price. The reliance requirement likely does not pose a meaningful barrier.

Furthermore, contrary to what we have just argued, if either reliance or the purchaser/seller requirement were the primary barrier to mutual fund participation in shareholder litigation, we would expect active funds to be more involved in shareholder litigation than index funds.²³³ Yet this is not the case. None of our empirical investigations into the litigation activity of mutual funds suggested any difference between active and passive funds, or more specifically, mutual fund companies that predominantly offer active funds (such as T. Rowe Price and Fidelity) and those that predominantly offer passive funds (such as Vanguard and State Street). Their participation in shareholder litigation is essentially indistinguishable. This suggests that substantive legal rules are not the problem.

²³⁰ See generally Davidson Heath, et al., *Passive Investors Are Passive Monitors* (Mar. 15, 2018) (unpublished manuscript), https://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=AFA2019&paper_id=1827 (documenting trading by passive and indexed mutual funds).

²³¹ See *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258, 274–77 (2014) (reaffirming the fraud on the market theory); see also *Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1988) (adopting the fraud on the market theory).

²³² See, e.g., Chad Langager, *How Is the Value of the S&P 500 Calculated?*, INVESTOPEDIA, <https://www.investopedia.com/ask/answers/05/sp500calculation.asp> (last updated June 28, 2019).

²³³ Active funds seek to overweight good performing companies and underweight bad performing companies. See generally Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2048 (1994) (“Overweighting means that the institution owns a greater share of the specific company than it owns of the market generally. An overweighted firm has a greater incentive to intervene, because it will gain more from success than its competitors.”).

Finally, not only are mutual funds *eligible* plaintiffs in securities suits (and indeed, in each of the shareholder suits we identified above), they are *ideal* plaintiffs in derivative suits. Because they are paradigmatic long-term investors, index funds easily satisfy the requirement that derivative plaintiffs hold shares from the time of injury through conclusion of the suit (the “contemporaneous ownership” requirement).²³⁴ The contemporaneous ownership requirement may pose an obstacle to active traders who prefer exit to litigation, but because long term shareholding is the core of their investment strategy, it poses no obstacle to index funds. Yet we could not find a single derivative suit filed by an index fund (or any of our mutual funds) over a ten-year period. The explanation must be something other than substantive legal barriers.

B. Structural Obstacles

A second possibility is that the structure of ownership rights and decisionmaking authority allocated to mutual funds presents an obstacle to active participation in shareholder litigation. As discussed, the power to bring litigation on the basis of portfolio company holdings is a default feature of the standard mutual fund investment contract.²³⁵ But not every mutual fund investor gets the standard contract. Approximately 11% of mutual fund investors are institutions—funds, corporations, and financial institutions—not individuals.²³⁶ Those institutional investors may have different contractual relationships with the mutual fund family than the individuals who invest in managed accounts. For example, some institutional clients contract for investment advisory services only.²³⁷ Pursuant to these arrangements, institutional clients may retain their voting and litigation rights.

This division of rights can present problems for the mutual fund complex, which will not be able to sue on behalf of the clients that have retained their litigation rights. In general, mutual fund families opt to solicit consent from those institutional clients before bringing a shareholder suit. Some investors might never consent to litigate,²³⁸ and administrative difficulties associated with soliciting and obtaining investor consent might deter mutual funds from bringing shareholder suits in the first place. While we recognize that this administrative difficulty exists, we do not view it as a substantial impediment to shareholder litigation. For example, funds could issue different shares to institutional and individual clients in order to separate those on whose behalf they or do not have the right to litigate.²³⁹

²³⁴ See generally J. Travis Laster, *Goodbye to the Contemporaneous Ownership Requirement*, 33 DEL. J. CORP. L. 673 (2008) (discussing the contemporaneous ownership requirement and recommending that it be eliminated).

²³⁵ See *supra* note 121 and accompanying text.

²³⁶ COLLINS ET AL., *supra* note 3 (showing that institutions held 11% of mutual fund assets in 2015).

²³⁷ See, e.g., VANGUARD. VANGUARD INSTITUTIONAL ADVISORY SERVICES, 1 (2016), <https://institutional.vanguard.com/iam/pdf/OCIOEXEC.pdf> (explaining that institutions can secure Vanguard as a co-fiduciary and retain investment advice for assets that remain under institutional management).

²³⁸ For example, a corporate pension fund (e.g., the Apple 401(k) plan) seems unlikely to consent to litigation against the corporate issuer (Apple). See *infra* Part IV.D.1.

²³⁹ The practice would be similar to issuing different classes of shares to track different fee arrangements, a practice currently followed by several mutual funds in order to reward (and encourage) higher investment amounts. For example, Vanguard offers lower expense ratios its “Admiral” class shares, which differ from its “Individual” class shares only in their minimum investment thresholds. See Vanguard Group, “Admiral Shares help keep your costs under control,” available at <https://investor.vanguard.com/mutual-funds/admiral-shares?WT.srch=1&cmpgn=PS:RE>.

Perhaps the obstacle is not the organization of the fund's investors, but rather the organization of fund management. The mutual fund representatives that we spoke to informed us that litigation decisions are often siloed in the general counsel's office and made without input from either the stewardship group charged with overseeing portfolio company governance or the portfolio managers charged with making investment decisions. Insofar as fund's litigation activities are housed in the general counsel's office, distinct from fund management, then those with the best information and expertise—that is, portfolio managers with intimate knowledge of the companies in which they invest—may be unable to influence whether and how litigation proceeds. Note too that legal departments are generally seen as cost rather than profit centers, suggesting incentives—remaining within budget and mitigating risk—that are inconsistent with entrepreneurial litigation. As a result, they may disfavor bringing even those claims that are suggested to them by portfolio managers.²⁴⁰

Still, while we acknowledge that organizational obstacles can pose a challenge, such problems are entirely within the power of fund families to solve. The siloing of legal and operational departments can be solved by reorganizing reporting lines within the firm and empowering fund managers or stewardship groups to consider at least some kinds of shareholder claims. Moreover, funds could hire outside law firms to assist in these efforts; they could also hire in-house attorneys to assist fund managers and members of the stewardship team in evaluating and monitoring claims.²⁴¹ These costs would more than pay for themselves if they resulted in just one additional recovery each year.²⁴² The fact that funds have generally not made these changes suggests that some factor other than structural obstacles explains the failure to participate in shareholder litigation.

C. Circularity

Perhaps it is the structure of mutual fund holdings, not their organizational structure, that inhibits shareholder litigation. Mutual funds are broadly diversified. Index funds, in particular, own essentially all publicly traded securities. As a result, some shareholder suits instigated by a mutual fund will be paid by the fund itself, as a shareholder of the corporate defendant.²⁴³ This, of course, is a version of the circularity problem reviewed above.²⁴⁴

In our conversations with mutual fund representatives, they emphasized the circularity problem in answering why they are not more active participants in shareholder litigation. And they have a point. The circularity critique applies against several of the forms of shareholder

²⁴⁰ Portfolio managers may have their own reasons for avoiding litigation, such as a fear of having their access to management cut off as a result of bringing a claim. See Bebchuk & Hirst, *supra* note 14. We consider these incentive conflicts below. See *infra* Part IV.D.1.

²⁴¹ Many mutual fund families are in the process of expanding their stewardship groups. See, e.g., Ning Chiu, *BlackRock's Annual Letter to CEOs Focuses on Doing Good and Continues to Emphasize Governance and Strategy*, DAVIS POLK (Jan. 17, 2018), <https://www.briefinggovernance.com/2018/01/blackrocks-annual-letter-to-ceos-focuses-on-doing-good-and-continues-to-emphasize-governance-and-strategy/> (explaining that BlackRock plans to double the size of its corporate governance group).

²⁴² As Section III.A reveals, mutual funds can reap tens of millions of dollars when settling claims against portfolio companies.

²⁴³ Amanda M. Rose & Richard Squire, *Intraportfolio Litigation*, 105 NW. U. L. REV. 1679, 1688 n.32 (2011).

