

# THE GATEKEEPERS OF SHAREHOLDER LITIGATION

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*Concerns over agency costs dominate corporate law. The central challenge in corporate law is ensuring that directors act in the corporation's best interests, rather than their own best interests. Shareholder litigation is a key tool in controlling these agency costs, allowing shareholders to sue if directors overstep legal limits. Shareholder litigation, however, has agency costs of its own because most shareholder plaintiffs lack sufficient incentives to closely monitor these lawsuits. As a result, plaintiffs' attorneys can make litigation decisions that benefit themselves at the expense of their shareholder clients. This concern arises in nearly all types of shareholder litigation—from shareholder derivative suits to securities class actions and merger cases. Regardless of the underlying law, shareholder litigation faces a common need for a gatekeeper to monitor and oversee these cases.*

*Yet, despite this shared problem, different types of shareholder litigation use very different gatekeepers. In securities class actions, Congress put its trust in institutional investors. In derivative suits, the law relies on corporate boards. And in merger cases, the law depends on greater oversight by judges in their review of settlements coupled with greater power for corporations to screen these lawsuits ex ante in their bylaws and charters. This Article, written for the OKLAHOMA LAW REVIEW's symposium on *Confronting New Market Realities: Implications for Stockholder Rights to Vote, Sell, and Sue*, explores why corporate law has chosen different gatekeepers for different types of shareholder litigation. It then argues that the legal system should look for ways to use a greater mix of gatekeepers in these cases.*

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### Introduction

Concerns over agency costs dominate corporate law.<sup>1</sup> The central challenge is ensuring that directors act in the corporation's best interests, rather than their own best interests.<sup>2</sup> Shareholder litigation is a key tool in controlling these agency costs.<sup>3</sup> If directors cross the line, the law provides an array of litigation options that shareholders can use to hold directors accountable. Shareholders can file securities class actions if directors lie to them.<sup>4</sup> They can file shareholder derivative suits if directors engage in egregious misconduct.<sup>5</sup> And they can file lawsuits under both state and federal law if directors try to sell the company at too low of a price or without adequate disclosures.<sup>6</sup>

Shareholder litigation, however, has agency costs of its own.<sup>7</sup> Most shareholder plaintiffs lack sufficient incentives to closely monitor these lawsuits.<sup>8</sup> As a result, plaintiffs' attorneys can make litigation decisions that

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1. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (Transaction Publishers 1991) (1932); Margaret M. Blair & Lynn A. Stout, *Team Production in Business Organizations: An Introduction*, 24 J. CORP. L. 743, 743 (1999) ("It is difficult to overstate the influence that the principal-agent approach has had on modern thinking about business organizations.").

2. See Steven M. Bainbridge, *Unocal at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 785-86 (2006) (noting that "agency costs are the inevitable consequence of vesting discretion in someone other than the residual claimant" and that "[a] complete theory of the firm therefore requires one to balance the virtues of discretion against the need to require that discretion be used responsibly").

3. See Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 118 (2006) ("In theory, directors are accountable to shareholders through derivative lawsuits, shareholder voting, and the invisible hand of the market.").

4. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975).

5. See *Agostino v. Hicks*, 845 A.2d 1110, 1116 (Del. Ch. 2006) ("Recognizing, however, that directors and officers of a corporation may not hold themselves accountable to the corporation for their own wrongdoing, courts of equity have created an ingenious device to police the activities of corporate fiduciaries: the shareholder's derivative suit.").

6. See *In re Trulia, Inc. Stockholder Litig.*, 129 A.3d 884 (Del. Ch. 2016) (discussing the legal landscape of merger class actions).

7. See, e.g., David H. Webber, *Private Policing of Mergers and Acquisitions: An Empirical Assessment of Institutional Lead Plaintiffs in Transactional Class and Derivative Suits*, 38 DEL. J. CORP. L. 907, 923 (2014) ("But litigation to enforce these rights generates costs of its own, including agency costs created by the disconnect between the interests of plaintiffs' lawyers and those of the shareholder class they represent.").

8. See 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, 19 (1991) (attributing high agency costs in class action and derivative

benefit themselves at the expense of their shareholder clients.<sup>9</sup> This concern arises in nearly all types of shareholder litigation—from shareholder derivative suits to securities class actions and merger cases.<sup>10</sup> Regardless of the underlying law, shareholder litigation faces a common need for a gatekeeper.

Yet, despite this shared problem, different types of shareholder litigation use very different gatekeepers to solve it. In securities class actions, Congress put its trust in institutional investors, hoping that their significant financial stake in these lawsuits would lead them to exercise greater control over their attorneys.<sup>11</sup> In derivative suits, the law places its faith in corporate boards, who can use special procedural devices to take control of suits filed in the corporation's name.<sup>12</sup> And in merger cases, the law relies on greater oversight by judges in their review of settlements coupled with greater power for corporations to screen these lawsuits *ex ante* in their bylaws and charters.<sup>13</sup>

There are good reasons for these differences. In securities class actions, the plaintiffs are often large institutions, which are uniquely suited to monitor these claims.<sup>14</sup> Derivative suits are filed on behalf of corporations, not shareholders,<sup>15</sup> so it makes sense to give corporate boards a voice in how these cases are litigated. And when it comes to merger cases, Delaware judges are motivated to exercise special oversight over these cases because they can threaten Delaware's dominance over state corporate law.<sup>16</sup> Different gatekeepers, in other words, make sense.

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litigation primarily to the inability of the class to effectively monitor the attorneys); Alon Klement, *Who Should Guard the Guardians? A New Approach for Monitoring Class Action Lawyers*, 21 REV. LITIG. 25, 45 (2002) (“Common to all agency problems is their correlation with the asymmetry of information between the principal and the agent. The less the principal is informed, the higher the agency costs will be.”).

9. See John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986).

10. See *infra* Part II.

11. See 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I) (2012).

12. See *infra* Section II.C.

13. See *infra* Section II.B.

14. See LAARNI T. BULAN ET AL., CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: 2015 REVIEW AND ANALYSIS 16 (2016), <https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Settlements-2015-Review-and-Analysis> (noting that a majority of securities class actions are filed today are filed by institutional investors).

15. See *La. Mun. Police Emps.' Ret. Sys. v. Pyott*, 46 A.3d 313, 330 (Del. Ch. 2012) (holding that it is a “legal truism that the underlying claim in a derivative action belongs to the corporation”).

16. See *infra* Section II.B.

None of the gatekeepers in these areas, however, have solved all of the problems in shareholder litigation. Institutional investors have cut down on some of the abuses in securities class actions, but created others.<sup>17</sup> Corporate boards are often motivated to protect their own interests in derivative suits, rather than the interests of plaintiff corporations.<sup>18</sup> And Delaware judges have been unable to stop merger cases from fleeing to other jurisdictions to escape their scrutiny.<sup>19</sup> By viewing each type of shareholder litigation as its own discrete problem, the legal system has missed an opportunity to learn broader lessons about the role of gatekeepers in shareholder litigation.

This Article examines gatekeepers through a wider lens. Given that no single gatekeeper is perfect, the legal system should look for ways to use a greater mix of gatekeepers in shareholder litigation. First, judges should take the enhanced scrutiny used in merger cases and apply it in derivative suits and securities class actions—areas where settlements have traditionally received only cursory review from judges. Second, corporate boards should have a greater role in shaping procedural rules through bylaw and charter provisions, subject to judicial and market scrutiny to ensure that boards are not misusing this power. Finally, legislatures should adopt heightened procedures, where appropriate, to better identify meritorious cases at an early stage of the proceedings.

This Article proceeds in three parts. Part I examines the common need for gatekeepers in shareholder litigation. Part II describes the different types of gatekeepers used in different types of shareholder lawsuits. Part III takes a broader view of gatekeeping in shareholder litigation, exploring how gatekeeping lessons can be applied across different types of lawsuits. In the end, as we will see, gatekeeping is too important to be left to any single group.

### *I. The Need for Gatekeepers in Shareholder Litigation*

Shareholder litigation is designed to combat one type of agency costs, but, in the process, it has created an entirely different type. While corporate law is primarily concerned with mitigating the agency costs between shareholders and corporate managers,<sup>20</sup> debates about shareholder litigation

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17. *See infra* Section II.A.

18. *See infra* Section II.C.

19. *See infra* Section II.B.

20. *See* BERLE & MEANS, *supra* note 1, at 86-88 (describing the agency costs that result from a separation of ownership and control in the modern corporation); Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1911 (2013) (“The separation of ownership and control has been the master problem of U.S. corporate law since the days of Berle and Means, if not before.”).

revolve around how best to mitigate the agency costs between shareholders and their attorneys.<sup>21</sup> This Part I explains those agency costs generally and then discusses how they play out in different types of shareholder lawsuits.

Agency costs exist in all types of lawsuits. Whether the case is a multimillion-dollar securities class action or a run-of-the-mill negligence case, there is always a concern that a lawyer will act in his or her own best interests rather than in the interests of the client.<sup>22</sup> In most cases, however, these agency costs are controlled in two ways. First, a client can monitor his or her attorney's decisions, questioning those that do not appear to be in the client's best interests and ultimately firing the attorney if the client's wishes are not followed.<sup>23</sup> Second, in contingency cases, the attorney's interests are typically aligned with the client's interests.<sup>24</sup> If, for example, the victim of an auto accident agrees to pay her attorney thirty percent of the recovery, both the victim and her attorney benefit from a higher recovery. Their interests are aligned, reducing the agency costs in the suit.

Shareholder lawsuits are different. Most shareholder lawsuits are representative suits, which means that a shareholder plaintiff represents the real parties in interest in the suits.<sup>25</sup> In securities and merger class actions, the real party in interest is a much larger class of shareholders,<sup>26</sup> while in derivative suits, it is the corporation that was allegedly injured by the misconduct of its directors or officers.<sup>27</sup> The representative nature of these suits means that the real parties in interest are not directly involved in the litigation and are therefore limited in their ability to monitor or control their attorneys.

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21. See James D. Cox & Randall S. Thomas, *Corporate Darwinism: Disciplining Managers in a World with Weak Shareholder Litigation*, 95 N.C. L. REV. 19, 22 (2016) (“[T]he benefits created by [shareholder litigation] are qualified by the litigation agency costs that surround them.”).

22. See Macey & Miller, *supra* note 8, at 3, 8.

23. See *id.* at 8–9.

24. See *id.* at 17–18.

25. See Sean J. Griffith, *Correcting Corporate Benefit: How to Fix Shareholder Litigation by Shifting the Doctrine on Fees*, 56 B.C. L. REV. 1, 6 (2015) (“[M]ost shareholder litigation is representative litigation, brought by a single shareholder or group of shareholders on behalf of an interest common to all.”)

26. See ROBERT C. CLARK, CORPORATE LAW § 15.1 (1986).

27. See *Kramer v. W. Pac. Indus., Inc.*, 546 A.2d 348, 351 (Del. 1988) (“In [a derivative suit] the shareholder sues on behalf of the corporation . . . [A]ny damages recovered . . . are paid to the corporation.” (quoting CLARK, *supra* note 26, at 639–40)); Jessica Erickson, *Corporate Misconduct and the Perfect Storm of Shareholder Litigation*, 84 NOTRE DAME L. REV. 75, 81 (2008).

In theory, the representative shareholder will monitor these lawsuits.<sup>28</sup> In practice, however, this monitoring function is limited because most representative shareholders lack the necessary incentives to monitor the suit.<sup>29</sup> There is no minimum ownership requirement to file a shareholder lawsuit, so a shareholder representative could theoretically own as little as one share of stock in the relevant company.<sup>30</sup> And, although many shareholder plaintiffs own more than one share, they may still not own a large enough stake to justify the costs of closely monitoring the litigation.<sup>31</sup> In other words, the shareholder plaintiff incurs all of the costs of monitoring the attorney, but receives only a fraction of the benefits.

These mismatched incentives increase the agency costs in shareholder lawsuits in two related ways. First, they create an incentive for attorneys to file lawsuits that may not be in their clients' best interests.<sup>32</sup> In typical negligence lawsuits, clients will only seek an attorney and authorize a lawsuit if they believe that the suit would be in their best interests.<sup>33</sup> In contrast, in shareholder lawsuits, the real parties in interest (i.e., the entire class of shareholders in a class action or the plaintiff corporation in a derivative suit) do not decide whether to file the suit. Instead, this decision is made by representative shareholders and their attorneys.<sup>34</sup> And once the suit is filed, the real parties in interest are extremely limited in their ability to control the course of the litigation.<sup>35</sup> As a result, suits may be filed that have a positive

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28. See John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, LAW & CONTEMP. PROBS., Summer 1985, at 5, 49.

29. See *id.*

30. See Cox & Thomas, *supra* note 21, at 22 ("Litigation agency costs arise because suits are often brought by a named plaintiff that has no substantial ownership interest in the corporation."); Macey & Miller, *supra* note 8, at 3-4.

