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Shareholder Litigation Without Class Actions

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SHAREHOLDER LITIGATION WITHOUT CLASS ACTIONS

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In this Article, I imagine a post-class-action landscape for shareholder litigation. Projecting an environment in which both securities-fraud and transactional class actions are hobbled by procedural or substantive reforms—most likely through the adoption of mandatory-arbitration provisions or fee-shifting provisions—I assess what shareholder litigation would disappear, what (if any) would remain, and what a post-class-action landscape would look like. I argue that loss of the class action would remove a layer of legal insulation that prevents institutional investors from having to pursue positive-value claims against companies. Currently, the class action effectively ratifies fund fiduciary passivity in the face of fraud, for example, as long as the institution files a claim form to collect its share of a class action settlement that has been judicially certified. But without the class action, monitoring and litigation costs for such institutions may increase because fund fiduciaries must monitor their portfolios for, and litigate, positive-value claims. Failure to do so could expose them to liability to fund beneficiaries. I offer some suggestive, but incomplete, evidence about how many funds will have positive-value claims. Whether institutions in fact pursue such claims will

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decisively determine whether shareholder litigation has a post-class-action future. I also argue that bizarre gaps in liability coverage for public-pension-fund fiduciaries—who serve the funds that have traditionally been the most active litigants—may have unpredictable effects on trustee behavior outside the class action, may tilt in favor of bringing claims, and may also lead to herding behavior in arbitration. I also assess how loss of the class action would affect plaintiff law firms. I argue that the end of the class action means, at a minimum, abandonment of the idea that investors should be compensated for losses due to fraud or other corporate malfeasance. And I demonstrate that loss of the class action leaves investors in smaller firms with no legal remedy for wrongdoing, even if some form of litigation survives.

Finally, I argue that shareholder litigation without class actions—should institutional investors choose to pursue it—would create a new distortion in the private enforcement regime, what I call the "semi-circularity problem." Without class actions, negative-value claimants would no longer be able to recover for their damages in shareholder litigation. But they would still be forced to subsidize the losses of positive-value claimants to the extent that the smaller investors own shares in defendant companies that must pay damages claims to large institutional investor plaintiffs. Loss of the class action device creates a two-tier legal system for investors: one in which large institutions may recover while individuals and smaller institutions do not from the same fraud (or mispriced deal), and one in which smaller investors that still own defendant companies must reach farther into their pockets to compensate large institutional investor losses for that fraud (or mispriced deal).

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INTRODUCTION

In the past 20 years, the securities class action has endured a series of existential crises. The most recent example was *Erica P. John Fund v. Halliburton* (*Halliburton II*),[1] in which the Supreme Court considered overruling precedent that had allowed plaintiffs to rely on the fraud-on-the-market theory to demonstrate reliance in fraud cases.[2] Without this theory, the shareholder class action cannot proceed because individualized issues of reliance would predominate over common issues and therefore the shareholder class could not be certified under Rule 23 of the Federal Rules of Civil Procedure.[3] As on prior occasions, the securities class action survived the existential challenge in *Halliburton II*. And, as on prior occasions, it did not do so intact. The Court's decision allows defendants to challenge whether the alleged misrepresentation affected the stock price at the class certification stage, rather than at the summary judgment stage.[4] Allowing defendants to challenge causation at an earlier stage in the proceeding tilted securities litigation even further in their favor.[5] In so doing, *Halliburton II* continued the general trend that recently led Professor Barbara Black to quip that,

1. 134 S. Ct. 2398 (2014).

2. *Id.* at 2407.

3. Stephen M. Sinaiko and Arielle Warshall Katz, *The Future Of The "Fraud On The Market" Presumption In Securities Litigation: A Not-So-Basic Question*, THE METROPOLITAN CORPORATE COUNSEL, Dec. 18, 2013, at 26.