²⁴⁴ See *supra* notes 109–112 and accompanying text.

litigation we reviewed above. Circularity suggests that compensation from successful securities class actions and even derivative suits are unimportant to long-term diversified shareholders. Circularity would also apply in the rare merger cases that recover additional deal compensation, provided that both the buyer and the target are represented in the fund's portfolio. In such cases, broadly diversified long term shareholders would not necessarily prefer that the buyer pay more for the target company since they are effectively paying themselves.²⁴⁵ However, in this context, the extent of the circularity problem depends on the relative weight of a fund's holdings. For example, a fund with a substantially larger economic stake in the target than the acquiring company may still have incentives to pursue merger litigation or seek appraisal.²⁴⁶

More fundamentally, however, compensation is not the only goal of shareholder litigation. Shareholder suits can also provide deterrence and governance enhancements. Lawsuits that actively police managerial misconduct will benefit the fund across its holdings not only by punishing misconduct when it occurs but also by discouraging misconduct at other firms in the portfolio. Likewise, governance-enhancements extracted through litigation may improve the performance of firms in the portfolio, leading other firms to copy these innovations, and enhancing the value of the portfolio as a whole.

Moreover, not all shareholder suits are intra-portfolio. Shareholder suits may also arise against firms as they exit the portfolio. In some cases, the mutual fund may be able to exit from the investment by selling down shares: for example, T. Rowe Price's actively managed funds unloaded the bulk of their Valeant shares before commencing litigation against the drug company.²⁴⁷ But not all funds will be able to exit by selling their shares. In those circumstances, a company can still exit the fund's portfolio through bankruptcy or acquisition, in which case compensation paid to shareholder plaintiffs would not be funded by other public shareholders. For example, a severe fraud may push a company into bankruptcy, in which case shareholder recoveries from securities or fiduciary duty lawsuits come not from other public shareholders but from assets otherwise available to creditors of the firm.²⁴⁸ Shareholder suits against Enron and WorldCom, firms driven into bankruptcy by managerial misconduct, were not funded by public company shareholders and therefore do not present the circularity problem.

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

²⁴⁵ Because broadly diversified shareholders are as sensitive to overpayment as they are to underpayment, they would have a preference for passivity in takeover defense. See Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management In Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981). For index funds, however, the incentives may be slightly different. Index funds are likely to own a proportionally greater interest in large market cap companies than in small market cap companies due to their weighting in the index. See *supra* notes 232–233 and accompanying text. Their interest in M&A thus depends on who is buying whom. If the deal is one in which a large company buys a smaller one, as is often the case, the index fund may prefer to pay the smallest possible premium because they are more exposed to overpayment than underpayment. This will be a systematic preference. Index funds will be indifferent to premia only in deals in which companies of similar size (and therefore similar weigh in the index) acquire each other.

²⁴⁶ For index funds, however, this will not often be the case. As long as the acquiror is the larger company (as it usually is) and the index is weighed by company size (as indexes usually are), the acquiror will likely be a larger part of the index portfolio than the target.

²⁴⁷ See *supra* Section III.A.4.

²⁴⁸ They likely come from D&O insurance proceeds. See Baker & Griffith, *supra* note 111, at 1826 (discussing how D&O policies may become an asset of the bankruptcy estate).

not by definition have a public company buyer, public company investors are not on both sides of the transaction. The Dell transaction we discussed above is a good example of this.²⁴⁹ As a result, shareholder suits that cause additional consideration to be paid in take-private transactions, whether these suits are brought as fiduciary duty claims or appraisal actions, are not subject to the circularity critique. Mutual funds would benefit from such suits.

D. Agency Problems

Mutual funds' lack of engagement in shareholder litigation may be explained by a principal-agent problem: the interests of the institution charged with making the litigation decisions may diverge from the interests of the institution's investors. Agency cost issues are frequently raised to account for perceived defects in how mutual funds exercise their voting rights.²⁵⁰ They may thus also play a role in explaining how mutual funds exercise litigation rights.²⁵¹ In discussing these issues, we will distinguish between two distinct agency cost problems. First, mutual fund complexes are for-profit institutions and suffer from conflicts of interest. Second, intermediation creates collective action problems that may cause mutual fund complexes to engage in a sub-optimal amount of litigation. We address each of these in turn below.

1. Corporate Client Conflict

Mutual funds' incentives to cater to the interests of their corporate clients may lead them astray from acting as faithful stewards of their investors' capital, a situation we have elsewhere referred to as "Corporate Client Conflict."²⁵² The most obvious but by no means only such conflict is corporate 401(k) accounts. Insofar as fund families derive profits from assets under management and corporate 401(k) accounts are a large source of potential assets under management, fund families have a strong incentive not to upset the corporations that direct 401(k) assets by, for example, suing them.²⁵³ In this way, corporate client conflict may undermine mutual funds' efforts in litigation.

Consider BlackRock, one of the world's largest asset managers with over \$6 trillion AUM.²⁵⁴ Approximately 40% of BlackRock's AUM comes from corporate pension plans.²⁵⁵

²⁴⁹ See *supra* notes 186-190 and accompanying text.

²⁵⁰ See Bebhuk & Hirst, *supra* note 14; Gilson & Gordon, *supra* note 83, at 789; Lund, *supra* note 14, at 106-14; Rock & Kahan, *supra* note 5.

²⁵¹ See, e.g., Webber, *supra* note 15, at 14-15 (discussing how agency problems that may compromise mutual funds' efforts in litigation).

²⁵² Griffith & Lund, *supra* note 14, at 1157.

²⁵³ 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, 1442 (2006); Tamar Frankel, *Advisory Fees: Evolving Theories*, 10 INV. L. 21, (2003); John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 639-40 (2001); Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. ECON. PERSP. 161, 172 (2004).

²⁵⁴ This example also appears in our forthcoming publication, BU paper. Note that by choosing BlackRock as an example, we do not suggest that it experiences more severe conflicts than other mutual fund complexes. Similar conflicts likely exist at all institutional investors.

²⁵⁵ BLACKROCK, FOR YOU 6 (2018), <http://ir.blackrock.com/Cache/1500109547.PDF?O=PDF&T=&Y=&D=&FID=1500109547&iid=4048287>.

Investors pay a fee that is calculated as a percentage of these assets, and that fee accrues to BlackRock, rather than the fund.²⁵⁶ In total, these fees make up about 88% of BlackRock’s quarterly revenue.²⁵⁷

Recently, however, BlackRock, like all mutual fund complexes, has faced pressure to lower fees. This is in part because competition over fees has become more intense, especially for the passively managed mutual funds in which BlackRock specializes.²⁵⁸ Hence, BlackRock has focused on diversifying its revenue sources, primarily by providing other services to corporations and institutional clients.²⁵⁹ BlackRock is not unique in this respect—large mutual fund complexes often provide a range of client services, including brokerage, underwriting, insurance, or banking services. But insofar as BlackRock and other funds depend upon corporate revenue lines, they may be less likely to oppose corporations, in either voting or litigation.

Evidence supporting this view comes from findings that mutual fund complexes are very likely to vote for management proposals, especially when they hold a large percentage of assets under management in passive investment vehicles.²⁶⁰ Likewise, mutual funds almost never bring shareholder proposals or proactively engage in shareholder activism.²⁶¹ If voting against management likely threatens the mutual fund business, suing management certainly does.²⁶² Any suit that requires the mutual fund to take a position contrary to management—which is to say all shareholder suits—would threaten to disrupt its ability to retain or win 401(k) assets or other business from management. These incentives are compounded by reputational effects. For example, if BlackRock were known in the market to litigate against managers, regardless of whether they in fact managed assets or had other business from that particular corporate client, it might discourage other corporate clients from placing business with BlackRock.

Nevertheless, Corporate Client Conflict does not necessarily dampen funds’ incentives to bring *all* forms of shareholder litigation. A company exiting the portfolio through bankruptcy or acquisition will not be able to punish mutual funds for litigating against it (although its managers, if their careers are not also brought to an end, may). Corporate Client Conflict may therefore operate as a weaker constraint with regard to bankrupt defendants, especially where misconduct suggests the end of the managers’ careers as well. Likewise, Corporate Client Conflict may not constrain funds from bringing shareholder suits against target companies that have been acquired. However, insofar as the managers of these companies do not themselves exit the market but go on

²⁵⁶ Fisch et al., *supra* note 14, at 9.