31. See *id.*

32. See Macey & Miller, *supra* note 8, at 17.

33. See Anthony Sebok, *Dispatches from the Tort Wars*, 85 TEX. L. REV. 1465, 1492 (2007) (reviewing WILLIAM HALTOM & MICHAEL McCANN, *DISTORTING THE LAW: POLITICS, MEDIA, AND THE LITIGATION CRISIS* (2004), HERBERT M. KRITZER, *RISKS, REPUTATIONS, AND REWARDS: CONTINGENCY FEE LEGAL PRACTICE IN THE UNITED STATES* (2004), and TOM BAKER, *THE MEDICAL MALPRACTICE MYTH* (2005)) ("A rational self-interested 'investor'— . . . the plaintiffs' lawyer--would be incentivized to take steps to increase his client's expected return, since he now owns part of that return.")

34. See Macey & Miller, *supra* note 8, at 21 ("The attorneys themselves are responsible for initiating the litigation and do not rely on clients to come to them with cases.")

35. See, e.g., Kenneth W. Kossoff, *Director Independence and Derivative Suit Settlements*, 1983 DUKE L.J. 645, 657 ("Although the derivative plaintiff is the party that initiates the suit, courts routinely approve derivative settlements over the plaintiff's vehement objection." (footnotes omitted)).

value to their attorneys, but do not ultimately benefit the shareholders or the plaintiff corporation.

Second, reduced monitoring in shareholder litigation can increase agency costs by allowing attorneys to seek a higher percentage of the recovery for their fee. To understand this point, imagine a shareholder lawsuit in which the defendants agree to pay \$1 million to the plaintiffs. If the plaintiffs' attorney receives twenty-five percent of the recovery, the attorney will walk away with \$250,000 and the shareholder class will receive \$750,000, with the shareholder representative receiving his pro rata share of this amount. But what would stop the plaintiffs' attorney from seeking a greater percentage of the recovery, say thirty percent?<sup>36</sup> The defendants should not care—they pay the same amount either way, so it should not matter to them how this amount is divided between the plaintiffs' attorney and the class.<sup>37</sup> The shareholder representative should theoretically be monitoring the case, but as discussed above, many shareholder plaintiffs do not have the financial incentives to do the type of detailed monitoring required to prevent marginally higher fees.

It is one thing for the plaintiffs' attorney to seek a higher percentage of the recovery. But there are other, even more egregious possibilities. For example, the defendant and the plaintiffs' attorney could conspire to craft a settlement that benefits both of them at the expense of the absent class members.<sup>38</sup> Instead of the \$1 million settlement outlined above, what if the defendant offered \$900,000, but agreed to look the other way if the plaintiffs' attorney sought forty percent of the recovery? In this case, the settlement would be in

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36. See Tim Oliver Brandi, *The Strike Suit: A Common Problem of the Derivative Suit and Shareholder Class Action*, 98 DICK. L. REV. 355, 389 (1994) (arguing that the interests of shareholder plaintiffs and their attorneys "may conflict since the fee award comes out of the damage recovery so that any increase in the fee award necessarily leads to a decrease in plaintiffs' recovery").

37. See Macey & Miller, *supra* note 8, at 25–26 ("Defendants in common benefit and fee-shifting cases typically wish to minimize the sum of three costs: the costs of the relief on the merits, the costs of their own attorney's fees, and the costs of the plaintiffs' attorney's fees. Defendants are typically indifferent about how the total cost of litigation is distributed among these elements.").

38. See John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215, 232 (1983) ("The possibility of collusive settlements grows in direct proportion to the attorney's 'independence' from his client. . . . To say this is not to claim that plaintiffs' attorneys systematically subordinate the class recovery to their own fee, but it is to say that the plaintiff's attorney is subject to a serious conflict of interest."); Susanna M. Kim, *Conflicting Ideologies of Group Litigation: Who May Challenge Settlements in Class Actions and Derivative Suits?*, 66 TENN. L. REV. 81, 124 (1998) ("There is always the possibility that plaintiffs' attorneys will conspire with the defendants to exchange a small settlement for a large award of attorneys' fees.").

the defendants' interests because they would pay less, and it would be in the attorney's interest because he or she would receive more.<sup>39</sup> The only people who would be hurt by this settlement are the shareholders who receive significantly less than they otherwise would have.

The defendants might try an even bolder strategy. Instead of offering \$1 million or even \$900,000, they might offer no money at all to the plaintiffs. Instead, they might put on the table what is known as a "non-monetary settlement," or a settlement that includes consideration other than money.<sup>40</sup> In this instance, the defendants will probably still have to pay some money to the plaintiffs' attorney in fees, but the overall cost to the defendants will be much less than if they had to pay both the plaintiffs and the plaintiffs' attorney. And, depending on the amount of the fees and the upfront costs to litigate, the plaintiffs' attorney may end up with more money in his or her pockets as well.

This last example is not as far-fetched as it may sound. Non-monetary settlements are surprisingly common in shareholder litigation.<sup>41</sup> Until approximately 2015, nearly *all* merger class actions ended with non-monetary settlements, with the consideration of additional disclosures to shareholders about the merger.<sup>42</sup> And despite the non-monetary nature of the settlements, the plaintiffs' attorneys still received six-figure fees, averaging

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39. See Macey & Miller, *supra* note 8, at 26 ("Thus the conditions are present for a bargain under which the plaintiffs' attorneys agree to a lower overall settlement on the merits of the litigation in exchange for a higher fee.").

40. See Coffee, *supra* note 9, at 716 ("The availability of these bloodless settlements gives rise to a set of circumstances in which it can appear economically irrational not to settle. By settling, neither side loses anything, and both recoup their legal expenses from the corporation (and thus indirectly from the shareholders).").

41. See 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, 559 (2015) ("In most settled cases, the only relief provided to shareholders consists of supplemental disclosures in the merger proxy statement. In compensation for the benefit produced by these settlements--often worth no more, in the words of a famous jurist, than a 'peppercorn'—plaintiffs' attorneys receive a fee award." (footnote omitted)).

42. See OLGA KOUMRIAN, CORNERSTONE RESEARCH, SHAREHOLDER LITIGATION INVOLVING MERGERS AND ACQUISITIONS: REVIEW OF 2014 M&A LITIGATION 5 (2015), <https://www.cornerstone.com/Shareholder-Litigation-Involving-Acquisitions-2014-Review> [hereinafter KOUMRIAN, REVIEW OF 2014]; RAV SINHA, CORNERSTONE RESEARCH, SHAREHOLDER LITIGATION INVOLVING ACQUISITION OF PUBLIC COMPANIES: REVIEW OF 2015 AND 1H 2016 M&A LITIGATION 5 (2016), <https://www.cornerstone.com/Publications/Reports/Shareholder-Litigation-Involving-Acquisitions-2016>.

\$500,000 in these cases.<sup>43</sup> Similarly, in shareholder derivative suits, plaintiff corporations—the real parties in interest in these suits—often agree to settle the derivative claims in exchange for making relatively modest changes to their corporate governance practices.<sup>44</sup>

In theory, non-monetary settlements might have value.<sup>45</sup> There may well be situations in which additional disclosures or corporate governance reforms may be more valuable to the plaintiffs than money.<sup>46</sup> Yet, they also raise a risk that attorneys and defendants may benefit themselves at the expense of the shareholders or the plaintiff corporation.<sup>47</sup> And numerous empirical studies have found that these settlements often offer little value to plaintiffs, illustrating that these settlements can be abused by plaintiffs' attorneys.<sup>48</sup> As a result, whatever theoretical value these types of settlements might have, they seem to have less value in practice.

Bringing the analysis full circle, in most areas of the law, the legal system does not worry about the merits of settlements. Instead, it trusts plaintiffs to monitor their attorneys and ensure that any agreed-upon settlements reflect their best interests. In shareholder litigation, however, the plaintiffs are often

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43. See OLGA KOUMRIAN, CORNERSTONE RESEARCH, SETTLEMENTS OF SHAREHOLDER LITIGATION INVOLVING MERGERS AND ACQUISITIONS—REVIEW OF 2013 M&A LITIGATION, at 3 (2014), <https://www.cornerstone.com/Publications/Reports/Settlements-of-M-and-A-Shareholder-Litigation> [hereinafter KOUMRIAN, REVIEW OF 2013]; see also Matthew D. Cain & Steven Davidoff Solomon, *A Great Game: The Dynamics of State Competition and Litigation*, 100 IOWA L. REV. 465, 479 (2015) (“The average attorneys’ fees for disclosures [between 2005-2011] are \$749,000, considerably lower than other settlement types. This supports the principle put forth by some that ‘disclosure only’ settlements are not highly valued by the litigant participants or the courts.”).

44. See Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, 51 WM. & MARY L. REV. 1749 (2010) (analyzing corporate governance settlements in derivative suits filed in federal court).

45. See *id.* (discussing analytical frameworks to evaluate the benefits of non-monetary settlements); Fisch et al., *supra* note 41, at 570 (“Disclosure-only settlements can benefit the shareholder class if the required disclosures allow the shareholders to exercise their voting rights in a more meaningful manner.”).

46. See Erickson, *supra* note 44 (explaining how non-monetary settlements might cure an underlying governance problem at the corporation that led to the problems challenged in the suit).

47. See Macey & Miller, *supra* note 8, at 94-95.

48. See Erickson, *supra* note 44, at 1755 (explaining that “corporate governance settlements often fail to live up to their potential because they include reforms that are unlikely to benefit corporations or their shareholders”); Fisch et al., *supra* note 41, at 561 (“[D]isclosure-only settlements do not appear to affect shareholder voting in any way. We also find only weak evidence that consideration-increase settlements increase shareholder voting in favor of a transaction.”).

absent class members who lack the financial incentives to closely monitor the litigation. As a result, the legal system cannot rely on them to ensure that these suits are litigated in a way that reflects the best interests. Instead, they must rely on different gatekeepers. As we will see, however, these gatekeepers are not the same across different types of shareholder lawsuits.

## *II. The Diverse Gatekeepers in Shareholder Litigation*

Part I explained how different types of shareholder lawsuits all face the same challenge in ensuring that plaintiffs' attorneys make litigation decisions that are in the plaintiffs' best interests. Yet in the three main types of representative shareholder lawsuits—securities class actions, merger suits, and derivative suits—each choose different gatekeepers to monitor the attorneys' conduct. This Part II explains the different gatekeepers in these lawsuits, as well as the pros and cons of each.

### *A. Securities Class Actions*

In 1995, Congress enacted the Private Securities Litigation Reform Act (“PSLRA”),<sup>49</sup> which overhauled the procedural rules governing securities class actions. Pursuant to the PSLRA, there are now two primary gatekeepers in securities class actions: lead plaintiffs and Congress. The subsections below discuss the PSLRA's effectiveness in reducing agency costs in securities class actions.

#### *1. Lead Plaintiffs*

One of the PSLRA's primary goals was to increase the role of large, institutional shareholders.<sup>50</sup> Prior to 1995, if multiple shareholders filed parallel suits, courts had significant discretion to decide which shareholder would oversee the litigation.<sup>51</sup> The PSLRA significantly limited that discretion, creating a presumption that the lead plaintiff should be the

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49. Private Securities Litigation Reform Act of 1995 § 101, 15 U.S.C. § 78u-4(b)(2) (2012).

50. See S. REP. NO. 104-98, at 11 (1995) (“The Committee intends to increase the likelihood that institutional investors will serve as lead plaintiffs . . . .”); H.R. REP. NO. 104-369, at 34 (1995) (“The Conference Committee seeks to increase the likelihood that institutional investors will serve as lead plaintiffs . . . .”).

51. See, e.g., Elliott 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, 2062 (1995) (“Courts most often appoint as lead counsel the lawyer who files the first complaint.”).

shareholder applicant with the largest financial stake in the litigation.<sup>52</sup> The PSLRA also requires the lead plaintiff, “subject to the approval of the court, [to] select and retain counsel to represent the class.”<sup>53</sup>

According to the legislative history, this provision was designed to increase the role of institutional plaintiffs in securities class actions.<sup>54</sup> The idea was that institutional investors with large financial stakes in the litigation would monitor the cases more closely than smaller shareholders.<sup>55</sup> In many ways, the PSLRA has succeeded in this goal. Approximately two-thirds of settled cases have at least one institutional investor as lead plaintiff.<sup>56</sup> These institutions are largely labor unions and public pension funds, rather than the mutual funds envisioned by Congress,<sup>57</sup> but they nonetheless tend to have substantial stakes in the outcome of the lawsuits.

Overall, these institutional investors have succeeded in lowering the fees of their attorneys. One study, for example, found that cases in which state pension funds serve as lead plaintiff result in lower attorneys’ fees as a percentage of the total recovery than cases in which an individual served as lead plaintiff.<sup>58</sup> Additionally, larger funds negotiate for even lower fees.<sup>59</sup> These findings confirm Congress’s intuition that institutional investors have greater incentives to protect absent class members.

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52. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb).

53. *Id.* § 78u-4(a)(3)(B)(v).

54. *See* S. REP. NO. 104-98, at 11 (1995); H.R. REP. NO. 104-369, at 34 (1995).

55. *See* Elliott J. Weiss, *The Lead Plaintiff Provisions of the PSLRA After a Decade, or “Look What’s Happened to My Baby”*, 61 VAND. L. REV. 543, 547 (2008) (stating that the PSLRA was based on research predicting that “if class action procedures could be reformed to make it easier for institutional investors with large losses to become lead plaintiffs and to select the attorneys who would represent the class, those institutions would have an economic incentive to retain and to monitor class counsel so as to reduce substantially the agency costs associated with securities class action litigation”).

56. *See* BULAN ET AL., *supra* note 14, at 16.