4. Jordan Eth and Mark R.S. Foster, *Beyond Basic: Supreme Court's Halliburton Ruling Strengthens Defenses In Securities Fraud Class Actions*, MONDAQ (July 7, 2014), http://www.mondaq.com/unitedstates/x/324908/Securities/Beyond+Basic+Supreme+Courts+Halliburton+Ruling+Strengthens+Defenses+in+Securities+Fraud+Class+Actions ("Now defendants 'may seek to defeat the *Basic* presumption' at class certification, rather than waiting for summary judgment or trial, by seeking to introduce 'direct as well as indirect price impact evidence.' To do so, defendants can submit expert analyses, including event studies, that demonstrate specific alleged misrepresentations did not affect the market price of a stock. The Court reasoned that permitting this rebuttal by defendants at class certification was necessary 'to maintain the consistency of the presumption with the class certification requirements of Federal Rule of Civil Procedure 23.'").

5. *Id.* ("By explicitly allowing defendants to rebut the presumption of reliance . . . the *Halliburton* decision alters the status quo of securities litigation, and is likely to breathe new life into the class certification stage of securities class actions.").

"[t]he attacks on the securities fraud class action never end."[6] Beginning with the Private Securities Litigation Reform Act of 1995 ("PSLRA"), a series of statutory and judicial reforms to the securities class action have: (1) placed a ceiling on damages;[7] (2) eliminated aiding and abetting liability;[8] (3) eliminated liability for fraud participants who were nonspeakers;[9] (4) denied discovery prior to a ruling on the motion to dismiss;[10] (5) instituted a higher pleading standard for scienter (the highest pleading standard in civil procedure);[11] (6) narrowed the scope of causation;[12] (7) barred the litigation of securities cases by classes of 50 or more people in state court;[13] and (8) allowed defendants to contest the efficiency of the market for purposes of the fraud-on-the-market theory.[14]

The elimination of the securities class action has long been the goal of some academics, policymakers, and business lobbies.[15] It is also part of a long-term retrenchment in the private attorney-general model for enforcing federal statutes generally.[16] At several points in this "death-of-a-thousand-cuts" approach

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6. Barbara Black, *Eliminating Securities Class Actions Under the Radar*, 2009 COLUM. BUS. L. REV. 802, 802 (2009).

7. 15 U.S.C. § 78u-4(e) (2012).

8. Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

9. Stoneridge Inv. Partners v. Scientific-Atlanta, 552 U.S. 148 (2008) (finding respondents not liable to petitioner because respondents' deceptive acts were not relied upon by petitioners); Janus Capital Grp. Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011) (limiting primary liability under Rule 10b-5 to those persons who "made" the alleged misstatement).

10. *See* 15 U.S.C. § 78u-4(b)(3)(B) (2012).

11. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007). *See also* Bell Atl. Corp. v. Twombly, 550 U.S. 544 (2007); Ashcroft v. Iqbal, 566 U.S. 662, 678 (2009) (raising pleading standards from a "possibility" to a "plausibility" standard asking "for more than a sheer possibility that a defendant has acted unlawfully" (citing *Twombly*, 550 U.S. at 556)).

12. Dura Pharm., Inc. v. Broudo, 544 U.S. 336 (2005).

13. *See* 15 U.S.C. § 77p(c) (2012) (stating that "any covered class action in any State court involving a covered security . . . . shall be removable to the Federal district court for the district in which the action is pending").

14. *See In re* Initial Pub. Offerings Sec. Litig., 471 F.3d 24 (2d Cir. 2006). Additionally, as I noted above, due to the Supreme Court ruling in *Halliburton II*, defendants can now present evidence to defeat the *Basic* presumption of reliance at an earlier stage of litigation, specifically, the class certification stage. *See supra* note 4 and accompanying text.

15. Hal S. Scott & Leslie N. Silverman, *Stockholder Adoption of Mandatory Individual Arbitration for Stockholder Disputes*, 36 HARV. J. L. & PUB. POL'Y 1187, 1205 (2013) (discussing the numerous scholars and committees who believe that "securities class actions are a major contributor to making the U.S. capital markets less competitive and less attractive").