²⁵⁷ BLACKROCK, Q4 2017 EARNINGS 6 (2018), <http://ir.blackrock.com/Cache/1001230788.PDF?O=PDF&T=&Y=&D=&FID=1001230788&iid=4048287>.

²⁵⁸ Jason Zweig & Sarah Krouse, *Fees on Mutual Funds and ETFs Tumble Toward Zero*, WALL STREET J. (Jan 26, 2016), <https://www.wsj.com/articles/fees-on-mutual-funds-and-etfs-tumble-toward-zero-1453858966>.

²⁵⁹ BLACKROCK, *supra* note 255, at 1.

²⁶⁰ Alon Brav et al., *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests* 3 (ECGI Working Paper Series in Fin., Working Paper No. 601/2019, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3101473; Ryan Bubb & Emiliano Catan, *The Party Structure of Mutual Funds* 28 (Mar. 10, 2019) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3124039.

²⁶¹ Emiliano Catan, *Shareholder Proposal Working Paper*; John Morley, *Too Big To Be Activist*, S. CAL. L. REV. (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3225555.

²⁶² See Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. OF FIN. ECON. 552, 554 (2007) (quoting Jack Bogle, the founder of Vanguard, in an SEC comment letter, noting that “Votes against management may jeopardize the retention of clients of 401(k) and pension accounts.”).

to manage other firms, the Corporate Client Conflict may still exert some deterrent effect on merger suits brought by mutual funds. Managers who are in jail or otherwise out of the C-suite are in no position to retaliate, but managers who go on to serve as managers at other firms are.

2. Collective Action Problems

The reluctance of mutual funds to participate in shareholder litigation may also be related to the collective nature of lawsuit recoveries. Compensation paid in a securities class action, for example, is awarded *pro rata* to the class, meaning that a mutual fund that sues benefits according to its proportional stake in the company, but so too do mutual fund competitors whose portfolios also include the corporate defendant. Likewise, any benefits from deterrence or governance enhancements won through litigation will also be enjoyed not only by the fund bringing the lawsuit but also by every other fund (and every other investor) that also owns the underlying company. Insofar as mutual funds compete for capital inflows on the basis of their performance relative to other funds, they have little incentive to use litigation to improve performance on a *pro rata* basis.²⁶³ This is especially true if lawsuits are costly, in which case litigious funds bear all the costs while sharing the benefits with rival funds. The collective nature of lawsuit recoveries thus inhibits mutual funds from participating in litigation to bring them about.

Several scholars have recently focused on the collective action problem arising from mutual funds' measurement of their performance on a relative basis.²⁶⁴ As one of us recently pointed out, this problem is most pronounced for index funds.²⁶⁵ Active funds, by contrast, may be able to increase their relative performance by using the levers of corporate governance, including litigation.²⁶⁶

Our point here is not to claim that collective action problems are insurmountable, but to acknowledge their role in shaping mutual funds incentives to litigate. In particular, collective action problems may explain the failure of mutual funds to serve as lead plaintiffs.²⁶⁷ Many forms of shareholder suits seek to reduce the cost of participating as plaintiff—for example, taking attorneys' fees out of the recovery, taxing them to the corporate defendant rather than the plaintiff and, in some cases, providing an incentive payment to lead plaintiffs to offset costs incurred in monitoring class counsel.²⁶⁸ But none of these strategies address the problems created by the

²⁶³ Professor Rock was one of the first to draw attention to this phenomenon as a barrier to institutional investor engagement in corporate governance. See Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 461–62 (1991) (discussing the free-rider problem created by the fact that the fruits of any such efforts will be shared with the rest of the class, while the costs will be borne by the mutual fund alone).

²⁶⁴ See, e.g., Bebchuk et al., *supra* note 14, at 97–98; Gilson & Gordon, *supra* note 83, at 890.

²⁶⁵ Lund, *supra* note 14, at 119–20.

²⁶⁶ *Id.* Others contest that these incentives will lead to too little stewardship. Fisch, Hamdani, and Solomon claim that index funds compete with active funds for capital inflows which may give them an incentive to engage with corporate governance. See *The New Titans of Wall Street*, *supra* note 14. Rock and Kahan, meanwhile, acknowledge that performance benefits must be shared with other investors but emphasize the direct benefits in fees that the largest index funds stand to gain from improvements in portfolio company performance. See Rock & Kahan, *supra* note 5.

²⁶⁷ See Webber, *supra* note 15, at 34–35.

²⁶⁸ See generally Theodore Eisenberg & Geoffrey P. Miller, *Incentive Awards to Class Action Plaintiffs: An Empirical Study*, 53 UCLA L. REV. 1303, 1320 (finding that incentive fees are common in federal class actions). The PSLRA generally bars incentive awards in securities class actions. 15 U.S.C. §78-u-4(a)(4). However, Delaware courts

sharing of the benefit. This incentive problem is compounded by the Corporate Client Conflict discussed above—a litigious fund may not be able to find corporate clients. Better, then, to free ride on the efforts of other investors.

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

3. Diminished Incentives Due to Fee Structure

Lucian Bebchuk and Scott Hirst point out that mutual funds have incentives to under-invest in stewardship because they receive only a small percentage of any gains.²⁶⁹ As discussed, mutual fund fees are set at a percentage of assets under management. As such, the mutual fund complex will not be interested in investing in stewardship or litigation if those actions are unlikely to increase assets under management, and therefore, the amount of fees that the complex collects. In other words, the problem might not be that the benefit is shared, but that the benefit to the complex is small or negligible.

However, as the examples in Section III.A demonstrate, stewardship litigation can generate compensation and deterrence benefits for mutual fund investors. Mutual fund portfolio managers owe fiduciary duties to their investors. They would therefore seem to be obligated to pursue litigation in best interests of their investors without regard to the impact on their own fees.

E. A Revealed Preference on Stewardship

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

have occasionally awarded incentive fees. See, e.g., *Chen v. Howard-Anderson*, C.A. No. 5878-VCL (June 30, 2017) (awarding \$1.25 million in incentive fees to plaintiffs).

²⁶⁹ See *Bebchuk & Hirst*, *supra* note 14 (manuscript at 34–36).

Mutual funds almost always vote.²⁷⁰ And, increasingly, they boast about it.²⁷¹ This was not always so. Indeed, Jack Bogle, the inventor of the index fund, recalled a time when mutual fund managers believed that they should leave the performance of the companies in their portfolios to “the invisible hand of the marketplace.”²⁷² But as investor dollars continued to flow into mutual funds, rendering them a powerful force in corporate governance, the SEC took action to make their fiduciary obligations clear—at least with respect to voting. Specifically, in 2003 the SEC adopted rules stating that investment advisors are required by fiduciary duty to cast votes in the best interests of their investors and requiring mutual funds to disclose how they vote.²⁷³ Overlaying these obligations are regulations created by the Department of Labor that strongly encourage funds managing ERISA assets to vote.²⁷⁴ Although many mutual funds do not manage ERISA assets, fund advisors may reason that given the lack of an obvious distinction between pension fund fiduciary duties and mutual fund fiduciary duties, they are likewise compelled to vote.²⁷⁵ Although there are good reasons to question this legal interpretation, it may nevertheless be followed by fund managers to mitigate compliance risk.²⁷⁶ As a result, funds now employ third-party proxy advisors and in-house stewardship teams to manage the voting of their massive portfolios.²⁷⁷ And they do so largely because regulators have told them to.

²⁷⁰ See Broadridge & PWC, *2018 Proxy Season Review*, PROXYPULSE, Oct. 2018, at 4, https://www.broadridge.com/_assets/pdf/gated/broadridge-2018-proxy-season-review.pdf (reporting institutional investor participation at 91%, compared to 28% for ordinary “retail” investors). For discussion of the reasons why mutual funds are now actively voting, see *infra* Part II.B.