57. *See* H.R. REP. NO. 104-369, at 34-35 (1995); Elizabeth Chamblee Burch, *Optimal Lead Plaintiffs*, 64 VAND. L. REV. 1109, 1121 (2011) (arguing that “because other eligible institutions like banks, mutual funds, and insurance companies maintain commercial relationships with the defendants or defendants’ customers, public and union pension funds are the institutions that typically take on the lead-plaintiff role”).

58. *See* Stephen J. Choi et al., *The Price of Pay to Play in Securities Class Actions*, 8 J. EMPIRICAL LEGAL STUD. 650, 678 (2011) (“We also find that local pension funds, although generally having smaller stakes in class action recoveries, appear to negotiate lower fees than individuals.”).

59. *See id.* at 651 (“We also find that larger funds, of all types, tend to negotiate lower attorney fees.”).

And the reliance on institutional investors as gatekeepers in these lawsuits makes sense. Unlike many other types of class actions, securities class actions typically end with multi-million-dollar settlements,<sup>60</sup> and many class members have multimillion-dollar claims themselves.<sup>61</sup> As a result, they have greater financial incentives to monitor the litigation than a stereotypical class member with only a few dollars at stake.<sup>62</sup> Framed another way, securities class actions may be one of the only types of class actions able to rely on lead plaintiffs to monitor the litigation because it is one of the only types of class actions with class members who have substantial financial stakes in the outcome. As a result, it is not surprising that securities class actions, unlike many other types of class actions, have put greater monitoring responsibilities on lead plaintiffs.

On the other hand, the reliance on institutional shareholders has not cured all of the problems in securities class actions. First, the PSLRA did not mandate that large shareholders control all securities class actions. Instead, it only stated that, in most instances, the lead plaintiff should be the applicant with the largest financial stake in the litigation.<sup>63</sup> If all applicants are individual shareholders with small holdings, the lead plaintiff will be selected from among this group. Indeed, post-PSLRA studies find that there is a subset of securities class actions that continues to be controlled by individual investors, and this subset, on the whole, tends to involve smaller, potentially more frivolous claims.<sup>64</sup>

Moreover, as soon as the legal system gave institutional investors more power, it also created incentives for plaintiffs' attorneys to curry favor with these investors. Most of the institutions that serve as lead plaintiff are pension

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60. See BULAN ET AL., *supra* note 14, at 1 (finding that average settlement size of securities class actions in 2015 was \$37.9 million).

61. See generally James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?*, 80 WASH. U. L.Q. 855, 855-65 (2002).

62. See Weiss, *supra* note 55, at 574 (stating that "a class member with a considerable sum at stake was likely to be more committed than a court to ensuring that all claims asserted on behalf of the plaintiff class were prosecuted vigorously").

63. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb).

64. See James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587, 1620-22 (2006) (finding that cases controlled by individuals or groups of individuals involve lead plaintiffs with small dollar value and respective stakes in the cases and therefore "[i]t seems apparent that these claimants cannot be realistically expected to engage in costly monitoring of class counsel").

funds,<sup>65</sup> and most of these pension funds are controlled by politicians who often have to campaign to retain their current seat or have an eyes on other elected offices.<sup>66</sup> Empirical evidence suggests that at least some of these firms make campaign contributions to these politicians in the hopes of inducing the funds that these politicians control to hire them as lead counsel.<sup>67</sup>

For example, in Mississippi, the Attorney General oversees the state's retirement system.<sup>68</sup> Starting in 2004, plaintiffs' firms started to make considerable donations to the Attorney General's campaign, comprising approximately a significant percentage of the total contributions to his campaign from 2007 through 2009.<sup>69</sup> These campaign contributions seemingly paid off. The same law firms that donated to his campaign were also chosen to serve as lead counsel or co-lead counsel in securities class actions in which the Mississippi retirement system served as one of the lead plaintiffs.<sup>70</sup> Many of these cases ended with sizable settlements that resulted in substantial fees for the law firms.<sup>71</sup> Mississippi is far from the only state subject to allegations that plaintiffs' law firms must "pay to play" when it comes to pension funds' selection of lead counsel.<sup>72</sup>

This influence matters. As noted above, state pension funds generally bargain for lower attorneys' fees in securities class actions than do individual investors.<sup>73</sup> This fee differential, however, largely disappears when

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65. See BULAN ET AL., *supra* note 14, at 16 (finding that approximately forty percent of settlements in securities class actions have involved a public pension fund as lead plaintiff).

66. See David H. Webber, *Is "Pay-to-Play" Driving Public Pension Fund Activism in Securities Class Actions? An Empirical Study*, 90 B.U. L. REV. 2031, 2044-46 (2010).

67. See, e.g., Choi et al., *supra* note 58, at 653-54; Drew T. Johnson-Skinner, Note, *Paying-to-Play in Securities Class Actions: A Look at Lawyers' Campaign Contributions*, 84 N.Y.U. L. REV. 1725, 1728 (2009). This point, however, is not without controversy. See, e.g., Webber, *supra* note 66, at 2044.

68. 2014 MISS. ATT'Y GEN. ANN. REP. 81, <http://www.ago.state.ms.us/wp-content/uploads/2014/12/AGO-FY2014-Annual-Report.pdf> ("Special Assistant Attorney General Jane Mapp serve[d] as legal counsel to the Public Employees' Retirement System of Mississippi (PERS). PERS is responsible for administering the Public Employees' Retirement System . . .").

69. STEPHEN J. CHOI ET AL., U.S. CHAMBER INST. FOR LEGAL REFORM, FREQUENT FILER: REPEAT PLAINTIFFS IN SHAREHOLDER LITIGATION 6-8 (2013), [http://www.instituteforlegalreform.com/uploads/sites/1/FrequentFilers\\_FINAL.pdf](http://www.instituteforlegalreform.com/uploads/sites/1/FrequentFilers_FINAL.pdf).

70. *Id.* at 8.

71. *Id.* at 8-9.

72. *Id.* at 14 n.2 (explaining that states such as Louisiana, North Carolina, and Oklahoma face similar problems).

73. Choi et al., *supra* note 58, at 650.

researchers control for campaign contributions made to candidates with influence over the pension funds. And this effect is particularly pronounced when it comes to the funds whose officials receive the largest campaign contributions and the funds that have a long-term relationship with a single firm.<sup>74</sup> This data shows that, although we might expect that public pension funds that repeatedly rely on the same firm might bargain for lower fees, in fact the opposite happens. Experience matters, but not in the way we might hope.

More broadly, institutional investors have not exercised their new monitoring responsibilities as well or as creatively as lawmakers might have hoped. Although institutional investors are correlated with lower fees, empirical studies have found that this reduction does not result from *ex ante* bargaining between these investors and their lawyers, as Congress had hoped.<sup>75</sup> Instead, in most cases, courts still set fees after the parties have agreed on a settlement.<sup>76</sup> And this lack of bargaining has had a predictable impact on fees, with studies demonstrating that “courts in most cases set fees in precisely the same manner they did before passage of the PSLRA--*ex post*, after a settlement has already been reached.”<sup>77</sup> As a result, while fees have gone down, the reduction might not be as much as Congress had hoped.

Pulling this analysis together, ever since the enactment of the PSLRA, securities class actions have relied on institutional investors to serve as monitors in securities class actions, and for good reason given that these institutions often have multimillion-dollar stakes in the litigation. And, on average, this reliance has paid off with lower attorneys’ fees, which means the class ends up with more money. But there are downsides to this reliance as well, as *pay-to-play* allegations demonstrate, and limits to what institutional investors have been able to accomplish. As we shall see, however, they are not the only monitors in securities class actions. Congress also claimed an important role for itself in the PSLRA.

## 2. Congress

When it came to tinkering with the rules governing securities class actions in the PSLRA, Congress did not stop with the lead plaintiff provisions described above. It also included heightened pleading requirements, which make it more difficult for plaintiffs to survive a motion to dismiss and

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74. *See id.* at 651.

75. Lynn A. Baker et al., *Is the Price Right? An Empirical Study of Fee-Setting in Securities Class Actions*, 115 COLUM. L. REV. 1371, 1379-80 (2015).

76. *Id.* at 1380.

77. *Id.*

proceed to discovery. The PSLRA requires that, in any case in which the plaintiff alleges that the defendant made a false or misleading fact (i.e., almost all securities class actions), the plaintiff must specify “each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading.”<sup>78</sup> Moreover, “if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.”<sup>79</sup> In addition, when it comes to allegations of scienter, or the defendant’s state of mind, the PSLRA requires that the plaintiff allege “with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”<sup>80</sup> The PSLRA is one of the only federal statutes that relies on heightened pleading requirements to sort cases,<sup>81</sup> and it is a significant break from the less stringent pleading requirements under the Federal Rules of Civil Procedure.<sup>82</sup>

The PSLRA requires judges to dismiss a securities class action that does not comply with these heightened pleading requirements.<sup>83</sup> At first glance, therefore, these provisions appear to give judges, rather than Congress, extra monitoring responsibility in securities class actions. And in many ways, judges do have more power because Congress deputized them to sort the good cases from the bad. Judges, in other words, are the monitors on the front lines, making the case-by-case decisions on whether specific claims meet the given pleading requirements.

But judges have always played this role, albeit usually under a different pleading standard. Regardless of whether securities class actions are governed by Rule 8, Rule 9, or the new pleading requirements of the PSLRA, judges must decide whether a given complaint meets the relevant pleading standard.<sup>84</sup> And judges play this role in every case, or at least in every case where the defendant challenges the sufficiency of a pleading. The pleading standards may be different, but the role of judges in applying these standards is not. As a result, judges do play a monitoring role in securities class actions,

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78. 15 U.S.C. § 78u-4(b)(1)(B) (2012).

79. *Id.*

80. *Id.* § 78u-4(b)(2).

81. See Jessica Erickson, *Heightened Procedure*, 102 IOWA L. REV. 61, 85-86 (2016).

82. See generally FED. R. CIV. P. 8 (establishing a notice pleading standard for most civil claims).

83. 15 U.S.C. § 78u-4(b)(3)(A) (“In any private action arising under this chapter, the court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met.”).

84. See FED. R. CIV. P. 12(b)(6).

but this role is not fundamentally different than in any other type of federal civil case.<sup>85</sup>

The role of Congress, however, is different. In the PSLRA, Congress claimed for itself a greater gatekeeper role to sort the good cases from the bad. In most types of federal cases, Congress sits back and lets the normal Rule 8 pleading standards do their work. In securities class actions, however, Congress intervened, making ex ante decisions about the types of cases that should survive. Congress, in other words, is the ultimate decision-maker in these cases, crafting the standard that is then used in federal courts across the country in deciding motions to dismiss.

So how has Congress performed in this gatekeeping role? The empirical evidence is decidedly mixed. The PSLRA succeeded in reducing the number of frivolous cases, exactly the result that Congress wanted.<sup>86</sup> Yet it also reduced the number of non-frivolous cases, especially those in which there is no hard evidence of fraud, such as a restatement or SEC enforcement action.<sup>87</sup> As one study concluded, “the PSLRA operated less like a selective deterrence against fraud and more as a simple tax on all litigation (including meritorious suits).”<sup>88</sup> As a result, Congress may have inserted itself into securities class actions, but it cannot argue that it has been an especially effective gatekeeper.

### *B. Merger Class Actions*

Merger class actions have faced even greater agency cost challenges than securities class actions, and these challenges have been addressed in radically

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85. This is not to say that judges’ role in securities class actions is exactly the same. First, a heightened pleading standard may have an impact on how judges approach the case and see their own role. As scholars have noted, judges use heuristics to evaluate claims on a motion to dismiss, and they may see their own role differently when they are asked by Congress to use a more skeptical eye. See Hillary A. Sale, *Judging Heuristics*, 35 U.C. DAVIS L. REV. 903, 946 (2002) (arguing that the rhetoric in decisions on motions to dismiss in securities class actions “arguably reveals that the courts are not simply applying pre-PSLRA standards designed to sort the good cases from the bad” but instead are “disdainful of the plaintiffs’ attorneys before them and aggravated by the length and complexity of the complaints”).

86. Stephen J. Choi et al., *The Screening Effect of the Private Securities Litigation Reform Act*, 6 J. EMPIRICAL LEGAL STUD. 35, 64-66 (2009).

87. *Id.*; see also Eric Talley & Gudrun Johnsen, *Corporate Governance, Executive Compensation and Securities Litigation* 4 (Univ. of S. Cal. Law Sch., Olin Research Paper No. 04-7, 2004), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=536963](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=536963) (presenting data “that even if the PSLRA reduced frivolous litigation (as its proponents claim), it likely deterred meritorious litigation as well, and in such proportions as to swamp the deterring effects on non-meritorious suits”).

88. Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J.L. ECON. & ORG. 598, 623 (2007).

different ways. In 2014, approximately ninety-three percent of large mergers and acquisitions were challenged in court.<sup>89</sup> Whatever one may think about corporate boards, it is hard to imagine that they breach their fiduciary duties nearly every time they approve a large merger or acquisition.<sup>90</sup> Under significant pressure to protect the shareholder litigation franchise, Delaware and other states explored ways to reduce frivolous merger litigation. Rather than passing a PSLRA-style law, however, states have relied on two other gatekeepers—judges and the targeted companies themselves. This section examines how these gatekeepers came into power and their mixed success in exercising it.