16. Stephen Burbank & Sean Farhang, *Litigation Reform: An Institutional Approach*, 162 U. PA. L. REV. 1543 (2014). Some scholars argue that the rise of shareholder activism as a mechanism for policing managerial agency costs may be a response to the policing void left by the narrowing of the shareholder class action. *See* James D. Cox and

to securities class action reform, the threat of the latest reform was viewed as existential. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*[17] threatened to raise the pleading burden for a "strong inference" of scienter—adopted in the PSLRA—to the point where surviving a motion to dismiss would be impossible in all but the most egregious frauds where the relevant factual information most likely became public through either a whistleblower or a governmental investigation.[18] In the legislative arena, academic critics and powerful interest groups—including the U.S. Chamber of Commerce and the Business Roundtable—have repeatedly called for elimination or reform of such actions.[19] Such legislation may be more likely to pass under Republican majorities in the House and Senate, although even divided governments have adopted similar legislation—the PSLRA was adopted by a Republican House and a Democratic Senate after the Senate overrode the veto of President Clinton, a fellow Democrat.[20] Immediately preceding the recent financial crisis, the Paulson Committee, appointed by former Secretary of the Treasury Henry Paulson, argued that shareholder litigation undermined the competitiveness of U.S. capital markets and called for increased guidance from the Securities and Exchange Commission ("SEC") regarding the pleading for a 10b-5 claim and the pursuit of alternatives to litigation for shareholders.[21] These proposals dropped off of the legislative agenda during and after the recent financial crisis. But if history is any guide, it is only a matter of time before additional legislative threats to the existence of the 10b-5 class action emerge. The only thing that might prevent this

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Randall S. Thomas, Addressing Agency Costs through Private Litigation in the U.S.: Tensions, Disappointments, and Substitutes, (unpublished manuscript) (on file with author).

17. 551 U.S. 308 (2007). In his *Tellabs* concurrence, Justice Scalia argued that "strong inference" should mean that the facts as pleaded had to be "more plausible than the inference of innocence," a far cry from the then-prevalent notice pleading standard. (I note that Scalia's standard is not the one adopted by the Court). Even now, the *Tellabs* standard is a substantially higher burden than today's general pleading standards under *Twombly* and *Iqbal*, which require that the plaintiff's claim be plausible, but not more plausible than the defendant's competing inference of innocence. Stephen Burbank has pointed out that certain language in *Twombly* can be read to be even more demanding than the PSLRA standard interpreted in *Tellabs*, a reading that *Burbank* concludes "would be ridiculous." Stephen B. Burbank, *Pleading and the Dilemmas of "General Rules,"* 2009 WISC. L. REV. 535, 552. (2009). The standard also requires pleading facts. *Tellabs*, 551 U.S. at 329.

18. *Tellabs*, 551 U.S. at 324 (resolving a circuit split by holding that "[t]he inference that the defendant acted with scienter need not be irrefutable, i.e., of the 'smoking-gun' genre, or even the 'most plausible of competing inferences'" (quoting Fidel v. Farley, 392 F.3d 220, 227 (6th Cir. 2004))).

19. *See, e.g.*, *U.S. Chamber Policy Priorities for 2014*, U.S. CHAMBER OF COMMERCE, 30 (2014) https://www.uschamber.com/sites/default/files/2014_policy_priorities-september_2014.pdf (listing that they seek to "[o]ppose efforts by plaintiffs' bar to expand the abuse of the class action device" among other policy initiatives).

20. Nicole M. Briski, comment, *Pleading Scienter Under the Private Securities Litigation Reform Act of 1995: Did Congress Eliminate Recklessness, Motive and Opportunity?*, 32 LOY. U. CHI. L.J. 155, 169 (2000) ("Despite President Clinton's concerns that Congress raised the pleading standard for scienter above that of the Second Circuit, Congress overrode President Clinton's veto and enacted the PSLRA into law . . . .").