²⁷¹ See VANGUARD, *supra* note 13, at 3 (emphasizing “four pillars” of engagement: board composition, executive compensation, oversight of risk and strategy, and governance structures); *Asset Stewardship*, *supra* note 10 (“Our approach to stewardship is designed to have an impact through thought leadership, engagement, proxy voting and client disclosure.”); Larry Fink, *Larry Fink’s 2018 Letter to CEOs*, BLACKROCK (2018), <https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter> (last visited July 2, 2019) (noting that “our responsibility to engage and vote is now more important than ever”).

²⁷² See, e.g., Sarah Krouse et al., *supra* note 4.

²⁷³ 17 C.F.R. § 275.206(4)-6(a) (2019); Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564, 6564 (Feb. 7, 2003) (codified at 17 C.F.R. pts. 239, 249, 270, 274) (2003) [hereinafter Voting Disclosure Rule].

²⁷⁴ The Department of Labor articulated its position first in a set of letter rulings. See Letter from Alan D. Lebowitz, Deputy Assistant Sec’y, Dep’t of Labor, to Helmut Fandl, Chairman of the Ret. Bd., Avon Prods., Inc. (Feb. 23, 1988) (Feb. 29, 1988) (reprinted in 15 PENSION REP. (BNA) 71, 391) (“The decision[s] as to how proxies should be voted ... are fiduciary acts of plan asset management.”); Letter from Alan D. Lebowitz, Deputy Assistant Sec’y, Dep’t of Labor, to Robert Monks, Institutional S’holder Servs, Inc. 3 (Jan. 23, 1990) (reprinted in 17 PENSION REP. (BNA) 244) (“The fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock.”). These rulings were later reaffirmed in guidelines stating that “the fiduciary act of managing plan assets that are shares of corporate stock includes the management of voting rights appurtenant to those shares of stock.” Interpretive Bulletin Relating to the Exercise of Shareholder Rights, 73 Fed. Reg. 61,731, 61,732 (Oct. 17, 2008) (codified at 29 C.F.R. 2509.08-2 (repealed 2016)).

²⁷⁵ Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217, 219 n.4 (2018) (noting that the effect of the Department of Labor’s ruling “has been that investment advisers to mutual funds routinely vote the shares of those mutual funds”).

²⁷⁶ See Griffith, *supra* note 14 (manuscript at 54) (arguing that voting is not necessarily compelled by mutual fund advisors’ fiduciary duties).

²⁷⁷ A deeper look at their voting record leaves much to be desired. For example, mutual fund complexes—and especially the large passive ones—support management much more often than other investors. Bubb & Catan, *supra* note 260 (manuscript at 3). They also follow their proxy voting guidelines closely, achieving impressive uniformity in voting across vastly different funds. Griffith & Lund, *supra* note 14, at 1157; Lund, *supra* note 14, at 125.

Regulators have made no such pronouncement with regard to litigation. Neither the SEC nor the Department of Labor has ever adopted rules suggesting that fund advisors' duties to their investors compel them to litigate. Nor are we suggesting that they should. But the obvious parallel between the benefits attainable through voting and the arguably greater benefits attainable through litigation suggest that if mutual fund stewardship programs were driven by the desire to secure benefits for investors, such programs would also include litigation.

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

V. A Mission Statement for Mutual Funds in Shareholder Litigation

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

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

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

Therefore, the regulatory pressure may be alleviating the symptom of the problem—the lack of voting—rather than resolving the underlying agency problems that compromise mutual fund voting.

A. Litigate Outside of the Portfolio for Compensation

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

1. Exit Cases

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

In the acquisition context, shareholders can bring derivative or securities claims challenging the merger, as well as appraisal suits, in order to increase the amount they receive in the deal. Note again that when mutual funds stand on both sides of the "v," the desirability of participating in shareholder litigation challenging the merger will often depend on the relative size of those investments.²⁷⁸ From the mutual fund's perspective, litigating to increase the consideration paid in connection with the acquisition of one portfolio company by another is typically pointless, and once litigation costs are taken into account, wasteful. Such claims benefit only those mutual funds with a significantly larger stake in the target than in the acquirer.

But mutual funds should favor merger claims when the acquiring company is not in the fund's portfolio. This will typically be the case in a going-private transaction, but it may also be true in cases where the acquirer is not in the index for other reasons. In such cases, mutual funds should consider filing derivative or direct claims seeking additional consideration. Appraisal actions are also possible, but they present a special challenge for mutual funds. Appraisal suits are a potentially powerful mechanism to increase consideration paid in acquisitions. But the mechanics of appraisal suits raise the specter of destroying the deal. First, because appraisal rights arise only when the shareholder has voted against the transaction, a large blockholder looking to perfect their appraisal rights may cause the deal not to be approved.²⁷⁹ Additionally, even if seeking appraisal does not cause the transaction to be voted down, many acquisition agreements contain a term allowing the buyer to terminate the agreement if a sufficiently large group of shareholders seeks appraisal.²⁸⁰ A large blockholder seeking appraisal may thus be enough to scuttle the deal. Mutual funds should therefore weigh the appraisal option carefully, seeking it only where there are indicia of wrongdoing—a cursory process infected with

²⁷⁸ See *supra* note 246 and accompanying text.

²⁷⁹ See, e.g., DEL. CODE ANN. tit. 8, § 262(j) (2019)

²⁸⁰ See Boone, et al. *supra* note 92, at 25 (discussing "appraisal out" clauses and finding that they are less common as the likelihood of appraisal rises).

self-interest—and where their opposition will not lead to the failure of the deal or where they do not mind if it does.

Second, apart from acquisition, firms may also exit the portfolio through bankruptcy. When this occurs, shareholders may be able to bring derivative or securities law claims against managers whose misconduct caused the corporation to fail. Because the shareholders' interest is generally extinguished when firms fail, these may not seem to be a promising setting for investor compensation. However, when the firm failure is caused by fraud or mismanagement, there may often be a derivative suit or securities claim against the individual managers that perpetrated the fraud. These cases are typically funded by D&O insurance and, on occasion, by contributions from the managers themselves.²⁸¹ As a result, such claims present an opportunity for the mutual fund to secure compensation without funding the recovery through the portfolio.²⁸²

2. Extra-Portfolio Defendants

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

In a paradigmatic derivative suit, the shareholder sues on behalf of the company to force a culpable manager to pay funds back into the corporation. Because such recoveries are funded by individual managers, not the corporation itself—corporations are barred by state law from indemnifying managers in such cases²⁸³—they do not present the same circularity problem as other compensation-based claims. Insurance, however, complicates this dynamic. Most D&O policies provide coverage for derivative suits.²⁸⁴ As a result, derivative suit recoveries may be largely funded by D&O insurance, which again raises the specter of circularity since corporations pay for D&O policies.

There is an exception, however, for cases establishing actual fraud, either through settlement or adjudication. Policies exclude actual fraud from coverage.²⁸⁵ This suggests a narrow way out of the circularity problem. The market investor's incentive to bring derivative suits is strongest when the evidence suggests actual fraud, in which case recoveries will be funded by individual defendants, not by the company either directly or indirectly through insurance.

²⁸¹ For example, the former directors of Enron contributed funds to settle the securities class actions involving that firm. See Rebecca Smith and Jonathan Weil, "Ex-Enron Directors Reach Settlement," *Wall St. J.* (Jan. 10, 2005) (noting that 10 former Enron executives agreed to contribute a total of \$13 million to the settlement).

²⁸² Even when the recovery is funded wholly by insurance, because the companies are exiting the portfolio, the insurer will not be able to collect future premiums to recoup the losses. However, the fund may have to consider whether the insurer is likely to raise premiums for other companies—if so, the market investor will bear these costs across the portfolio. Further complications may be introduced into this analysis if the insurer is itself a portfolio company. But even in such cases, the structure of D&O coverage, involving multiple insurers and reinsurers, not all of which are public companies and therefore within the portfolio, suggests that at least some of this cost will fall outside of the portfolio.

²⁸³ § 145(a)–(b).

²⁸⁴ Baker & Griffith, *supra* note 111, at 1803. Moreover, the deductibles for derivative suit recoveries are substantially lower than the deductibles for other forms of loss under the policy, such as the company's indemnification obligations or its own liabilities in securities claims. *Id.* at 1804 n.38.