### 1. Judges

Until fairly recently, judges did not have to worry about merger class actions. Shareholders would occasionally challenge a corporate board's decision to merge or be acquired, especially if there was a controlling shareholder involved,<sup>91</sup> but these cases did not raise serious agency cost concerns. Some of these cases were good, some were bad, but courts were largely able to tell the difference.

This all changed over the last several years. Between 2007 and 2014, the percentage of large mergers acquisitions challenged in court increased from forty-four percent to ninety-three percent.<sup>92</sup> There does not appear to have been a single event that precipitated this change,<sup>93</sup> but regardless of the cause, lawyers figured out that these cases were relatively easy money. Traditionally, a shareholder challenging a merger or acquisition would allege

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89. See KOUMRIAN, REVIEW OF 2014, *supra* note 42, at 1.

90. See James D. Cox, *How Understanding the Nature of Corporate Norms Can Prevent Their Destruction by Settlements*, 66 DUKE L.J. 501, 505 (2016) (arguing that the prevalence of deal litigation provides “ample reason to believe that more is afoot in corporate litigation than an abundance of potential wrongdoing”).

91. See, e.g., *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110 (Del. 1994).

92. KOUMRIAN, REVIEW OF 2014, *supra* note 42, at 1.

93. See, e.g., Edward B. Micheletti & Jenness E. Parker, *Multi-Jurisdictional Litigation: Who Caused This Problem, and Can It Be Fixed?*, 37 DEL. J. CORP. L. 1, 6 (2012) (“Many believe, for example, that the advent of multi-jurisdictional litigation was a reaction by the plaintiffs’ bar to certain unfavorable rulings in Delaware from a stockholder point of view.”); Randall S. Thomas & Robert B. Thompson, *A Theory of Representative Shareholder Suits and Its Application to Multijurisdictional Litigation*, 106 NW. U. L. REV. 1753, 1769 (2012) (arguing that the PSLRA contributed to the rise of merger litigation in part because the PSLRA’s lead plaintiff provisions mean that “[n]ewer, smaller firms with fewer financial resources will only be able to enter the market if they find niches where they can litigate what they perceive as good cases without investing large amounts of resources but still earn sufficient fees to stay in business”).

that the price was too low or the terms too onerous.<sup>94</sup> This type of claim would require wrangling about the actual value of the company and, if the plaintiffs were successful, would typically end with a higher deal price or altered deal terms. Defendants would fight these claims to avoid risking the merger and/or paying a significant cash settlement.<sup>95</sup>

Shareholder plaintiffs (or their lawyers) realized more recently that they would have an easier time if they challenged a company's disclosures about a merger, rather than the merger itself.<sup>96</sup> If the plaintiffs alleged that the company's disclosures were inadequate, then the company could fix the problem by making additional disclosures, rather than by paying money.<sup>97</sup> Most companies would rather make a few additional disclosures rather than re-negotiate the deal or pay millions in damages.<sup>98</sup> And, even if the companies thought their existing disclosures were adequate, they would rather disclose a little more information about the deal than pay to fight the case and risk holding up the deal.

As a result, more and more merger cases now end with the prototypical, non-monetary settlements discussed in Part I. In 2014, only eight percent of the settlements in merger cases involved cash consideration, while nearly eighty percent included additional disclosures or other non-monetary changes to the deal terms.<sup>99</sup> The average fees resulting from these settlements were approximately half a million dollars.<sup>100</sup> This relatively easy money

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94. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 464-67 (1977).

95. This is not to say that these settlements were utterly different from the settlements we see today. Corporations could make relatively minor changes to the terms of the deal to settle the case, later bringing in the plaintiffs to bless the changes and give them their release, a move that the Delaware Court of Chancery called a "Kabuki dance." See *In re Revlon, Inc. S'holders Litig.*, 990 A.2d 940, 945 (Del. Ch. 2010). This pattern was thus a precursor to the disclosure-only settlements that would soon follow.

96. See *Fisch et al.*, *supra* note 41, at 564-65 ("Although the courts have long recognized that the board in a merger is responsible for providing shareholders with sufficient information to approve or reject the transaction on an informed basis, the suggestion that directors have an independent duty of disclosure and that directors can breach that duty by failing to provide shareholders with information material to the vote is of recent vintage." (footnote omitted)).

97. See Phillip R. Sumpter, *Adjusting Attorneys' Fee Awards: The Delaware Court of Chancery's Answer to Incentivizing Meritorious Disclosure-Only Settlements*, 15 U. PA. J. BUS. L. 669, 686-87 (2013) ("[M]uch of the improved disclosure can be attributed, at least in part, to the disclosure-only line of cases.").

98. *Cf. Cox*, *supra* note 90, at 510 ("[D]isclosure-only settlements are an efficient medium for addressing deal litigation: the defense lawyers' clients are happy, and the plaintiffs' counsel are paid.").

99. KOUMRIAN, REVIEW OF 2014, *supra* note 42, at 5.

100. KOUMRIAN, REVIEW OF 2013, *supra* note 43, at 1.

prompted lawsuits of most deals in more than one jurisdiction, as multiple lawyers tried to get a piece of the litigation pie. It became commonplace for corporations to pay a “deal tax” to plaintiffs’ attorneys every time they entered into a large merger or acquisition.<sup>101</sup>

There was no PSLRA that could solve this problem. These cases were filed under state law, often in state court. The federal government could preempt state law or provide an exclusive forum for these cases in federal court,<sup>102</sup> but doing so would upset the traditional role of states in corporate law, especially Delaware, given the significant percentage of companies incorporated there.<sup>103</sup> As a result, the federal government had a limited ability to solve the problem. Instead, the responsibility rested with states, and more specifically Delaware courts, to address the problems that these cases raised.

For several years, judges in Delaware decried the developments in merger litigation.<sup>104</sup> In January 2015, however, Delaware took action, rejecting a non-monetary settlement in a merger class action filed against Trulia, Inc.<sup>105</sup> This case challenged Zillow, Inc.’s acquisition of Trulia, Inc. on the grounds that Trulia’s board had failed to properly value the company.<sup>106</sup> Although the plaintiffs challenged the deal terms, they agreed to settle the claims in exchange for additional disclosures about the deal.<sup>107</sup>

In rejecting the settlement, Chancellor Bouchard roundly criticized merger litigation more generally. He stated that “far too often such litigation serves no useful purpose for stockholders.”<sup>108</sup> The Chancellor continued:

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101. See K. Tyler O’Connell et al., *Reducing the “Deal Tax”: Delaware’s Recent Scrutiny of Nonmonetary Settlements*, BUS. L. TODAY, Oct. 2015, at 1.

102. Cf. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, 3231 (preempting state securities class actions).

103. See, e.g., J. Travis Laster, *A Milder Prescription for the Peppercorn Settlement Problem in Merger Litigation*, 93 TEX. L. REV. SEE ALSO 129, 132 (2015) (arguing against “radical surgery on Delaware corporate law by removing the entire subject of transaction-related disclosure”).

104. See, e.g., Transcript of Settlement Hearing and Request for Attorneys’ Fees and the Court’s Rulings at 73-74, *Acevedo v. Aeroflex Holding Corp.*, C.A. No. 7930-VCL (Del. Ch. July 8, 2015), <http://blogs.reuters.com/alison-frankel/files/2015/07/acevedovaeroflex-settlementhearingtranscript.pdf> (refusing to approve the intergalactic releases that have been previously accepted by the courts); Transcript of Settlement Hearing Rulings of the Court at 73, *In re Aruba Networks, Inc. S’holder Litig.*, No. 10765-VCL (Del. Ch. Oct. 9, 2015), <http://www.dandodiary.com/wp-content/uploads/sites/265/2015/10/Aruba-Networks-Transcript.pdf>.

105. *In re Trulia, Inc. S’holder Litig.*, 129 A.3d 884, 907-08 (Del. Ch. 2016).

106. *Id.* at 889.

107. *Id.* at 887.

108. *Id.* at 891-92.

Instead, it serves only to generate fees for certain lawyers who are regular players in the enterprise of routinely filing hastily drafted complaints on behalf of stockholders on the heels of the public announcement of a deal and settling quickly on terms that yield no monetary compensation to the stockholders they represent.<sup>109</sup>

He announced that the court would “reexamine[]” its “historical predisposition toward approving disclosure settlements.”<sup>110</sup> He also promised that the court would “disfavor” disclosure-only settlements that do not involve “plainly material” information.<sup>111</sup>

Since the *Trulia* decision, the Delaware Court of Chancery has largely stayed true to its word. It has rejected several settlements,<sup>112</sup> and a few courts in other jurisdictions have followed suit.<sup>113</sup> The fallout from *Trulia* has been both positive and negative. On the positive side, the percentage of large mergers and acquisitions that were challenged in court was down precipitously—from a high of ninety-four percent in 2013 to sixty-four percent in the first half of 2016.<sup>114</sup> On the negative side, *Trulia* did not completely solve the problem of frivolous merger litigation.<sup>115</sup> Although it reduced the incidence of this litigation, it is still hard to imagine that corporate boards breach their fiduciary duty in nearly two-thirds of large mergers and acquisitions. And in the suits that remain, non-disclosure settlements remain common.<sup>116</sup>

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109. *Id.*

110. *Id.* at 896.

111. *Id.* at 898.

112. See Edward Micheletti et al., *Trulia's Impact on Deal Litigation in Delaware and Beyond*, LAW360 (Nov. 28, 2016, 9:47 AM), <https://www.law360.com/articles/864466/trulia-s-impact-on-deal-litigation-in-delaware-and-beyond> (“Disclosure-based settlements before the Court of Chancery have fallen out of favor.”).

113. See, e.g., *In re Walgreen Co. Stockholder Litig.*, 832 F.3d 718 (7th Cir. 2016); *Vergiev v. Aguero, et al.*, No. L-2776-15 (N.J. Super. Ct. 2016). *But see* *Corwin v. British Am. Tobacco PLC*, No. 14 CVS 8130, 2016 WL 635191 (N.C. Super. Ct. Feb. 17, 2016) (approving the partial settlement despite counsel’s objection that *Trulia* should be considered).

114. SINHA, *supra* note 42, at 1.

115. See Sean J. Griffith, *Private Ordering Post-Trulia: Why No Pay Provisions Can Fix the Deal Tax and Forum Selection Provisions Can't*, in *THE CORPORATE CONTRACT IN CHANGING TIMES* (Steven Davidoff Solomon & Randall S. Thomas, eds., forthcoming 2017), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2855950](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2855950) (describing the limitations of *Trulia*).

116. See SINHA, *supra* note 42, at 1 (finding that post-*Trulia* “monetary consideration paid to shareholders has remained relatively rare”).

*Trulia* has also incentivized plaintiffs to try their chances outside of Delaware. A few courts have adopted *Trulia*,<sup>117</sup> but others have not, continuing to approve disclosure-only settlements.<sup>118</sup> And even in the jurisdictions that have adopted *Trulia*, plaintiffs may think their chances under the “plainly material” standard are better outside of Delaware. As a result, the forum shopping that plagued merger litigation before *Trulia* continues.<sup>119</sup>

This impact shows the difficulty of relying on judges as the primary monitors in shareholder lawsuits. These lawsuits can often be filed in more than one jurisdiction. As a result, if one court starts to crack down, plaintiffs can just move to other jurisdictions that are less attuned to the problems. Given the costs of litigating a merger case to conclusion, it may be cheaper for plaintiffs to file outside of Delaware and the defendants not to fight the choice of forum and simply agree to nuisance settlements.

Moreover, the *Trulia* approach depends on judges with the knowledge and incentives to act as strict monitors. The Delaware Court of Chancery judges are experts in Delaware corporate law and were well-aware of the rising problems in merger litigation.<sup>120</sup> They are also presumably motivated to protect the shareholder litigation franchise and protect the court’s reputation as the overseer of corporate litigation. And yet even with their knowledge and incentives, it still took them several years to crack down on a situation that everyone agreed had gotten out of hand, and even now they have not been able to completely solve the problem.

Few other courts face similar knowledge or incentives. A federal judge, for example, may handle a securities class action occasionally, but is unlikely to be an expert in all the ins and outs of these cases.<sup>121</sup> If a shareholder lawsuit

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117. See, e.g., *Walgreen*, 832 F.3d at 725 (adopting the “plainly material” standard from *Trulia* in an opinion by Judge Posner on the Seventh Circuit); *Vergiev v. Aguero*, No. L-2276-15 (N.J. Super. Ct. June 6, 2016).

118. See, e.g., *In re Sigma-Aldrich Corp. S’holder Litig.*, No. 1422-CC09684 (Mo. Cir. Ct. Aug. 19, 2015) (approving the disclosure-only settlement); see also *Murphy v. Synergetics USA Inc.*, No. 1511-CC00778 (Mo. Cir. Ct. July 29, 2016).

119. See Griffith, *supra* note 115, at 2 (arguing that the belief that *Trulia* would solve the problems in merger litigation appear to be “wishful thinking”).

120. See, e.g., Laster, *supra* note 103, at 134 (“The Delaware courts are different. The Court of Chancery’s jurisdiction is focused. It does not hear criminal cases, and a substantial majority of the court’s caseload concerns mergers and other transactions.”).