21. R. Glenn Hubbard & John L. Thornton, *Action Plan for Capital Markets*¸ WALL ST. J., Nov. 30, 2006, at A16.

reemergence, even under Republican congressional control, is that legislative reform would be mooted by procedural and judicial changes that threaten to eliminate these actions without a vote. That would fit a long standing pattern of legislatures avoiding action on litigation reform, possibly because they see that reform is taking place in the courts, though perhaps also because of the difficulty of legislating class action reforms.[22]

The most serious threats to the shareholder class action have already emerged in two forms: unilateral board adoption of mandatory-arbitration provisions or fee-shifting provisions in corporate bylaws. These threats follow the aforementioned pattern in which class action opponents have shifted their efforts to procedural, rather than substantive, reforms.[23]

Beginning with arbitration provisions, the Supreme Court's recent Federal Arbitration Act ("FAA") decisions combined with corporate-law decisions in Delaware and elsewhere, strongly suggest that there is no remaining legal barrier to a board unilaterally adopting bylaws requiring mandatory bilateral arbitration of shareholder claims against the company, its board, or its managers. Professor Brian Fitzpatrick has argued, that in the aftermath of Supreme Court cases like *AT&T Mobility L.L.C. v. Concepcion*[24] and *American Express Co. v. Italian Colors Restaurant*,[25] businesses can bind their shareholders to arbitration clauses with class action waivers, as long as the terms of the waiver are themselves legal.[26] In *Concepcion*, the Supreme Court upheld a mandatory-arbitration provision in an AT&T cell phone contract, concluding that the FAA preempted California's criteria for determining when waivers in consumer contracts could be deemed unconscionable.[27] In *American Express*, the Supreme Court held that the FAA "does not permit courts to invalidate a contractual waiver of class arbitration on the ground that the plaintiff's cost of individually arbitrating a federal statutory claim exceeds the potential recovery."[28] Fitzpatrick discusses these cases in the context of shareholder approval of such bylaws,[29] but it appears as if shareholder approval may not be necessary under the recent Delaware holdings, *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*[30] and *ATP Tour, Inc. v. Deutscher*

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22. Burbank & Farhang, *supra* note 16.
23. *Id.* (describing the tactical shift by critics of the private attorney-general model to pursue procedural rather than substantive or legislative reforms).
24. 131 S. Ct. 1740 (2011).
25. 133 S. Ct. 2304, 2306 (2013).
26. Brian Fitzpatrick, *Is the End of Class Actions Upon Us?*, SCOTUSBLOG (Sept. 14, 2011, 9:55 AM), http://www.scotusblog.com/2011/09/is-the-end-of-class-actions-upon-us/ [hereinafter Fitzpatrick, SCOTUSblog].
27. *Concepcion*, 131 S. Ct. at 1740.
28. *Am. Express*, 133 S. Ct. at 2306.
29. Fitzpatrick, SCOTUSblog, *supra* note 26 (discussing the "transactional relationship" between those who bring class actions and the businesses they bring class actions against); *see also* Brian Fitzpatrick, *The End of Class Actions?*, 57 ARIZ. L. REV. 161 (forthcoming 2015) [hereinafter Fitzpatrick, *The End*].
30. 73 A.3d 934, 939 (Del. Ch. 2013).

Tennis Bund.[31] Ms. Claudia Allen has argued that *Concepcion*, *American Express*, and these recent Delaware decisions suggest that a board-adopted mandatory bylaw with a class action waiver would be enforceable, even if it sidestepped shareholder approval.[32] All of this cements the argument that there is no remaining legal barrier to unilateral board adoption of mandatory-arbitration or fee-shifting provisions. In *Boilermakers*, then-Chancellor (and current Chief Justice of the Delaware Supreme Court) Leo Strine upheld a forum-selection clause mandating that shareholders sue the company only in Delaware[33] even though the board adopted the clause without shareholder approval.[34] The court held that Delaware law places shareholders on notice that boards may change corporate bylaws at any time without shareholder approval, so long as the bylaw complies with § 109 of the Delaware General Corporation Law ("DGCL"), which bars bylaws that conflict with the law.[35] Mandatory-arbitration and fee-shifting bylaws might once have conflicted with the law, but this no longer seems to be the case after *Concepcion* and *American Express*.[36]

Corporate boards' power to chip away at shareholder class actions was further solidified in the second Delaware opinion, *ATP*. There, the Delaware Supreme Court enforced a board-adopted bylaw that instituted a "plaintiff-pays"[37] provision that requires shareholders to pay the company's attorneys' fees if the shareholders "[do] not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought."[38] Although the Delaware legislature is considering amending the DGCL to bar such "loser pays" provisions, the precedent stands.[39] Boards may unilaterally limit the rights of company

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31. 91 A.3d 554, 558 (Del. 2014).