²⁸⁵ *Id.* at 1804–05.

Such claims will likely be rare—the cost of litigation, often funded by the corporation through the D&O policy, may often exceed the potential recovery from individual defendants. But even if they are rare, such suits may provide some compensatory benefit, and as discussed below, an even greater benefit through deterrence.

The second form of extra-portfolio litigation arises in connection with securities cases against non-issuer defendants. For example, cases under Section 11 of the Securities Act may be brought against a range of non-issuer defendants including individual directors and officers, underwriters, and accountants. Although seeking compensation from individual directors and officers in such claims may again raise circularity problems through the D&O policy, claims against underwriters and accountants may not. Because some underwriting firms—for example, Goldman Sachs—are publicly traded and therefore present in the market investor’s portfolio, compensation-based claims against such defendants do effectively suffer from a circularity problem.²⁸⁶ Nevertheless, some underwriters and most accounting firms are not publicly traded and therefore not present in the market portfolio. Mutual funds might therefore pursue compensation-based claims against such defendants. Likewise, securities claims under Rule 10b-5 may be brought against those who aid and abet the corporation in committing fraud.²⁸⁷ As long as aiding and abetting defendants are not public companies, recoveries against those firms are not funded by shareholder plaintiffs themselves.

B. Ensure that Litigation Inside the Portfolio Provides Effective Deterrence

The circularity critique also does not reach the deterrence rationale for shareholder suits. The basic goal of deterrence in civil litigation is to make the wrongdoer internalize enough of the cost of her activity to induce her not to engage in socially harmful conduct.²⁸⁸ By pursuing deterrence goals, mutual funds would act as “private attorneys general,” policing their portfolio for misconduct.²⁸⁹ There are two ways for mutual funds to serve in this role: either as lead plaintiffs, bringing claims themselves, or as overseers of shareholder suits brought by other plaintiffs, using their influence to ensure that the suits accomplish meaningful deterrence. We address each in turn.

First, mutual funds should seek to serve as lead plaintiffs for strong shareholder claims. As lead plaintiffs, mutual funds would be in the best position to ensure that the lawsuit accomplished meaningful deterrence. Most obviously, mutual funds could insist on personal liability for responsible managers as a condition to resolving shareholder suits. Or, in cases of severe managerial misconduct, mutual funds could insist upon the termination of top managers and, by pre-committing to vote against any board employing these managers in the future, effectively ban them from the management of publicly traded corporations. Mutual funds can thus enhance deterrence by imposing a credible threat of punishment through civil litigation.

²⁸⁶ See Rose & Squire, *supra* note 243, at 686–89.

²⁸⁷ *Stoneridge Inv. Partners, LLC v. Sci.-Atlanta, Inc.*, 552 U.S. 148, 161–64 (2008).

²⁸⁸ On the problem of setting sanctions to promote optimal deterrence, see STEVEN SHAVELL, *FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW* 483 (2004).

²⁸⁹ See John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215, 227–30 (1983) (discussing virtues and vices of private attorney general model in securities litigation).

Mutual fund participation in merger litigation can also enhance deterrence. When mutual funds are on both sides of public company deals, their principal interest in merger litigation will be to deter serious misconduct in the deal process more than it will be to extract additional consideration from the buyer. By serving as the class representative in cases where misconduct may be present, mutual funds can insist that managers bear personal responsibility for the deal process, again threatening personal liability or portfolio-wide bans of managers that engage in serious misconduct. Likewise, in a derivative suit, mutual funds could pursue claims to extract genuine deterrence against specific corporate managers and refuse to settle for corporate therapeutics that offer little or no value.²⁹⁰

Serving as lead plaintiff or class representative comes at a cost. However, given the willingness of attorneys to litigate shareholder suits on a contingency fee basis, the cost will principally be one of time and attention. Furthermore, some forms of shareholder suits offer fees to offset such costs borne by lead plaintiffs and class representatives.²⁹¹ This would seem to be an ideal role for mutual fund stewards, with the availability of fees offsetting the costs of stewardship.

Still, mutual funds cannot bring every shareholder suit. The PSLRA limits the number of times a single plaintiff can serve as lead plaintiff in a private securities class action to five times in three years.²⁹² Nor, we expect, would they want to bring every claim. As a result, even if mutual funds were to become more involved in shareholder litigation, we expect that other plaintiffs would continue to bring many suits on a class or other representative basis. Nevertheless, mutual funds retain a critical role in these suits as well. Their block-holdings put large mutual funds in an excellent position to oversee shareholder suits brought by other plaintiffs.²⁹³ This leads us to our second point: Mutual funds should actively oversee shareholder suits brought by other plaintiffs and use their influence to ensure that these suits achieve meaningful deterrence.

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

Nevertheless, a major obstacle to accomplishing deterrence goals through shareholder litigation arises from D&O insurance policies that indemnify managers and the corporations they serve for losses incurred in shareholder litigation.²⁹⁴ Insofar as D&O insurance holds companies and their managers harmless for the kind of conduct leading to shareholder claims, we cannot

²⁹⁰ On the debate over therapeutic relief in the settlement of derivative suits, *see supra* notes 53–64 and accompanying text.

²⁹¹ *See supra* note 268 and accompanying text.

²⁹² 15 U.S.C. § 78u-4 (2019).

²⁹³ Rose, *supra* note 108, at 1354–64 (2008) (suggesting that the SEC be given oversight authority to pre-screen 10b-5 complaints to protect against overdeterrence).

²⁹⁴ Baker & Griffith, *supra* note 111, at 1832–33.

expect liability in shareholder suits to adequately deter managerial misconduct. This leads us to the third priority for mutual funds: if funds are to use shareholder litigation to create meaningful deterrence, they should first consider encouraging portfolio companies to realign their D&O policies to be consistent with deterrence objectives.

Most D&O policies include two basic types of coverage. First, individual-level coverage protects individual managers against covered losses.²⁹⁵ Second, entity-level coverage protects the corporation itself from losses arising from its indemnification obligations to individual managers and from losses it incurs as a named defendant in shareholder suits.²⁹⁶ The vast majority of losses incurred under D&O policies are incurred under entity-level coverage.²⁹⁷ Entity-level coverage effectively means that, apart from the deductible, the corporation suffers no harm from managerial misconduct provided the settlement is within the limits of the insurance policy. When corporate losses are indemnified by an insurance company, the corporation therefore has less of an incentive to police the conduct of its managers to prevent misconduct *ex ante*. In this way, the principal effect of entity-level coverage is to render corporations less sensitive to managerial misconduct. In prior co-authored work, one of us has argued that there is no good explanation for this form of coverage, only a bad one—that is, agency costs.²⁹⁸ Managers use D&O insurance to sever shareholder litigation from its deterrence function.

Mutual funds could reestablish the deterrence function of shareholder litigation by minimizing the distortions introduced by entity-level coverage. One way of doing this would be simply to eliminate entity-level D&O coverage, insisting that policies cover only individual directors' liabilities.²⁹⁹ Restructuring policies in this way would protect against managerial risk aversion while at the same time leaving corporate assets exposed in shareholder suits. Corporate losses in shareholder suits would be rendered more salient. Uninsured losses would have a greater impact on share price and on incentive compensation packages. As a result, the corporation would likely take greater care to avoid them *ex ante*. Eliminating entity-level D&O coverage would thus improve the deterrent effect of shareholder litigation.

If their appeals to restructure D&O coverage falls on deaf ears, mutual funds might be able to achieve a similar effect by insisting, either as lead plaintiffs or as prospective objectors, that a significant portion of any recovery *not* be funded by insurance. Forcing the corporate defendant

²⁹⁵ This is referred to as “Side A coverage” under most D&O policies. *Id.* at 1802.

²⁹⁶ Losses incurred as a result of corporate indemnification obligations are covered under “Side B” of the D&O policy, and losses directly incurred by the corporation as a defendant are covered under “Side C.” *Id.*

²⁹⁷ *See id.* at 1803 (“Our participants confirmed that the vast majority of D&O insurance losses are incurred under Side B and C—that is, entity-level coverage. Thus, to a substantial extent, D&O insurance is corporate insurance.”) (citation omitted).