121. See *id.* at 133 (“[F]ederal courts hear disclosure cases within a broader docket that encompasses criminal cases, lawsuits invoking myriad other federal statutes, and state law diversity actions. Docket composition varies across districts, so while it may well be that judges in the Southern District of New York and other commercial centers have developed

is simply one more case on a judge's docket, it is unlikely that the judge will know about the specific problems in those types of suits or devote the time necessary to try to solve them. And even if one judge takes on this effort, it is unlikely that a sufficient number of other judges will join the effort and thus have a meaningful impact across the legal system.

Indeed, any excitement that one might get from *Trulia* must be tempered by the PSLRA's failure to make judges more active monitors in securities class actions. In addition to the provisions described above, the PSLRA also mandates that judges conduct a Rule 11 inquiry at the end of every securities class action.<sup>122</sup> Yet, despite the mandatory nature of this provision, federal judges are largely ignoring it. A recent empirical study found that judges conduct this "mandatory" review in only fourteen percent of the cases.<sup>123</sup> And even in these cases, their review is typically perfunctory.<sup>124</sup> This experience suggests that it is not always easy to get judges to serve as more active monitors. Delaware aside, most judges simply do not have the time or inclination to actively monitor shareholder lawsuits.

As we shall see, however, Delaware is not relying on judges alone to solve the merger litigation crisis. It has also deputized corporations and their shareholders to police these suits through ex ante restrictions in their governing documents.

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takeover-disclosure expertise, it is not clear that such a claim can be made about the federal court system as a whole.”).

122. 15 U.S.C. § 78u-4(c)(1) (2012) (“In any private action arising under this chapter, upon final adjudication of the action, the court shall include in the record specific findings regarding compliance by each party and each attorney representing any party with each requirement of Rule 11(b) of the Federal Rules of Civil Procedure as to any complaint, responsive pleading, or dispositive motion.”).

123. See M. Todd Henderson & William H.J. Hubbard, *Judicial Noncompliance with Mandatory Procedural Rules Under the Private Securities Litigation Reform Act*, 44 J. LEGAL STUD. 587, 590 (2015).

124. See *id.* at 599 (stating that “consistent with our results based on proxies for effort or motivation—that a judge will do so only when the effort involved is minimal”).

## 2. *Bylaws and Charters*

Corporate law has long allowed corporations to alter default rules in their charters and bylaws.<sup>125</sup> It is therefore surprising that it took corporations until recently to use this power to address frivolous shareholder lawsuits. In 2010, the Delaware Court of Chancery publicly acknowledged that it was having difficulty policing merger cases because parties could just settle the suit in other jurisdictions to avoid the court's oversight.<sup>126</sup> The court suggested that defendants could avoid litigating in other jurisdictions by including a forum selection clause in their charters, stating that all intra-corporate disputes must be filed in Delaware.<sup>127</sup>

Many corporations follow the court's suggestions, especially those that were already amending their governing documents before announcing a merger. These corporations were able to include a forum selection clause in their charters or bylaws before they were inevitably sued by shareholders upon announcement of a merger.<sup>128</sup> Soon, corporations began to experiment by putting other heightened procedures into these documents, including fee-shifting provisions.<sup>129</sup> These provisions caused concern among shareholders' and plaintiffs' counsel because they made representative shareholders liable for all of the defendants' fees if the suit was unsuccessful, even though these

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125. See, e.g., *CA, Inc. v. AFSCME Emps. Pension Plan*, 953 A.2d 227, 235 (Del. 2008) (holding that shareholders can amend bylaws to change the "process and procedures by which [corporate] decisions are made").

126. See *In re Revlon, Inc. S'holders Litig.*, 990 A.2d 940, 960 (Del. Ch. 2010) ("The limiting function of the defendants' ability to seek dismissal, however, operates imperfectly when defendants can routinely purchase global releases by paying transactionally immaterial plaintiffs' fees, and when defendants rationally prefer to do so.").

127. See *id.* ("[I]f boards of directors and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes.").

128. Although the Delaware Court of Chancery had originally stated that forum-selection clauses should go in corporate charters, it became far more common for corporations to put them into their bylaws. This difference mattered because charter provisions have to be adopted by both the board and the shareholders, while bylaws provisions can generally be adopted by the board on its own. Compare DEL. CODE ANN. tit. 8, § 109(a) (2011) (providing that corporations can allow shareholders or the board to amend the bylaws) with *id.* § 242(b) (providing that both the shareholders and the board must approve amendments to the charter). As a result, corporations favored putting litigation-limiting procedures in their bylaws because they did not have to get their shareholders' approval.

129. See Stephen M. Bainbridge, *Fee-Shifting: Delaware's Self-Inflicted Wound*, 40 DEL. J. CORP. L. 851, 858 (2016) (noting that "over fifty Delaware corporations adopted fee-shifting bylaws by April 2015").

shareholders would only receive their pro rata shares of the recovery if the suit was successful.<sup>130</sup> This combination of high risks and low rewards made it financially perilous for any shareholder to serve as a lead plaintiff, potentially threatening shareholder litigation as an enterprise.<sup>131</sup>

In June 2015, the Delaware legislature stepped in and barred fee-shifting provisions.<sup>132</sup> At the same time, however, it expressly permitted forum-selection clauses in either the charter or the bylaws.<sup>133</sup> The legislative blessing of forum-selection clauses provided support to Delaware judges who were looking to crack down on frivolous merger cases. As discussed in the prior section,<sup>134</sup> the challenge for these judges has been maintaining control over these suits given the wide array of forums in which plaintiffs can sue. Without forum selection clauses, plaintiffs who wanted to avoid Delaware's more stringent review of settlements could just file their suit in another jurisdiction. Now, assuming that a corporation has adopted a forum-selection clause, Delaware could maintain control over the suits and reject disclosure-only settlements that do not pass muster under its new heightened scrutiny.

With the Delaware legislature's approval and the Delaware courts standing guard, it seemed like the problem of frivolous merger cases would disappear.<sup>135</sup> But the reality has not been so simple because defendants still

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130. See, e.g., Mark Lebovitch & Jeroen van Kwawegen, *Of Babies and Bathwater: Detering Frivolous Stockholder Suits Without Closing the Courthouse Doors to Legitimate Claims*, 40 DEL. J. CORP. L. 491, 515-16 (2016) (“[I]t will be difficult for even the largest institutional investors to take the risk of paying millions, or tens of millions, of dollars in defense attorneys’ fees to correct corporate misconduct when their individual, pro rata share of the potential benefit or recovery created by the litigation will only be a fraction of the total benefit sought, and when achieving a ‘full remedy’ is not possible absent lengthy proceedings.”).

131. See *id.*

132. See DEL. CODE ANN. tit. 8, § 109(b) (Supp. 2016) (“The bylaws may not contain any provision that would impose liability on a stockholder for the attorneys’ fees or expenses of the corporation or any other party in connection with an internal corporate claim, as defined in § 115 of this title.”).

133. See *id.* tit. 8, § 115 (“The certificate of incorporation or the bylaws may require, consistent with applicable jurisdictional requirements, that any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this State . . .”).

134. See *supra* Section II.B.1.

135. See Griffith, *supra* note 115, at 2 (noting that, in the wake of Trulia and legislative approval of forum-selection bylaws, the problems of merger litigation “appeared to be solved”).

have a financial incentive to waive forum selection clauses.<sup>136</sup> At first glance, this may sound surprising. Why wouldn't corporations want to be in Delaware where the judges are ready to crack down on nuisance settlements?

The answer lies in the incentives that create these settlements in the first place. As discussed in Part I, nuisance settlements are so prevalent in the merger context because they benefit corporate defendants as well as plaintiffs' attorneys.<sup>137</sup> If a corporation is going to face litigation, it would often favor a quick, cheap resolution of the suit even more than vindication after a lengthy and expensive legal battle.<sup>138</sup> And even if Delaware promises to dismiss frivolous suits quickly, corporations might still prefer to litigate the case outside of Delaware where it will get a cheap settlement and a global release of all related claims. Corporations are essentially buying a release when they settle these claims, and this release may be worth the relatively low cost of litigating and settling a nuisance suit.<sup>139</sup> As a result, even though Delaware stands ready and willing to exercise more stringent oversight over merger cases, corporations may not want them to do so.

Faced with this reality, most forum selection clauses allow corporations to have their cake and eat it, too. A typical clause might provide that the exclusive forum applies "unless the Corporation consents in writing to the selection of an alternative forum."<sup>140</sup> Such wording gives corporations a choice. They can enforce the provision if they want the claims to be reviewed in Delaware under Delaware's stringent standards. Or they can waive the provision if they would rather make a few additional disclosures, pay a few hundred thousand dollars in attorneys' fees, and take their release. Early

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136. *See id.* at 3 (stating that defendants have a "continued interest in retaining the option of a cheap settlement and a broad release in an alternative jurisdiction").

137. *See supra* Part I.

138. *See* Griffith, *supra* note 115, at 14 ("[O]nce the corporation has become a defendant in merger litigation, that corporation has a strong incentive to buy the broad, cheap releases that disclosure settlements provide.").

139. *Cf.* Sean J. Griffith & Alexandra D. Lahav, *The Market for Preclusion in Merger Litigation*, 66 VAND. L. REV. 1053, 1084 n.142, 1122 (2013) (discussing the value of preclusion to defendants).

140. *See* Cox, *supra* note 90, at 507-08 ("Though there are many varieties of forum-selection bylaws, the most common provision reflects a preference for the forum of the state of incorporation while also according the board of directors authority to 'waive' the selected forum in favor of another forum where a suit is pending." (footnote omitted)); Griffith, *supra* note 115, at 2-3 ("[D]efense counsel must be seen as complicit in the out-of-Delaware dynamic because they have failed to exercise Exclusive Forum bylaws to bring the litigation back to Delaware.").

evidence reveals that some corporations are indeed waiving these provisions, although it is still too early to determine the extent of this trend.<sup>141</sup>

This experience shows the drawbacks of relying on corporations as the gatekeepers in shareholder lawsuits. Although corporations often rail against frivolous claims, the reality is that many corporations like the opportunity to buy a release. And even those that do not place significant value in a release may still prefer a cheap settlement over litigating the case, even in front of a sympathetic judge. In making these decisions, corporations will act in their own best interests, even if these decisions do not benefit the legal system as a whole.

Even more concerning, these decisions might reflect other interests altogether. As noted above, the board alone can typically adopt a forum selection clause if it is in the corporation's bylaws.<sup>142</sup> And regardless of whether the clause is in the bylaws or the charter, the board alone decides whether to waive it. In nearly all shareholder lawsuits, however, the board members are named as defendants. Any board knows that it is the likely target of these suits when deciding whether to adopt a forum-selection provision, and, in most cases, it is the actual target when deciding whether to waive such a provision. It goes against human nature to presume that directors will put the corporation's interests ahead of their own. As a result, we should be wary of trusting directors to serve as faithful monitors of the corporation's interests, and much less of the legal system more broadly.

Judges should keep these concerns in mind when reviewing other types of heightened procedures that corporations may include in their charters or bylaws. Beyond fee shifting or forum selection, there are other types of procedures that enterprising corporations might want to adopt. Could, for example, a corporation adopt a minimum ownership requirement, barring shareholders from suing unless they own more than a threshold percentage of a corporation's stock?<sup>143</sup> Or could a corporation require all shareholder suits (or at least shareholder suits filed under state law) to be submitted to arbitration, effectively stripping courts of their jurisdiction over these

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141. *See, e.g.,* *Niedermayer v. Kriegsman*, C.A. No. 11800-VCMR (Del. Ch. May 2, 2016) (oral ruling acknowledging novel issues raised by selective enforcement and waiver of a forum selection bylaw).

142. *See supra* note 128 and accompanying text.

143. *See* Jill E. Fisch, *The New Governance and the Challenge of Litigation Bylaws*, 81 *BROOK. L. REV.* 1637, 1676 (2016) ("Boards can presumably adopt alternative approaches such as bylaws that require minimum ownership thresholds, limit the scope of available damages, or eliminate the availability of fees to prevailing plaintiffs.").

claims?<sup>144</sup> Or could corporations use still other types of procedures—heightened pleading, limitations on discovery, or complete bans on non-monetary settlements—to discourage shareholders from challenging board actions?<sup>145</sup>

The legality of such procedures is still up in the air. The Delaware legislature has only addressed fee shifting and forum selection.<sup>146</sup> Outside of these areas, Delaware has taken a hands-off approach, with the Delaware Supreme Court stating that any such procedures are facially valid and will be enforceable as long as they are “adopted by the appropriate corporate procedures and for a proper corporate purpose,” suggesting a fairly hands-off approach.<sup>147</sup> Few other states have weighed in at all.<sup>148</sup> As a result, despite the concerns outlined above, corporate boards have wide latitude to use procedure to police shareholder claims. As we will see, boards also have the ability to oversee other types of shareholder lawsuits, albeit in different ways.