32. Claudia Allen, *Bylaws Mandating Arbitration of Stockholder Disputes?*, 39 DEL. J. CORP. L. (forthcoming 2014), *available at* http://ssrn.com/abstract=2444771.

33. *Boilermakers*, 73 A.3d at 939 (holding that "the bylaws are valid and enforceable contractual forum selection clauses").

34. *Id. See also* North v. McNamara, No. 1:13-cv-833, 2014 WL 4684377, at *1, *7 (S.D. Ohio Sept. 19, 2014) (upholding a board-adopted forum-selection clause and stating that such forum selection clauses generate "cost and efficiency benefits that inure to the corporation and its shareholders by streamlining litigation.").

35. *Boilermakers*, 73 A.3d at 939–40 ("[W]hen investors bought stock in Chevron and FedEx, they knew (i) that consistent with 8 Del. C. § 109(a), the certificates of incorporation gave the boards the power to adopt and amend bylaws unilaterally . . . and (iii) that board-adopted bylaws are binding on the stockholders.").

36. *See supra* notes 27–28 and accompanying text.

37. Such provisions are frequently referred to as "loser-pays" provisions, but I call them "plaintiff-pays" provisions because plaintiff could still win a judgment on the merits and be forced to pay the defendants' legal bill under the provision approved in *ATP*.

38. ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554, 557 (Del. 2014).

39. *See The Fate of Delaware "Fee-Shifting" Bylaws*, WSGR (July 11, 2014), http://www.wsgr.com/WSGR/Display.aspx?SectionName=publications/PDFSearch/wsgralert-fee-shifting-0714.htm; *SB 236, An Act to Amend Title 8 of the Delaware Code Relating to General Corporate Law*, OPEN:STATES (last visited Oct. 14, 2014) http://openstates.org/de/bills/147/SB236/

shareholders to sue them, within the broad limits of § 109.[40] *Boilermakers* and *ATP* strongly suggest that a board can unilaterally adopt a bylaw requiring shareholders to arbitrate their claims, in part because the bylaw does not bar these claims, but rather changes the forum in which they may be brought. That such a provision would *economically* bar a remedy for meritorious but negative-value claims[41] would not seem to pose a legal barrier to their adoption. It did not stop the U.S. Supreme Court from enforcing the mandatory-arbitration provision in *American Express*.[42] In fact, under the U.S. Supreme Court's arbitration jurisprudence, the Delaware legislature might be preempted under the FAA from barring board adoption of such mandatory-arbitration provisions.[43]

Finally, the U.S. Supreme Court has narrowed the prospects for class arbitration. In *Stolt-Nielsen S.A. v. Animal Feeds International Corp.*,[44] the Court held that arbitration provisions could not be construed to require class arbitration absent consent to the class mechanism. Yet it left for another day the question of what contractual basis might support a finding that the parties agreed to authorize class action arbitration.[45] In *Oxford Health Plans LLC v. Sutter*,[46] the Supreme Court unanimously rejected the petitioners' contention that an arbitrator exceeded his powers under § 10(a)(4) of the FAA after the arbitrator found that the parties had impliedly consented to class arbitration.[47] These holdings requiring at least implicit consent to class arbitration contrast with the approach taken in international investor arbitration cases like *Abaclat & Others (formerly Giovanna*

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40. *ATP*, 91 A.3d at 558 ("Neither the DGCL nor any other Delaware statute forbids the enactment of fee-shifting bylaws.").

41. "Negative Value class actions . . . are class actions where the costs in establishing and collecting the individual claims are greater than the potential recovery." Martin H. Redish & Clifford W. Berlow, *The Class Action as Political Theory*, 85 WASH. U. L. REV. 753, 762 (2007).

42. Am. Express Co. v. Italian Colors Rest., 133 S. Ct. 2304, 2311 (2013) ("But the fact that it is not worth the expense involved in *proving* a statutory remedy does not constitute the elimination of the *right to pursue* that remedy.").