²⁹⁸ *Id.* at 1841–42 (footnote omitted), (arguing that “[i]n order for shareholders to benefit from entity-level D&O coverage, there must be some benefit to the coverage other than pure risk distribution, which shareholders could accomplish more efficiently through portfolio diversification. Although some plausible explanations have been suggested . . . [n]one . . . accounts for the pure risk distribution form of D&O insurance that we observed We are therefore left with only one satisfactory explanation for the form of D&O insurance that we observed: agency costs. Managers do not want insurers monitoring their decisions *ex ante* and they do not want them managing their defense *ex post*. Both monitoring and defense management would reduce managers' autonomy and, relatedly, their ability to profit at the shareholders' expense.”) (concluding that “our research strongly suggests that the prevailing form of D&O insurance benefits management at the shareholders' expense”).

²⁹⁹ This form of coverage exists. It is referred to in the industry as “Side-A only” coverage. Side-A only coverage benefits firms by addressing the risk-aversion of individual directors, thereby encouraging directors to serve without distorting their incentive to monitor.

or, in extreme cases, individual managers, to fund losses would have the same effect as eliminating entity-level coverage but on an *ad hoc* basis. Another way to accomplish the same thing would be to plead actual fraud in the complaint, thereby triggering the fraud exclusion and eliminating D&O coverage from the recovery.³⁰⁰ However they do it, mutual funds should work to improve the deterrence effect of shareholder by limiting the role of D&O insurance.

C. Litigate to Implement Meaningful Governance Reforms

Shareholder litigation can produce governance enhancements, for example, by dismantling obstacles to acquisitions or activism and also by improving corporate compliance programs.³⁰¹ Given that mutual funds advertise their interest in improving corporate governance, it seems natural that they should consider using litigation as a tool for doing so. Furthermore, given the systemic improvement that governance enhancements promise across portfolios, it seems reasonable to expect mutual funds to litigate for improved governance much as they might litigate for improved deterrence.

But the same issue that compromises index fund voting also affects stewardship litigation—mutual funds are unlikely to know how to improve governance at a given firm in the portfolio. Although it is possible to understand the basic effect of governance terms and to know their average effect on firm performance—staggered boards, for example, make it harder to replace the board of directors and may have a negative average effect on firm performance³⁰²—it is much harder to say what the optimal governance arrangement for a particular firm will be.³⁰³ There is no “one-size fits all” governance arrangement.³⁰⁴ Even staggered boards may enhance performance for some firms.³⁰⁵ Hence, knowing what is best for a particular firm requires a high degree of company-specific information.³⁰⁶

³⁰⁰ *See supra*. Because most D&O policies exclude actual fraud from coverage, pleading actual fraud and insisting upon an admission of fraud in settling the claim would void the insurer’s obligation to cover the resulting loss. Most shareholder suits are carefully plead to avoid triggering the fraud exclusion, thereby retaining access to insurance proceeds. However, insofar as mutual funds press shareholder claims more for their deterrence than for their compensation value, they may prefer to plead their claims intentionally to trigger the fraud exclusion.

³⁰¹ *See supra* notes 28–30.

³⁰² Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Effective Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 898, 937 (2002).

³⁰³ *See also* Miroslava Straska & H. Gregory Waller, *Antitakeover Provisions and Shareholder Wealth: A Survey of the Literature*, 49 J. FIN. & QUANTITATIVE ANALYSIS 933, 950 (2014) (broadly surveying the literature on the effects of anti-takeover provisions affect on shareholders and concluding that in spite of a large volume of studies, “the net effects of these provisions on shareholder wealth remain uncertain”).

³⁰⁴ Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 829 (2017).

³⁰⁵ *See, e.g.*, K.J. Martijn Cremers et al., *Staggered Boards and Long-Term Firm Value, Revisited*, 126 J. FIN. ECON. 422 (2017) (showing that staggered boards increase value at firms with greater research and development needs and a higher proportion of intangible assets); K.J. Martijn Cremers & Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 67, 104 (2016); *see also* Seoungpil Ahn & Keshab Shrestha, *The Differential Effects of Classified Boards on Firm Value*, 37 J. BANKING & FIN. 3993, 4011 (2013) (finding that in complex firms the benefits of staggered boards may outweigh the costs).

³⁰⁶ Gilson & Gordon, *The Agency Costs of Agency Capitalism*, 113 Columbia L. Rev. at 891 (“Effective use of governance rights requires firm-specific investigation and firm-specific activism, both of which are costly and will be undersupplied by institutional investors.”).

Mutual funds are generally in a poor position to evaluate the company-specific effects of a given governance arrangement. Index funds in particular lack the incentive to invest in acquiring company-specific information since their business model is essentially to hold the market as a whole and drive down the costs of investing.³⁰⁷ Active funds may have more of an incentive to invest in acquiring this information and, in such cases, may share their information with index funds in the same family of funds.³⁰⁸ But information-sharing of this type will not always be effective. Active funds typically hold a much narrower slice of the market than index funds.³⁰⁹ They may not price the effect of governance in their analyses of portfolio companies.³¹⁰ And they often get it wrong.³¹¹ Free-riding on the efforts of active funds will not always provide index funds with sufficient information to intelligently analyze governance arrangements.

The decision to use litigation to secure governance reforms, however, is different than relying on voting and engagement. One key difference is the involvement of a lawyer, which can be both helpful and harmful. On the one hand, a trusted attorney can seek out opportunities for governance litigation and present them to the mutual fund complex. Although the mutual fund tends to lack firm-specific information, cases involving gross misconduct may present enough red flags to justify the decision to proceed.³¹² And as the suit progresses, the litigation process itself will uncover additional information that can help the attorneys and mutual fund governance staff craft a settlement that addresses the specific problem.

Consider again the examples we highlighted above. Governance litigation proved to be an effective tool in undoing the harms of the stock option back-dating scandal.³¹³ Likewise, the CalPERS intervention at IAC successfully prevented management from solidifying its control over the company through the issuance of non-voting stock.³¹⁴ Finally, the settlement of the derivative suit against 21st Century Fox in the wake of sexual harassment claims against the company resulted in the establishment of a “Workplace Professionalism and Inclusion Council” aimed at correcting the deficiencies of the compliance program and improving the workplace environment.³¹⁵ While we take no position on whether such programs achieve their goals, we note that this governance reform emerged only after the litigation process produced information concerning the specific deficiencies then existing at the company, giving the plaintiffs an opportunity to target reforms to the company’s specific needs. This process might not be perfect,

³⁰⁷ Lund, *supra* note 14, at 119–20.

³⁰⁸ Kahan & Rock, *supra* note 5 (manuscript at 44–45) (arguing that “spillover knowledge” of this type is what enables index funds to play a meaningful role in corporate governance).

³⁰⁹ Lund, *supra* note 14, at 122.

³¹⁰ Griffith, *supra* note 14 (manuscript at 47) (arguing that the cost of valuing governance arrangements may often exceed the benefit of doing so).

³¹¹ J.B. Heaton et al., *Why Indexing Works*, 33 APPLIED STOCHASTIC MODELS BUS. & INDUS. 690, 693 (2017) (arguing that “the much higher cost of active management may be the inherently high chance of underperformance that comes with attempts to select stocks, since stock selection itself increases the chance of underperformance relative to the chance of overperformance in many circumstances”).

³¹² The decision to sue is similar to the decision to vote for the dissident slate in a proxy contest—for the latter, the activist hedge fund will have generated information in the campaign, reducing the likelihood of an uninformed vote. See Griffith, *supra* note 14.

³¹³ See *supra* note 58 and accompanying text.

³¹⁴ See *supra* note 200 and accompanying text.