### C. Derivative Suits

The legal system has long struggled with the role of the corporate board in derivative suits. On one hand, derivative suits exist because directors are frequently named in these suits, and therefore the legal system does not trust directors to exercise their normal authority over the corporation. Yet, these claims ultimately belong to the corporation, and directors normally make decisions on behalf of the corporation. As a result, the law wants to both give directors power but also closely monitor how they use it. This section outlines

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144. See Cox & Thomas, *supra* note 21, at 33 (“The 800-pound gorilla in the room that has yet to be addressed is whether any states will permit corporate bylaws that mandate sending shareholder-manager disputes to arbitration.”); Ann M. Lipton, *Manufactured Consent: The Problem of Arbitration Clauses in Corporate Charters and Bylaws*, 104 GEO. L.J. 583 (2016) (arguing that the Federal Arbitration Act does not require states to uphold corporate bylaw or charter provisions mandating that shareholder claims be arbitrated).

145. See generally Erickson, *supra* note 81, at 85-86.

146. See DEL. CODE ANN. tit. 8, §§ 109(b), 115 (Supp. 2016).

147. ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554, 556 (Del. 2014).

148. Oklahoma recently mandated fee-shifting in all shareholder derivative suits filed in the state. See 18 OKLA. STAT. § 1126 (Supp. 2017) (“In any derivative action instituted by a shareholder of a domestic or foreign corporation, the court having jurisdiction, upon final judgment, shall require the nonprevailing party or parties to pay the prevailing party or parties the reasonable expenses, including attorney fees, taxable as costs, incurred as a result of such action.”). And a few states have addressed forum-selection bylaws. See, e.g., Galaviz v. Berg, 763 F. Supp. 2d 1170, 1175 (N.D. Cal. 2011) (rejecting a forum-selection bylaw where the bylaw was adopted after the alleged misconduct). More broadly, however, there is little precedent on the limits of litigation-limiting bylaw and charter provisions.

the traditional power of the board over derivative suits, as well as the role of judges in monitoring how boards exercise this power.

### 1. Corporate Boards

Corporate boards have long been the primary gatekeepers in shareholder derivative suits, and for an ostensibly good reason. In a derivative suit, the corporation is the functional plaintiff.<sup>149</sup> Shareholders bring these suits on behalf of corporations because directors, who normally decide whether corporations should file lawsuits, are often implicated in the alleged wrongdoing.<sup>150</sup> The law understandably believes that directors cannot therefore be trusted to make unbiased decisions regarding the merits of these suits.<sup>151</sup> The corporation remains the real party in interest, however, and any recovery obtained in the suit goes into the corporation's coffers.<sup>152</sup> Accordingly, derivative suits are an exception to the normal rule that boards of directors control corporations.<sup>153</sup> Where possible, however, the law tries to return power to the board. This effort is reflected in two procedural mechanisms—the demand requirement and special litigation committees.

The demand requirement mandates that, before filing suit, the plaintiff make a demand on the corporation's board of directors, requesting that the board itself file the suit.<sup>154</sup> This requirement is based on the idea that the board may want to bring the lawsuit itself and, if it does, there is no reason

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149. See *NL Indus., Inc. v. MAXXAM, Inc. (In re MAXXAM, Inc./Federated Dev. S'holders Litig.)*, 698 A.2d 949, 956 (Del. Ch. 1996).

150. See *Van Gelder v. Taylor*, 621 F. Supp. 613, 620 (N.D. Ill. 1985) (“As a general rule, the plaintiff stockholder in a stockholder's derivative suit is ‘at best the nominal plaintiff.’ The corporation is the real party in interest, regardless of the fact that the corporate management has failed to pursue the action.” (internal citation omitted) (quoting *Liddy v. Urbanek*, 707 F.2d 1222, 1224 (11th Cir. 1983)).

151. See *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984) (“The derivative action developed in equity to enable shareholders to sue in the corporation's name where those in control of the company refused to assert a claim belonging to it.”).

152. See *Kramer v. W. Pac. Indus., Inc.*, 546 A.2d 348, 351 (Del. 1988) (“In [a derivative suit] the shareholder sues on behalf of the corporation . . . [A]ny damages recovered . . . are paid to the corporation.” (quoting CLARK, *supra* note 26, at 639-40)).

153. See *In re Activision Blizzard, Inc. S'holder Litig.*, 124 A.3d 1025, 1044 (Del. Ch. 2015) (“A corporate claim is an asset of the corporation, so authority over the claim ordinarily rests with the board of directors.”).

154. See, e.g., DEL. CH. CT. R. 23.1(a) (“The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.”).

why this power should be taken away from it.<sup>155</sup> From this simple requirement, however, comes a whole host of procedural complications. In many instances, the board faces a conflict of interest in reviewing the plaintiff's demand. If the directors face a meaningful risk of personal liability, they almost certainly will not authorize the corporation to file suit against them.

In recognition of this conflict, many states allow shareholders to avoid the demand requirement if they can allege with particularity that demand would be futile.<sup>156</sup> In these states, if the shareholder makes a demand and does not allege futility, the shareholder is deemed to have conceded the board's independence.<sup>157</sup> If the board then rejects the demand and decides not to sue, as is likely, that decision is protected by the business judgment rule and is unlikely to be overturned. Put another way, if the shareholder makes a demand, the board will likely reject it and the shareholder will not be able to sue. As a result, shareholders generally try to avoid the demand requirement by alleging that demand would be futile.<sup>158</sup> A significant number of derivative suits therefore begin with a procedural skirmish over demand futility.<sup>159</sup>

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155. *See, e.g.*, *Am. Int'l Group, Inc. v. Greenburg*, 965 A.2d 763, 808 (Del. Ch. 2009) (stating that the demand requirement "exists to preserve the primacy of board decisionmaking regarding legal claims belonging to the corporation").

156. *See, e.g.*, *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 120 (Del. Ch. 2009) ("Where, as here, a plaintiff does not make a pre-suit demand on the board of directors, the complaint must plead with particularity facts showing that a demand on the board would have been futile.").

157. *See* DEBORAH A. DEMOTT & DAVID F. CAVERS, *SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE* § 5.10, Westlaw (database updated Sept. 2016) (stating that, in many jurisdictions, "while the directors may ultimately refuse the demand, by making a demand the plaintiff may forego the opportunity of testing the availability of excuse").

158. *See id.*

159. *See* Erickson, *supra* note 44, at 1780-84 (discussing the fights over demand futility in derivative suits filed in federal court). Many states have tried to avoid these skirmishes by eliminating the futility defense. *See, e.g.*, FLA. STAT. ANN. § 607.07401(2) (West 2016); VA. CODE ANN. § 13.1-672.1(B)(1) (West 2016). In these states, the demand requirement is universal and cannot be avoided. Even here, however, there are fights about the implications of the board's rejection of the demand. *See* Daniel J. Morrissey, *The Path of Corporate Law: Of Options Backdating, Derivative Suits, and the Business Judgment Rule*, 86 OR. L. REV. 973, 999 (2007) ("However, the requirement of universal demand and the Delaware rule allowing it to be excused may amount to much the same thing. In a universal demand jurisdiction, if a board refuses to sue after a demand, the plaintiff must show by particularized pleadings why her derivative suit should go forward. That burden is just like the one facing a derivative plaintiff in Delaware who claims that demand should be excused." (footnotes omitted)).

If the board loses this skirmish, it has one more opportunity to take control of the suit. It can form a committee of one or more directors—called a special litigation committee (“SLC”)—to review the suit.<sup>160</sup> This review is different than that of a judge. The main goal of the SLC is not to determine whether the claims have merit, although the merits will likely be a significant part of the analysis. Instead, it is trying to determine whether the suit is in the best interests of the corporation.<sup>161</sup> This analysis can take into account the cost of the litigation, any bad press that might be associated with the suit, the impact of the suit on other legal proceedings to which the corporation is a party, and any other relevant factors.<sup>162</sup> If the SLC decides that the suit is in the corporation’s best interests, taking all of these factors into account, it can seek to take control of the litigation.<sup>163</sup> If it reaches the opposite conclusion, it can ask the court to dismiss the suit.<sup>164</sup>

Putting the pieces together, the board of directors serves as the primary gatekeeper in shareholder derivative suits, with judges closely monitoring their actions. The role of judges will be examined in the next subsection, but the role of directors is both understandable and somewhat concerning. On one hand, it makes sense that the law would rely on corporate boards to pass judgment on derivative claims. These claims belong to the corporation, and boards are the traditional steward of corporate interest.<sup>165</sup> As long as directors are able to act independently, the law should defer to them.

On the other hand, it is questionable whether directors can ever act truly independently when it comes to evaluating claims against fellow directors.

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160. See DEMOTT & CAVERS, *supra* note 157, § 5.14.

161. See *In re INFOUSA, Inc. S’holders Litig.*, 953 A.2d 963, 986 (Del. Ch. 2007) (stating that “[a] board may in good faith refuse a shareholder demand to begin litigation even if there is substantial basis to conclude that the lawsuit would eventually be successful on the merits” because the board may consider, in the exercise of its business judgment, whether it “would be excessively costly to the corporation or harm its long-term strategic interests”).

162. See, e.g., 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *The Delaware Law of Corporations and Business Organizations* § 13.15 (3d ed. 1997) (listing factors that special litigation committee should consider).

163. See Minor Myers, *The Decisions of Corporate Special Litigation Committees: An Empirical Investigation*, 84 IND. L.J. 1309, 1313 (2009) (“After its investigation, the SLC decides whether to pursue the claims, settle them, or seek their dismissal.”).

164. See *id.* (“If the SLC concludes that pressing the claims is not in the best interests of the corporation, it will generally produce a written report supporting its conclusion and will move on behalf of the corporation to dismiss the claims.”).

165. See e.g., DEL. CODE ANN. tit. 8, § 141(a) (2011) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.”).

Although SLC members are technically independent—i.e., they are generally not named as defendants in the suit—they are still directors evaluating claims made against other directors. As a result, they may have a “there but for the grace of God go I” feeling when evaluating the claims, giving other directors the same benefit of the doubt that they themselves would want if they were ever named in a similar lawsuit.<sup>166</sup> Judges evaluate SLC recommendations with an increased level of scrutiny,<sup>167</sup> but there are still concerns that structural bias makes the entire SLC process inherently suspect.<sup>168</sup>

Moreover, the demand requirement and the SLC process mean that shareholders must run a gauntlet of procedural hurdles before they can present the substance of their claims. Almost all published opinions in derivative litigation concern demand futility or SLC recommendations or other procedural battles.<sup>169</sup> It is not unusual for a case to proceed for years before the court gets to the merits of the claims. The goal of these myriad gatekeeping devices is to sort the cases with merit from those without. One wonders whether it would be more efficient to dispense with these costly procedures and proceed directly to the substance of the claims. This question becomes especially acute when one considers the judicial resources that these procedures entail.

## 2. Judges

Judges play a particularly important role in derivative litigation. Although the legal system depends largely on directors to evaluate the derivative claims filed by shareholder plaintiffs, it relies on judges to review the decisions made by directors. Put another way, directors monitor shareholder plaintiffs, and judges monitor the directors. Yet, as judges themselves have pointed out, they are not necessarily well-suited for this role.

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166. *Zapata Corp. v. Maldonado*, 430 A.2d 779,787 (Del. 1981).

167. *See id.* (“We are not satisfied, however, that acceptance of the ‘business judgment’ rationale at this stage of derivative litigation is a proper balancing point. While we admit an analogy with a normal case respecting board judgment, it seems to us that there is sufficient risk in the realities of a situation like the one presented in this case to justify caution beyond adherence to the theory of business judgment.”).

168. *See, e.g.*, Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305 (2005).

169. *See, e.g.*, *Stone v. Ritter*, 911 A.2d 362 (Del. 2006); *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2004) (evaluating a claim of demand futility); *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003) (reviewing an SLC decision); *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) (reviewing a settlement in a derivative suit).

This point is highlighted by the role of judges in reviewing SLC decisions. As noted above, judges use enhanced scrutiny in reviewing these decisions because SLC directors, although technically independent, have a structural bias in reviewing claims filed against other directors.<sup>170</sup> As a result, in Delaware and many other states, the court uses a two-step form of review. The Delaware Supreme Court developed this test in *Zapata Corp. v. Maldonado*.<sup>171</sup> First, under *Zapata*, the court examines the independence and good faith of the committee and the bases supporting its conclusions.<sup>172</sup> Second, it determines, “applying its own independent business judgment, whether the motion should be granted.”<sup>173</sup>

The second step of this test has raised eyebrows. Are judges particularly well-suited to apply “their own independent business judgment”? Do most judges even have such judgment? Yet, as the Delaware Supreme Court has made clear, this test was never meant to give judges a tremendous amount of power. Instead, it simply gives judges the flexibility to override an SLC decision when something feels “off.” As the Delaware Supreme Court has held, “The second step is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation’s interest.”<sup>174</sup> There is no expectation, in other words, that judges will conduct in-depth reviews of the business merits of SLC decisions.

Yet, this form of review highlights the curious role of judges in evaluating derivative claims. Although the law wants directors to be the first line of defense against frivolous derivative claims, it also does not fully trust them in this role. As a result, the legal system relies on judges to be the equivalent of watchdogs, stepping in when a board or SLC’s decision does not pass the smell test.

In this way, judges serve a somewhat different role than that contemplated by the PSLRA. Under the PSLRA, judges are supposed to apply the standards set out by Congress.<sup>175</sup> There will always be some discretion in how exactly judges apply these standards, but their discretion is still intentionally cabined.

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170. *See supra* notes 166-168 and accompanying text.

171. *Zapata*, 430 A.2d at 787.