43. Allen, *supra* note 32 (manuscript at 4–5) ("Reflecting the policy favoring arbitration, the Supreme Court has held that state rules or laws that have a disproportionate impact on, or discriminate against, arbitration agreements are preempted by the FAA . . . ."). *See also*, Fitzpatrick, *The End*, *supra* note 29, at 187 ("[I]f Delaware decided as a matter of its corporate law that corporations could not place arbitration clauses or class action waivers in corporate bylaws or charters, there is at least an argument that the FAA could not preempt that decision: corporate law is traditionally the domain of the states and there are doctrines that force courts to presume that Congress did not intend to preempt state laws in traditional state domains. On the other hand, contract law, too, is traditionally the domain of the states, but that did not give the Supreme Court pause in *Concepcion*. In the end, then I remain pessimistic that state law can slow class action waivers.")

44. 559 U.S. 662 (2010).

45. *Id.* at 685 (finding that a contractual basis is necessary to compel a party to submit to class arbitration because "class-action arbitration changes the nature of arbitration to such a degree that it cannot be presumed the parties consented to it by simply agreeing to submit their disputes to an arbitrator").

46. 133 S. Ct. 2064 (2013).

47. *Id.*

a Beccara & Others) v. Argentine Republic,[48] in which an international arbitration panel took jurisdiction over the collectively filed claims of 60,000 Italian bondholders dissatisfied with the restructuring of Argentine debt.[49] The arbitration clause in *Abaclat* excluded consent to class arbitration, but the arbitrators reasoned that they had jurisdiction over each individual claimant and that "no separate consent was required with regard to the *form* of the proceeding."[50] Taken together, these U.S. cases suggest that corporate boards could unilaterally adopt carefully drafted bylaws that require shareholders to arbitrate against them in bilateral proceedings and that bar class arbitration or consolidation of such proceedings. Such provisions, if upheld, would effectively terminate the possibility of collective prosecution of fraud and transactional claims.

These U.S. court decisions all but reverse the SEC's current policy barring mandatory-arbitration provisions, at least at the initial public offering ("IPO") stage.[51] Historically, the SEC refused to accelerate the registration statements for companies going public whose charters included mandatory-arbitration provisions.[52] Most recently, when the Carlyle Group sought to go public, they "include[d] a provision that would have required future stockholders to resolve any claim against [them] through arbitration rather than in court" in their initial filings.[53] Additionally, the provision precluded class action arbitration.[54] Carlyle withdrew the provision from its filing documents after encountering opposition from the SEC, potential investors, and shareholder rights activists.[55]

In light of the Supreme Court's pro-arbitration jurisprudence, it would not be surprising if companies in the process of going public were to push back harder against the SEC's position on mandatory arbitration, particularly if there is a

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48. Giovanna a Beccara, ICSID Case No. ARB/07/5, Decision on Jurisdiction and Admissibility, (Aug. 4, 2011), *sub nom*. Abacalat & others v. Argentine Republic.

49. *See* W.W. Park, *The Politics of Class Action Arbitration: Jurisdictional Legitimacy and Vindication of Contract Rights*, *in* ARBITRATION OF INTERNATIONAL BUSINESS DISPUTES (2d ed. 2012) (discussing *Abaclat*).

50. *Id.* (contrasting the approaches to class arbitration taken in *Animal Feeds* and *Abaclat*, and noting *Animal Feeds*'s effect on the economics of arbitration: "For the [*Animal Feeds*] majority, respondents' failure to consent to class proceedings trumped any efficiency benefits from collective arbitration such as the sharing of costs that might otherwise inhibit pursuit of claims.").

51. Karan Singh Tyagi & Gide Loyrette Nouel, *Carlyle Leaves out Mandatory Arbitration Clause in IPO*, KLUWER ARBITRATION BLOG (Feb. 7, 2012), http://kluwerarbitrationblog.com/blog/2012/02/07/carlyle-leaves-out-mandatory-arbitration-clause-in-ipo/ ("Historically the SEC has disfavored mandatory shareholder arbitration provisions.").