³¹⁵ See *supra* note 57 and accompanying text.

but it operates on better information and offers more carefully tailored solutions than the one-size-fits-all governance reforms typically offered in shareholder proposals.³¹⁶

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

D. Intervene to Contain Litigation Agency Costs

Most shareholder suits are not brought by mutual funds but rather by others suing in a class or other representative capacity. Yet even if mutual funds are not directly involved as plaintiffs, may still be adversely affected by the outcome of these suits. When corporations pay to settle non-meritorious cases³¹⁷ or agree to pay attorneys' fees in settlements that produce no value for the plaintiff class,³¹⁸ all shareholders are affected. As holders of the market portfolio, mutual fund investors bear the costs of such suits. As a result, an important role for mutual funds in shareholder litigation lies in intervening to reduce litigation agency costs.

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

Class and derivative suit settlements require a fairness hearing before they can become binding on unnamed shareholders.³¹⁹ If the judge does not approve the settlement, the settlement

³¹⁶ See Griffith, *supra* note 14, at YY.

³¹⁷ See Lucian A. Bebchuk, *Suing Solely to Extract a Settlement Offer*, 17 J. LEG. STUD. 437 (1988); Avery Katz, *The Effect of Frivolous Lawsuits on the Settlement of Litigation*, 10 INT'L REV. L. & ECON. 3, 5 (1990); D. Rosenberg & S. Shavell, *A Model in Which Suits Are Brought for Their Nuisance Value*, 5 INT'L REV. L. & ECON. 3, 4–5 (1985).

³¹⁸ See Coffee, *supra* note 40, at 20; Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. L. ECON. & ORG. 55, (1991);

³¹⁹ Rubenstein, *supra* note 74. At the fairness hearing:

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

does not bind the class.³²⁰ The trouble with fairness hearings, however, is that there is no adversarial interest to frame the problem for the judge.³²¹ Instead, “[t]he contending parties have struck a bargain, and have every interest in defending the settlement and in convincing the judge that it is in accord with the law.”³²² Questionable assertions of fact and law are not scrutinized by opposing counsel. Experts are not cross-examined or even questioned, and opposing views are not presented. A judge who questions the value of the settlement must do so on her own, in the face of all of the evidence presented by the parties before her.³²³ Given the apparent weight of the evidence before them and their otherwise crowded dockets, judges can perhaps be forgiven for generally rubber-stamping settlements to which the named parties have, after all, agreed. Settlements need, and frequently lack, a motivated gatekeeper.³²⁴

Mutual funds can act as gatekeepers by objecting to non-meritorious class settlements and presenting adversarial evidence at the fairness hearing. Courts would very likely take the arguments offered by mutual fund objectors very seriously were they to appear in this role.³²⁵ There is evidence that such objections can in fact succeed in causing judges to throw out settlements and refuse to approve fee awards.³²⁶ Moreover, the mere potential for objection may deter the filing of non-meritorious claims. Unlike rationally apathetic shareholders who lack the

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

³²⁰ Howard M. Erichson, *The Problem of Settlement Class Actions*, 82 GEO. WASH. L. REV. 951, 968–69 (2014) (citing RUBENSTEIN ET AL., 1 NEWBERG ON CLASS ACTIONS § 1.6 (5th ed., 2011); Howard M. Erichson, *The Role of the Judge in Non-Class Settlements*, 90 WASH. U. L. REV. 1015, 1020–25 (2013)) (“What binds the class is not the agreement between the defendant and the lead plaintiffs or class counsel, but rather the court’s judgment approving that agreement. The binding effect of a class settlement, in other words, must be understood as a function of judicial power.”).

³²¹ Griffith, *Corporate Benefit*, *supra* note 64, at 21-23 (emphasizing information asymmetries in the settlement hearing).

³²² Owen M. Fiss, *Against Settlement*, 93 YALE L.J. 1073, 1082 (1984). Accord Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs’ Attorney’s Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 46 (1991) (referring to settlement hearings as “pep rallies jointly orchestrated by plaintiffs’ counsel and defense counsel”).

³²³ *In re Trulia, Inc. Stockholder Litig.*, 129 A.3d 884, 894 (Del. Ch. 2016).

³²⁴ Rubenstein, *supra* note 74, at 1452–67 (examining various proposals for reducing agency costs at the settlement stage).

³²⁵ Courts have said so. See, e.g., *In re Riverbed Tech., Inc. Stockholders Litig.*, C.A. No. 10484-VCG, 2015 WL 5458041 (Del. Ch. Sept. 17, 2015).

³²⁶ One of us has been active in bringing objections to settlements and in providing testimony to judges evaluating settlements of shareholder suits. See, e.g., *Bushansky v. Remy Int’l, Inc.*, 262 F. Supp. 3d 742, 744 (S.D. Ind. 2017) (rejecting settlement after objection by Sean Griffith); *Stein v. Blankfein*, No. 2017-0354-SG, 2018 WL 5733671, at *1 (Del. Ch. Oct. 24, 2018) (rejecting settlement objected to by Griffith); Brief of Sean J. Griffith as Amicus Curiae at 1–4, *Trulia*, 129 A.3d 884 (No. 10020-CB), 2015 WL 6391945 (opposing settlement, ultimately rejected by court); Letter from Sam Glasscock III, Vice Chancellor, Court of Chancery of the State of Del. to Counsel at 7, *In re Riverbed Tech., Inc. Stockholders Litig.*, No. 10484-VCG (Del. Ch. filed Dec 2, 2015) (reducing attorneys’ fees after objection by Griffith); Entry of Appearance, *In re PMFG, Inc. Stockholder Litig.*, C.A. No. 11223-VCS (Del. Ch. filed June 29, 2015) (rejecting settlement after objection by Sean Griffith); *Griffith v. Quality Distrib., Inc.*, No. 17-3160, (Fla. Dist. Ct. App. 2018) (adopting *Trulia* as Florida law); Statement of Reasons, *Vergiev v. Agüero*, Docket No. L-2276-15 (N.J. Super. Ct. Law Div. June 6, 2016) (rejecting settlement objected to by Griffith); *Gordon v. Verizon Commc’ns, Inc.*, No. 653084/13, 2014 WL 7250212, at *7 (N.Y. Sup. Ct. Dec. 19, 2014), *rev’d*, 148 A.D.3d 146 (N.Y. App. Div. 2017) (rejecting settlement after Griffith testimony).

information to object to such settlements,³²⁷ mutual fund block-holders bear the cost of such suits across their portfolio.³²⁸ Furthermore, as market investors, funds have standing to appear in every case, threatening to object, or in appropriate cases, to challenge the adequacy of counsel or even file sanctions motions.³²⁹ Through interventions such as these, mutual funds could calibrate the deterrence effect of shareholder suits by controlling litigation agency costs.

Suits that settle for non-pecuniary relief—the paradigmatic form of relief in state law class and derivative actions—may be low-hanging fruit. What about the damages awards and monetary recoveries that are more typical of securities class actions? While there may still be a role for objections for inadequate monetary relief, it may also be the case that mutual funds operating from the perspective of the market investor would often prefer that monetary relief not be awarded at all. As discussed above, the logic of the circularity critique suggests that mutual funds would often prefer that shareholder suits not be brought to achieve compensatory ends but rather for deterrence alone. What should these funds do when faced with the prospect of monetary recoveries in settlement? The answer, in our view, is that mutual funds should frequently opt-out of such settlements.

Opting out of class litigation serves two purposes. First, it protects the mutual fund’s ability to litigate for higher rewards and faster payment, when appropriate.³³⁰ Second, it allows mutual funds to exclude their shares from the class recovery when the compensation offered in settlement does not serve the interests of their investors. By opting-out of settlement, whether or not they pursue claims of their own, mutual funds can limit the cost of such suits. For example, consider a 10b-5 class action claiming damages of \$1 per share in which 10 million shares trade during the class period. If mutual funds are responsible for 30% of the trading activity during the holding period, then by opting out of the settlement, they effectively reduce the potential recovery in the class action from \$10 million to \$7 million. If monetary compensation is not beneficial to mutual fund investors—as a result, for example, of the circularity critique—then mutual fund shares ought not to be included as a basis for recovery to the plaintiff class. Moreover, by excluding their holdings as a basis for damages (and fee) awards, mutual funds effectively reduce the cost of such claims while still preserving the potential for a compensatory relief for undiversified shareholders. Opting-out of compensation, in other words, does not have the same

³²⁷Theodore Eisenberg & Geoffrey Miller, *The Role of Opt-Outs and Objectors in Class Action Litigation: Theoretical and Empirical Issues*, 57 VAND. L. REV. 1529, 1548–50 & tbl.2 (2004) (showing that the objection rate is low across case types).