172. *See id.*

173. *See id.* at 789.

174. *See id.*

175. 15 U.S.C. § 78u-4(b)(3)(A) (2012) (“In any private action arising under this chapter, the court *shall*, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met.” (emphasis added)).

Under *Zapata*, however, judges are supposed to be broader protectors of the corporate interest. Their role here is similar to their role in reviewing settlements in derivative suits and class actions where they are tasked with ensuring that the settlement is “in the best interests” of the class or the plaintiff corporation.<sup>176</sup>

This broader role has its own challenges. It is one thing for judges to apply discrete legal standards. It is another thing altogether for judges to oversee decisions made by others, whether these decisions are SLC requests to dismiss a derivative suit or joint requests by the parties to settle the derivative suit. It takes a significant amount of time to dig into a case and come up with reasons to reject a suggested course of conduct. Given the already-significant demands on judges, will most judges find the time necessary to perform this oversight role effectively? Or will they simply rubberstamp a SLC’s request and get the case off their docket? These questions, and the paucity of data available to answer them, challenge the notion that judges are the key to solving the problems in shareholder lawsuits.

#### *D. Reflecting on Gatekeepers*

As we have seen, shareholder lawsuits share the same need for gatekeepers, yet different types of shareholder lawsuits rely on very different gatekeepers. Examining this phenomenon leads to two important observations. First, there are good reasons for the differences. Although securities class actions, merger cases, and derivative suits all fall under the umbrella of shareholder litigation, there are important differences between these suits that have influenced the gatekeepers in each. In securities class actions, for example, there is often enough money at stake to make it economically rational for institutional investors to spend more of their time monitoring the litigation.<sup>177</sup> In merger cases, the problems got so bad that Delaware judges were forced to step in to protect the shareholder litigation franchise.<sup>178</sup> And in derivative suits, the claims ultimately belong to the

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176. See FED. R. CIV. P. 23(1)(B); DEL. R. CIV. P. 23.1(a)-(b).

177. See Weiss, *supra* note 55, at 574.

178. See, e.g., Minor Myers, *Fixing Multi-Jurisdictional Shareholder Litigation*, 2014 U. ILL. L. REV. 467, 469 (arguing that Delaware had become a “pariah in shareholder litigation” because “[o]ver the past fifteen years, shareholders have spurned the Delaware courts and are now likely to file fiduciary lawsuits elsewhere”).

plaintiff corporation,<sup>179</sup> so it is not surprising that the law carves out a role for corporate boards to monitor these suits.

Second, there is no single gatekeeper that solves all problems associated with shareholder lawsuits. Each gatekeeper solves some of the problems, but creates others. In securities class actions, institutional investors do indeed bargain with plaintiffs' attorneys for lower fees, but they are also subject to their own conflicts of interest with law firms trying to curry favor.<sup>180</sup> In merger cases, Delaware judges can crack down on settlements that come before them, but they will have difficulty stopping cases from fleeing to other jurisdictions.<sup>181</sup> And in derivative suits, corporate boards can review derivative claims to determine whether they are in the corporation's interests, but it will be hard to avoid the directors' own interests seeping into this review.<sup>182</sup>

As a result, the goal of this comparative effort should not be to standardize the gatekeepers across different types of shareholder litigation. Nor should we call it a day and be satisfied with the status quo. Instead, we should try to take the lessons from these different contexts and see if they can have broader applicability.

### *III. Toward a Broader Approach to Litigation Gatekeeping*

#### *A. Judges as Enhanced Gatekeepers*

Judges are the first line of defense in shareholder lawsuits. In all class actions and derivative suits, judges approve all settlements, decide all motions, and preside over all trials.<sup>183</sup> In many ways, therefore, judges are already valuable gatekeepers in these suits. The experience of merger class actions, however, demonstrates that judges can be even more influential, dramatically changing the settlement practices in each type of litigation.

One wonders, therefore, whether judges could similarly act as enhanced gatekeepers in derivative suits and securities class actions. Rather than rubber-stamping settlements in derivative suits, judge could scrutinize these

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179. See *NL Indus., Inc. v. MAXXAM, Inc. (In re MAXXAM, Inc./Federated Dev. S'holders Litig.)*, 698 A.2d 949, 956 (Del. Ch. 1996) ("A derivative claim belongs to the corporation, not to the shareholder plaintiff who brings the action.").

180. See *supra* Section II.A.

181. See *supra* Section II.B.

182. See *supra* Section II.C.

183. See, e.g., FED. R. CIV. P. 23(e), 23.1(c) (requiring judges to approve settlements in class actions in derivative suits). In Delaware, judges preside over all trials in the Chancery Court. In other jurisdictions, the claims may be decided by a jury, but the judge will still preside over the trial.

settlements, especially those that involve corporate governance reforms rather than monetary consideration. Piggybacking on the Delaware Court of Chancery's new standard in reviewing merger settlements, they could then reject those derivative settlements that do not offer "plainly material" benefits for the plaintiff corporation and/or its shareholders.<sup>184</sup> Similarly, judges could adopt a rebuttable presumption against non-monetary settlements, forcing litigants to explain precisely how the settlement is beneficial.<sup>185</sup>

In securities class actions, the concerns are different, relating to conflicts of interest involving institutional plaintiffs, not non-monetary settlements. Nonetheless, judges could bring comparable oversight to these conflicts of interests, asking tough questions about the financial relationships between institutional investors and their attorneys. For example, in reviewing lead counsel petitions, judges could require applicants to complete standardized disclosure forms that include, among other things, information regarding any campaign contributions or other types of payments made by the applicants' law firms to the plaintiff or any individual who controls the plaintiff.<sup>186</sup> Alternatively, judges could ask about these relationships during hearings, making clear that any plausible conflicts of interests will bar a shareholder from serving as lead plaintiff. To the extent that sunshine is the best disinfectant, this oversight could reduce unethical practices.

This is not to say that judicial oversight is an easy panacea in either type of litigation. It is hard for individual judges to make systematic changes in the way these suits are litigated. Individual judges can reject poor-quality settlements presented to them, but it would take collective action from a significant number of judges to make a real difference in these suits. This collective action would be difficult to pull off. Judges work largely independently, and they handle civil and criminal cases in a variety of areas. It is difficult for them to know the enforcement problems in any particular area of the law, much less the specific steps taken by individual judges to try to combat these problems.

This collective action is especially challenging given that derivative suits and securities class actions are spread throughout the country. Delaware judges were able to crack down on abusive practices in merger litigation

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184. See *In re Trulia, Inc. Stockholder Litig.*, 129 A.3d 884, 898-99 (Del. Ch. 2016).

185. Cf. Griffith, *supra* note 25, at 47 ("[I]n cases where corporate benefit is recognized, courts should conduct a more rigorous inquiry into how the benefit was created.").

186. I suggested a similar form of standard disclosures in an earlier article. See Jessica M. Erickson, *The New Professional Plaintiffs in Shareholder Litigation*, 65 FLA. L. REV. 1089, 1134-37 (2013).

because a majority of merger cases were filed in Delaware.<sup>187</sup> Although Delaware had to struggle (and still struggles) to keep these cases,<sup>188</sup> they always maintained enough influence that lawyers had to pay close attention to their opinions. In contrast, securities class actions are filed in federal district courts across the country, and derivative suits can often be filed in state or federal court. These cases are overrepresented in certain geographical areas, but no state or court has the same influence that Delaware has over merger cases.

These challenges, however, should not deter judges from trying to serve as more active gatekeepers. First, individual judges can be influential. Judge Jed Rakoff's rejection of the corporate settlements with the Securities & Exchange Commission, for example, influenced the SEC's practices more broadly, revealing the power that one judge armed with good questions can have.<sup>189</sup> Moreover, judges in certain districts or courts can work together, announcing greater scrutiny in the cases that collectively come before them. Nearly sixty percent of securities class actions are filed in the Ninth and Second Circuits.<sup>190</sup> Any rule announced in these circuits would undoubtedly have reverberations throughout the country.

Derivative suits are also concentrated in these two circuits,<sup>191</sup> although they are likely more dispersed than securities class actions given that they can be filed in state or federal court.<sup>192</sup> Nonetheless, a few judges publicly critiquing practices in these suits and announcing new gatekeeping practices would likely get widespread attention. It would also give ammunition to shareholder objectors who could spread the message to other courts.

Greater judicial oversight is unlikely to completely solve the problems in securities class actions or derivative suits. It would, however, bolster efforts

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187. SINHA, *supra* note 42, at 3 (noting that in the first three quarters of 2015, plaintiffs filed seventy-four percent of cases challenging mergers in Delaware, although that percentage dropped sharply since the decision in *Trulia*).

188. *See id.* *See generally* Griffith, *supra* note 115 (describing Delaware's often unsuccessful struggle to retain control over merger cases).

189. *See* Matthew G. Neumann, Note, *Neither Admit Nor Deny: Recent Changes to the Securities & Exchange Commission's Longstanding Settlement Policy*, 40 J. CORP. L. 793, 794 (2015) (noting that Judge Rakoff's pushback on SEC settlement practices prompted the SEC to change its practices).

190. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2015 YEAR IN REVIEW 27 (2016), <https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Filings-2015-Year-in-Review>.

191. *See* Erickson, *supra* note 44, at 1764 (finding that more than half of federal derivative suits are filed in the Second or Ninth Circuits).

192. *See id.* (examining research on derivative suits filed in both state and federal courts).

by other gatekeepers to crack down on the problems in these lawsuits. As we will see, corporate boards and shareholders could also play a more significant role.

### *B. Corporate Boards and Shareholders as Enhanced Gatekeepers*

A second possibility for enhanced gatekeeping is through self-help. Corporate boards and shareholders may be able to make greater use of bylaw and charter amendments to protect themselves against frivolous shareholder lawsuits. As detailed above in Part II, corporate boards and shareholders have already started to use these amendments to limit merger litigation.<sup>193</sup> A significant number of companies have adopted bylaw or charter amendments specifying that any intra-corporate dispute, including fiduciary duty claims, must be filed in Delaware.<sup>194</sup> Several companies similarly adopted fee-shifting bylaws and charter amendments before they were barred by the Delaware General Assembly.<sup>195</sup> A few companies are also experimenting with other types of bylaw and charter amendments.<sup>196</sup> Collectively, these amendments have succeeded in bringing a significant percentage of merger cases back to Delaware and perhaps also in discouraging the filing of meritless challenges to mergers.

The question now is whether these amendments can have a similar impact in other types of shareholder litigation. Many of these provisions already cover shareholder derivative suits because they are worded broadly to include all fiduciary duty litigation.<sup>197</sup> And some are written even more broadly,

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193. *See supra* Section II.B.2.

194. *See supra* notes 125-133 and accompanying text.

195. *See supra* note 129 and accompanying text.

196. Soon after the Delaware Supreme Court upheld fee-shifting bylaws in *ATP Tours*, four related companies announced bylaws prohibiting its stockholders from initiating a direct or derivative claim unless the claiming stockholder delivers to the corporate secretary written consent by beneficial stockholders owning at least three percent of the outstanding shares. *See, e.g.*, Imperial Holdings, Inc., Current Report (Form 8-K) Exhibit 3.2 (Nov. 3, 2014).

197. *See, e.g.*, CLAUDIA H. ALLEN, STUDY OF DELAWARE FORUM SELECTION IN CHARTERS AND BYLAWS (Jan. 15, 2012), [https://www.kattenlaw.com/Files/45103\\_Jan\\_%202012\\_Forum\\_Study.pdf](https://www.kattenlaw.com/Files/45103_Jan_%202012_Forum_Study.pdf) (noting that the model forum selection bylaw typically covers (i) “any derivative action or proceeding brought on behalf of the corporation”, (ii) “any action asserting a claim of breach of a fiduciary duty owed by any director or officer to the corporation or its stockholders”, (iii) “any action asserting a claim arising pursuant to any provision of the Delaware General Corporation Law”, or (iv) “any action asserting a claim governed by the internal affairs doctrine”); *Shareholder Suit Challenging Groundbreaking Minimum-Support-to-Sue Bylaw Dismissed*, FOLEY & LARDNER LLP (Oct. 19, 2015), <https://www.foley.com/shareholder-suit-challenging-groundbreaking-minimum-support-to-sue-bylaw-dismissed-10-19-2015/> (providing language of minimum ownership bylaw that covers any claim “on behalf

sweeping in all claims filed by shareholders against the corporation, including securities class actions.<sup>198</sup> As a result, efforts by corporations and shareholders to limit frivolous merger claims may have spillover effects on derivative suits and securities class actions. And the fact that corporations have started to use bylaw and charter amendments in the merger context may prompt them to consider using these amendments in other types of shareholder lawsuits.

Nonetheless, there are particular challenges in relying on bylaw and charter amendments in securities class actions and derivative suits. First, it is unlikely that this form of self-help will become as common outside of the merger context. Merger cases are especially well-suited for such self-help. When a company is contemplating a merger or acquisition, it knows that it will likely be sued.<sup>199</sup> It also must often amend its charter and/or bylaws as part of the transaction.<sup>200</sup> As a result, the company knows that it is a target, and it is relatively easy for the company to protect itself.