52. *Id.* ("In 1990, when Franklin First Financial Corp that was planning its IPO sought to include an arbitration provision in its charter and bylaws, the SEC firmly objected to its inclusion.").

53. Miles Weiss et al., *Carlyle Drops Class-Action Lawsuit Ban as Opposition Mounts*, BLOOMBERG (Feb. 3, 2012, 5:57 PM), http://www.bloomberg.com/news/2012-02-03/carlyle-drops-class-action-lawsuit-ban.html.

54. Tyagi & Nouel, *supra* note 51.

55. *Id.*

change in administration.[56] Regardless of whether the SEC maintains its position against such provisions, there are already examples of boards unilaterally adopting them. Most recently, in *Corvex Management, LP v. Commonwealth REIT*,[57] the Circuit Court of Maryland upheld a mandatory-arbitration bylaw that had been unilaterally adopted by the board[58]—and *Commonwealth REIT* is not alone.[59] The effect of such bylaws, should they become widely adopted, would likely be "a marked decline in class actions."[60] The primary purpose of arbitration provisions in this context is not to shift shareholder claims from judges to arbitrators, but to eliminate the claims entirely by undermining their economic viability. In his dissenting opinion in *Concepcion*, Justice Breyer noted that, for negative-value claimants, the loss of the class action is a substantive waiver of their claims.[61] There was a time when this purpose would have been illegitimate, and would have led to courts striking down such provisions.[62] But *American Express* made clear that that time has passed.

It is true that some arguments remain as to why arbitration provisions might not be enforceable in the shareholder context. One such argument is that the securities laws explicitly bar anything that would reduce or eliminate the shareholder rights they provide.[63] The SEC has relied on such provisions to resist the adoption of mandatory-arbitration clauses.[64] However, *Concepcion* and

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56. *See* Weiss et al., *supra* note 53 ("Former SEC Chairman Harvey Pitt said the issue probably faced 3-2 ideological split on the current commission . . . ."). *But see id.* (suggesting that Carlyle faced pushback from the SEC, potential investors, and other interested parties).

57. 2013 Md. Cir. Ct. LEXIS 3 (Cir. Ct. Balt. May 8, 2013). In the interest of full disclosure, the Author submitted an affidavit, along with other academics, opposing *Commonwealth REIT*'s adoption of a mandatory-arbitration provision. We were not persuasive.

58. Corvex Mgmt. v. Commonwealth REIT, 2013 Md. Cir. Ct. LEXIS 3 (Cir. Ct. Balt. May 8, 2013).

59. *See, e.g.*, *id.*; Holly Gregory, *The Elusive Promise of Reducing Shareholder Litigation Through Corporate Bylaws*, HARVARD LAW SCH. FORUM ON CORPORATE GOVERNANCE & FIN. REGULATION (June 9, 2014, 9:25 AM), http://blogs.law.harvard.edu/corpgov/2014/06/09/; Fitzpatrick, SCOTUSblog, *supra* note 26.

60. Allen, *supra* note 32 (manuscript at 3).

61. AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1761 (2011) (Breyer, J., dissenting) ("In California's perfectly rational view, nonclass arbitration over such [small] sums will also sometimes have the effect of depriving claimants of their claims . . . ."); *see also* Am, Express Co. v. Italian Colors Rest. 133 S. Ct. 2304 (2013).

62. *See e.g.*, Mistubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.,473 U.S. 614 (1985).

63. 15 U.S.C. § 78cc(a) (2012) ("Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void.").

64. *See* Ralph C. Ferrara & Stacy A. Puente, *Holding IPOs Hostage to Class Actions: Mandatory Arbitration Clauses in IPOs*, 9 SEC. LITIG. REP. 1, 4 (2012) ("The mandatory arbitration clause is by no means a novel invention. The [SEC]'s established position has been that such clauses were void—particularly where the clause would limit a shareholder's ability to enforce his or her rights under Section 10(b) of the Exchange Act,