³²⁸ Mutual funds can distinguish themselves from hold-up objectors by refusing to settle their objection in exchange for a fee. Compare Fitzpatrick, *supra* note 99, at 1633–42 (highlighting concerns of objector “blackmail” and the use of quick-pay provisions used by class action counsel) with Sean J. Griffith & Anthony A. Rickey, *Objections to Disclosure Settlements: A How-to Guide*, 70 OKLA. L. REV. 281, 315 (2017) (noting that “an objector can offer to assuage concerns on this point by providing an affidavit attesting that he or she will not sell or settle an objection without court approval”).

³²⁹ The PSLRA requires courts to make Rule 11 findings in class action securities litigation, a requirement that is often disregarded in practice. 15 U.S.C. 77-z1(c) (2019); Henderson & Hubbard, *Judicial Noncompliance with Mandatory Procedural Rules under the Private Securities Litigation Reform Act*, *Journal of Legal Studies*. Mutual fund class members could intervene to demand Rule 11 sanctions against attorneys who engage in misconduct or who simply pursue shareholder suits when the benefits are outweighed by their costs. The threat of Rule 11 sanctions would create an important downside from the pursuit of securities class actions and again deter unaccountable conduct in litigation.

³³⁰ Consider here the mutual fund suits against Countrywide, Petrobras, American Realty, and Valeant. See Section IIIA.

effect as an objection. It preserves the remedy for those who can prove they were harmed while at the same time reducing the cost of the claim for diversified investors, for whom the payment of monetary relief plus attorneys' fees essentially amounts to waste.

In sum, mutual funds should act to minimize litigation agency costs and thereby control both underdeterrence and overdeterrence. Tools at funds' disposal include interventions and objections to settlement. Mutual funds should insist on meaningful deterrence while also opting out of intra-portfolio claims based solely on compensation, thereby mitigating the waste inherent in such claims.

E. Implementing the Mission Statement

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

But this leaves the question of how the decision to litigate should be made and who should be the one to make it. We imagine that, *ex ante*, stewardship groups could promulgate litigation guidelines along the lines we have suggested, similar to those used to guide voting and engagement decisions.³³¹ Authority to generate litigation consistent with the guidelines could then rest with portfolio managers (or a committee composed of portfolio managers and members of the stewardship team), subject to approval from the mutual fund's board of directors, who would certify that the litigation addresses a serious issue of corporate governance, is likely to secure compensation for investors, and/or is likely to defeat a transaction adverse to investors. Ultimately, we believe the individuals controlling litigation should have input from the fiduciaries who control the investment decisions for the funds' investors, rather than displacing that decision by individuals who are not fiduciaries (as mostly occurs now). And although these adjustments may somewhat increase costs for the mutual fund complex, these costs would likely be offset by successful claims.³³²

Alternatively, funds could outsource the litigation function to a portfolio monitor—a law firm—that would track litigation and potential litigation across the portfolio, recommending cases in which the fund might participate as a plaintiff or intervene as an objector. For example, three out of the four shareholder suits that we discuss in Section III—Countrywide, American Realty, and Valeant—involved the plaintiffs' firm Bernstein Litowitz Berger & Grossman LLP.³³³ Mutual funds could continue to develop relationships with repeat-play firms, communicating their guidelines in advance, and ensuring that portfolio managers, as well as the board of directors, keep a careful eye on litigation agency costs over the life of the relationship.

³³¹ Nearly every mutual fund family promulgates voting guidelines and follows them closely; see BIOY ET AL., *supra* note 8, at 11. By contrast, none have adopted any policies with regard to shareholder litigation.

³³² As an example, Vanguard's successful settlement of the American Realty litigation netted it \$90 million. *See supra* Section III.A.4. A single settlement of this size each year would fund the hiring of several new litigation employees—and then some.

³³³ *See Current Cases*, BERNSTEIN LITOWITZ BERGER & GROSSMAN LLP, <https://www.blbgllaw.com/cases> (last visited July 3, 2019).

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

This brings us back to the problem of agency costs, in particular Corporate Client Conflict. Insofar as mutual funds fear that participating in shareholder litigation would lead to a loss of corporate revenue, we should not expect them to do so in the absence of pressure from their investors or some other source. The Mission Statement gives investors a clear sense of what to ask for. Given the potential interference of Corporate Client Conflict, mutual fund investors could insist on internal separation—a “fire wall”—between litigation decisions and the sales and marketing apparatus. Alternatively, investors could demand that stewardship groups refer certain litigation decisions to an outside decision-maker independent of the incentives of the sales and marketing department. If mutual funds fail to redesign their approach to litigation, their investors might be able to bring fiduciary duty litigation against them. Recall that T. Rowe Price paid its investors \$200 million to avoid investor lawsuits when it accidentally forfeited their appraisal rights.³³⁴ Mutual funds have also faced litigation for failing to collect settlement proceeds in shareholder class actions.³³⁵ Therefore, investor suits might also be possible when mutual funds fail to exercise shareholders’ litigation rights. For example, BlackRock is a Petrobras investor.³³⁶ Yet BlackRock did not bring a direct suit against Petrobras, even though Vanguard did.³³⁷ While we would not want to see investor litigation against mutual funds for failure to bring every claim—a safe-harbor deferring to the decision of a properly constituted, independent litigation committee strikes us as appropriate—some form of investor pressure seems necessary, given the potential of Corporate Client Conflict to influence mutual fund decision-making.

The collective action problem raises a second substantial obstacle to mutual fund participation in shareholder suits. Many of the benefits we described above in producing deterrence, enhancing governance, and reducing litigation agency costs redound to the market as a whole.³³⁸ Insofar as funds measure their performance relative to that of their rivals, they may have little incentive to expend resources to produce benefits in which their rivals will share.

A partial answer to the collective action problem is that mutual fund involvement in shareholder litigation need not cost much. Attorneys’ fees can be contingency-based. Moreover, in a given year, there are likely to be many fewer plausible shareholder claims, at least in comparison to the tens of thousands of elections and proposals in which stewardship groups currently participate.³³⁹ The cost of screening litigation can be minimized by promulgating guidelines *ex ante*, as well as by designating outside counsel as portfolio monitors to do much of the work in discovering potential violations and framing the case.

³³⁴ See *supra* note 187 and accompanying text.

³³⁵ See *supra* note 225 and accompanying text.

³³⁶ *PBR/Petroleo Brasileiro SA Petrobras ADR - Institutional Ownership and Shareholders*, FINTEL,, <https://fintel.io/so/us/pbr> (last updated July 3, 2019, 12:59 PM).

³³⁷ See *supra* Section III.A.4.

³³⁸ Note, however, that collective action incentives do not inhibit funds from seeking compensation in non-class suits. See *supra* Section IV.D.2.

³³⁹ There are roughly 400 securities class actions filed in a single year. See *supra* notes 191-193 and accompanying text. Compare this number to the 500+ shareholder proposals, and the tens of thousands of management elections and other proposals on which mutual funds must vote annually. See Lund, *supra* note 14.

But containing the cost of becoming involved in litigation is only a partial solution. If mutual funds do not see the benefit, due to collective action problems, they are unlikely to become involved however low the costs. It is important to emphasize, however, that the collective action problem afflicts fund families, not individual funds. Investors put their savings with individual funds, which owe fiduciary duties to their investors, not to the institution. It is therefore a potential breach of fiduciary duty for mutual funds to fail to litigate on their investors' behalf due to collective action conflicts at the institution level. Overcoming the collective action problem, like the corporate client conflict, may thus require that investors bring fiduciary duty claims against funds that fail to litigate on their behalf. And here again, lest such claims overwhelm mutual funds, we recommend a clear safe-harbor, based on the insights of the mission statement, and implemented by a properly constituted, independent litigation committee.

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

V. Conclusion

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

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

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

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