In contrast, derivative suits and securities class actions are usually filed in the immediate aftermath of revelations of bad news.<sup>201</sup> This bad news typically is not easy to predict, making it difficult for the corporation to amend its governing documents beforehand. Amending protective provisions as soon as the bad news is announced would likely draw even more negative attention to the company. In addition, these revelations will likely occur at

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of (1) the corporation and/or (2) any class of current and/or prior shareholders against the corporation and/or against any director and/or officer of the corporation in his or her official capacity”).

198. See William K. Sjostrom, Jr., *The Intersection of Fee-Shifting Bylaws and Securities Class Actions*, 93 WASH. U. L. REV. 379, 388-89 (2015) (discussing a fee-shifting bylaw that covered both state and federal claims); see also John C. Coffee, Jr., *Delaware Throws a Curveball*, CLS BLUE SKY BLOG (Mar. 16, 2015), <https://perma.cc/BE9G-S8CE> (noting that Delaware’s prohibition against fee-shifting bylaw and charter provisions does not cover securities class actions).

199. See *supra* note 89 and accompanying text (discussing the prevalence of merger litigation).

200. See, e.g., Robert B. Little, “Exclusive Forum” Bylaws Fast Becoming an Item in M&A Deals, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 13, 2015), <https://corp.gov.law.harvard.edu/2015/05/13/exclusive-forum-bylaws-fast-becoming-an-item-in-ma-deals/> (“Public company M&A targets that do not already have such bylaws in place should consider adopting them concurrently with the announcement of a deal.”).

201. See Jessica M. Erickson, *Overlitigating Corporate Fraud: An Empirical Examination*, 97 IOWA L. REV. 49, 58 (2011) (noting that shareholder derivative suits are frequently filed in the wake of a “discrete event such as an accounting error or an alleged misstatement to the market”).

times when the company is not otherwise planning to amend its bylaws or charter, so doing so would take special effort.

Second, the types of provisions used in the merger context may not be the best fit for derivative suits or securities class actions. In the merger context, the chief goal of these provisions was to bring the cases back to Delaware where Delaware judges could scrutinize the claims and the settlements.<sup>202</sup> In derivative suits, there is not a single forum that offers such benefits. Delaware could start to monitor these suits more closely, but so far it has not shown much inclination to do so.<sup>203</sup> And there is good reason for most derivative suits to be filed outside of Delaware. These suits often arise out of the same series of events as a parallel securities class action, and therefore there are efficiencies in allowing the two suits to proceed in the same jurisdiction before the same judge.<sup>204</sup> The federal courts have exclusive jurisdiction over all securities class actions,<sup>205</sup> and therefore, forcing derivative suits into Delaware court would eliminate these efficiencies. Nor is there a specific federal court where judges are more likely to provide greater oversight of these claims. As a result, a forum-selection bylaw may not be the best way to improve derivative suits or securities class actions.

There may be other types of provisions, however, that would allow corporations and their shareholders to crack down on frivolous derivative or securities claims. The legal system is still largely in uncharted waters when it comes to bylaw or charter provisions designed to limit litigation.<sup>206</sup> For example, can corporations adopt minimum ownership requirements, limiting which shareholders are allowed to file derivative suits or class actions? Can they change the pleading standards or put new limitations on discovery? Can they police non-monetary settlements? In Delaware, at least, the answer appears to be yes, assuming that they are adopted for a proper corporate purpose.<sup>207</sup> This judicial deference gives corporations ample room to engage in self-help through litigation-limiting bylaw or charter amendments.

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202. See *supra* notes 125-133 and accompanying text.

203. There has been no equivalent of *Trulia* in the derivative suit context. There are a few instances of Delaware judges rejecting proposed settlements in derivative suits, but these cases are the exception. See, e.g., *Smollar v. Potarazu*, C.A. No. 10287-VCN (Del. Ch. Jan. 14, 2016) (rejecting a settlement in a derivative suit where the plaintiff had negotiated a separate benefit not shared by the corporation or the other shareholders).

204. Erickson, *supra* note 201, at 80 (arguing that “many shareholder derivative suits may simply serve as tagalong suits to other types of corporate litigation,” especially securities class actions).

205. See 15 U.S.C. §§ 78a to 78kk (2012).

206. See *supra* notes 146-147 and accompanying text.

207. *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554, 555 (Del. 2014).

Yet, there are dangers in relying on corporations to be the primary gatekeeper in shareholder lawsuits. For the most part, corporate boards can adopt bylaw provisions on their own, without shareholder approval.<sup>208</sup> Directors know that they are the likely defendants in any future shareholder lawsuit. It is inevitable, therefore, that their own self-interest will influence their decision making, especially as they consider proposed amendments that will make it more difficult for them to be sued.

This fact should prompt caution among those optimistic about the promise of self-help options. For obvious reasons, directors are not unbiased decision makers when it comes to deciding if the corporation should be able to sue them. The legal system has already recognized this exact point in derivative suits. The law allows corporate boards to review shareholder demands and then form an SLC to review the lawsuit as a whole, but it also subjects these decisions that emerge from such reviews to enhanced scrutiny.<sup>209</sup> SLC decisions are not entitled to the business judgment rule precisely because of concerns about possible unconscious biases.<sup>210</sup> These same biases should cause judges to proceed cautiously when reviewing litigation-limiting bylaws.

This does not mean that corporations should never be able to engage in self-help when it comes to shareholder litigation. First, if shareholders approve the provision either through a charter amendment or through a shareholder-approved bylaw amendment, there is less cause for concern.<sup>211</sup> Shareholders may not be perfect judges of the right procedure in shareholder lawsuits, but they do not suffer from the same biases as directors. Instead, their interests are perfectly aligned with the corporation—they only want the corporation to sue when the suit would be financially advantageous.

Second, if the board alone adopts the provisions through a bylaw amendment, courts should use greater scrutiny. This scrutiny can build on the enhanced review already used in derivative suits.<sup>212</sup> This review should not be fatal to all litigation-limiting bylaws, but courts should closely examine whether the procedures are likely to be effective in sorting meritorious claims from meritless ones. Procedures designed to curtail shareholder suits across the board, without regard to the merit of the claims, should be rejected. In

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208. *See* DEL. CODE ANN. tit. 8, § 109(a) (2011) (providing that corporations can allow shareholders or the board to amend the bylaws).

209. *See supra* notes 154-169 and accompanying text.

210. *See supra* notes 162-169 and accompanying text.

211. *See supra* note 128 and accompanying text (discussing how charter amendments must be approved by both shareholders and the board).

212. *Zapata Corp. v. Maldonado*, 430 A.2d 779,787 (Del. 1981).

short, the legal system should allow corporate boards to be active gatekeepers in shareholder lawsuits, but only under the careful supervision of the courts.

### *C. Legislatures as Enhanced Gatekeepers*

Legislatures have traditionally played only a small gatekeeping role in shareholder litigation. Aside from the PSLRA, Congress has rarely interjected itself into the fray of these suits. State legislatures have played a slightly greater role, but even they have not been active gatekeepers.<sup>213</sup> These lawmakers could build on the lessons of the PSLRA and explore new legislation to police shareholder lawsuits, including legislation that would improve the gatekeeping abilities of other players in these suits.

At the federal level, for example, Congress could amend the PSLRA to require greater disclosures by shareholders applying to serve as lead plaintiffs. Under the PSLRA as it is currently written, shareholders only need to disclose their financial stake in the litigation as well as their past participation in other shareholder lawsuits.<sup>214</sup> Congress could ensure that courts are in a better position to evaluate shareholder applicants by requiring shareholders to disclose any financial relationship with their counsel, including campaign contributions. It could also require shareholders to disclose fee arrangements they have made with their counsel, giving judges a way to know if shareholders are taking advantage of their bargaining power to protect class interests.

Similarly, at either the state or federal level, legislatures could serve as gatekeepers over litigation-limiting bylaw and charter provisions. Corporate boards and shareholders have an interest in using governance documents to limit frivolous litigation, but neither are perfectly positioned to be the sole arbiters of these suits. Boards have inherent conflicts of interest, while shareholders may not be sufficiently informed to know the costs and benefits of different procedural tools.

Legislatures, and the rulemaking committees that support them, can assist in this role.<sup>215</sup> Rather than allowing corporations to adopt any provisions they want, legislatures could come up with a menu of acceptable, procedural provisions that corporations can include in their bylaws or charters. The

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213. *See supra* note 147 and accompanying text.

214. *See* 15 U.S.C. § 78u-4(a)(2) (2012).

215. *See* 1 ADMIN. OFFICE OF THE U.S. COURTS, GUIDE TO JUDICIARY POLICY § 440 (rev. Sept. 2011), <http://www.uscourts.gov/rules-policies/about-rulemaking-process/laws-and-procedures-governing-work-rules-committees-0> (describing work of the Judicial Conference's Committee on Rules of Practice and Procedure and its Advisory Rules Committees).

ultimate decision of whether to adopt these provisions would remain with the corporation, but the legislature would ensure that the provisions available effectively sort the good cases from the bad.

This approach may reduce some of the bias in procedural rulemaking. Lawmakers do not have the same conflicts of interest as corporate directors in reviewing new procedures. And they can draw on the expertise of judges, lawyers, and academics who know more about the pros and cons of various procedures than do corporate directors. This is especially true if lawmakers work through the traditional rulemaking process, which seeks input from a variety of constituencies before implementing new rules.<sup>216</sup> This approach to procedure is far less likely to lead to biased procedures than corporate directors drafting the procedures that will later govern suits filed against them.

At the same time, it is important not to overstate the promise of legislative gatekeeping. First, lawmakers suffer from their own biases, as the PSLRA demonstrated.<sup>217</sup> Although the public may wish that lawmakers crafted impartial solutions to thorny problems, the reality is messier. Lawmakers often act with less nuance, and more partisan jockeying, than procedural experts might desire. In the end, politics comes into procedural drafting, just as it comes into everything else that legislatures do.

Second, legislatures may not be anxious to wade into the procedural fray. In Delaware, for example, the General Assembly largely leaves corporate law to the Delaware bar, relying on a committee of lawyers to propose and review amendments to Delaware's General Corporation Law.<sup>218</sup> This committee took more than a year to ban fee-shifting bylaws and charter provisions, despite the strong argument that these provisions could be fatal to shareholder

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216. See *How the Rule Making Process Works*, U.S. COURTS <http://www.uscourts.gov/rules-policies/about-rulemaking-process/how-rulemaking-process-works> (last visited May 27, 2017) (describing the process for amending federal procedural rules).

217. See, e.g., Joel Seligman, *The Private Securities Reform Act of 1995*, 38 ARIZ. L. REV. 717, 732 (1996) (describing Congress's selective use of anecdotes in compiling a record to support the PSLRA); Jeffrey W. Stempel, *Class Actions and Limited Vision, Opportunities for Improvement Through a More Functional Approach to Class Treatment of Disputes*, 83 WASH. U. L.Q. 1127, 1140 (2005) (describing Congress's view toward securities class actions when it passed the PSLRA as "more hostile than welcoming").

218. See Guhan Subramanian, *Delaware's Choice*, 39 DEL. J. CORP. L. 1, 48 (2014) ("As is well-known to insiders but surprising to everyone else, the Council of Corporation Law, a group of 27 well-respected attorneys mostly from prominent Wilmington firms, proposes all amendments to the DGCL. The Council writes the corporate law of Delaware and, by extension, the country." (footnote omitted)).

litigation more broadly.<sup>219</sup> It seems unlikely that the Delaware legislature would take on a wholesale review of litigation-limiting procedures. In other states, litigation-limiting bylaws or charter amendments are not on current agendas, and there is no indication that other states want to be leaders in this area. As a result, while legislatures could play a more significant gatekeeping role, it is questionable whether they in fact have the inclination to do so.

In the end, there is no perfect gatekeeper when it comes to shareholder litigation. This point, however, bolsters the argument in favor of *multiple* gatekeepers. Rather than relying on judges or shareholders or legislatures to single-handedly monitor shareholder lawsuits, the legal system should think more broadly. Different gatekeepers can work together to ensure that these lawsuits reflect the best interests of shareholders.

### *Conclusion*

Corporate law is all about agency costs. Within the world of shareholder litigation, the question is how to make plaintiffs' attorneys act in the best interests of shareholders—a problem that is common to all types of shareholder lawsuits. Yet, as this Article demonstrates, different types of shareholder lawsuits rely on very different gatekeepers to control agency costs. Securities class actions rely on institutional plaintiffs and Congress. Merger cases rely on judges and litigation-limiting provisions in corporate bylaws and charters. And derivative suits rely largely on corporate boards. On their own, however, none of these gatekeepers have been able to solve the problems inherent in shareholder litigation.

This Article advocates a broader approach to litigation gatekeeping. Rather than relying on a narrow gatekeeping model, the legal system should explore the possibility of using a broader range of gatekeepers to control agency costs. Judges should use closer scrutiny in reviewing proposed settlements in all types of shareholder lawsuits. Corporate boards and shareholders should make greater use of their bylaws and charters. And legislatures should explore the use of heightened procedure to cut down on frivolous lawsuits. No single gatekeeper is the answer, but together, they may be able to solve the oldest problem in corporate law.

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219. See Francis Pileggi, *Delaware Proposes New Fee-Shifting and Forum Selection Legislation*, DEL. CORP. & COM. LITIG. BLOG (Mar. 6, 2015), <https://perma.cc/TP2C-8YJ3> (describing the process leading up to the legislation).