American Express offer little comfort that the Court would defer to the SEC's view of the securities laws, or that the securities laws would trump the FAA or Delaware corporate law.[65] Despite the limited, if nonexistent, legal barriers to the widespread adoption of mandatory-arbitration and class action waivers, it remains possible that businesses will not adopt them for a variety of reasons—including opposition by their own shareholders. Institutional Shareholder Services ("ISS"), the powerful proxy advisory firm, has stated that it recommends voting against directors who vote to unilaterally amend company bylaws without shareholder approval, and recently clarified that this advice includes unilateral amendments affecting litigation rights.[66] This could provide a powerful nonlegal counterweight to arbitration provisions (and the plaintiff pays provisions discussed below) because of ISS's strong influence over proxy voters.[67] Similarly, the Council of Institutional Investors ("CII"), a powerful investor coalition, has publicly stated its opposition to the adoption of such provisions.[68] It and its members may be able to dissuade corporate boards from adopting such bylaws. It is noteworthy that CII has taken this position, given that its constituents comprise the set of investors that is most likely to have positive-value claims and therefore most likely to be able to continue to pursue those claims in arbitration.[69] I will return to this point below. Even investors beyond CII may be interested in obtaining credible commitments from their investees that they should have a remedy for fraud, and may demand retraction of mandatory-arbitration or "plaintiff-pays" provisions, or contract around such provisions, before investing.

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which would violate the prohibition against waiver of rights under Section 29(a) of the Exchange Act." (internal citations omitted)); Christos Ravanides, *Arbitration Clauses in Public Company Charters: An Expansion of the ADR Elysian Fields or A Descent into Hades?*, 18 AM. REV. INT'L ARB. 371, 407 (2008) ("The SEC . . . has been shortsightedly insisting on a near ban on experimentation with ADR methods for domestic companies . . . .").

65. *See supra* text accompanying notes 24–36.

66. Ferrara & Puente, *supra* note 64.

67. Michael J. Ryan, Jr., *U.S. Capital Markets Competitiveness: The Unfinished Agenda*, CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA 5 (2011), https://www.uschamber.com/sites/default/files/legacy/reports/1107_UnfinishedAgenda_WEB.pdf; *see also* James Cotter, Alan Palmiter & Randall Thomas, *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 55 VILL. L. REV. 1, 31 (2010) (finding that "with a proposal that management recommends to shareholders, a negative ISS recommendation seems to reduce the number of all shareholder 'for' votes by 28.8%" and that "when management is opposed to a proposal, a negative ISS recommendation appears to lead to another 33.3% drop in all shareholder voting support").

68. *See, e.g.*, Letter from Jeff Mahoney, Gen. Counsel, Council of Institutional Investors, to Keith F. Higgins & John Ramsey, Dirs., U.S. Sec. and Exch. Comm'n (Dec. 11, 2013) (available at: http://www.cii.org/files/issues_and_advocacy/correspondence/2013/12_11_13_CII_letter_to_SEC_forced_arbitration.pdf). *See also* Letter from Jeff Mahoney, Gen. Counsel, Council of Institutional Investors, to Patrick J. Leahy & Charles Grassley, U.S. Senate (Dec. 12, 2013) (available at: http://www.cii.org/files/issues_and_advocacy/correspondence/2013/12_12_13_CII_letter_to_senate_judiciary_forced_arbitration.pdf).

69. *See* discussion *infra* Part V.

Many of these same arguments apply to fee-shifting provisions.[70] In the aforementioned *ATP* case, the Delaware Supreme Court approved unilateral board adoption of a fee-shifting bylaw that stated, in pertinent part:

> In the event that . . . the Claiming Party . . . does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought, then each Claiming Party shall be obligated jointly and severally to reimburse the League and any such member or Owners for all fees, costs and expenses of every kind and description (including, but not limited to, all reasonable attorneys' fees and other litigation expenses) (collectively, "Litigation Costs") that the parties may incur in connection with such Claim.[71]

As noted, the Delaware legislature is actively considering overturning the Delaware Supreme Court's ruling in *ATP*, and there are mounting efforts to challenge it or limit its scope.[72] But already, 42 companies have adopted such "loser-pays," or what I call "plaintiff-pays" provisions, and some top law firms have started incorporating them into certificates of incorporation in preparation for IPOs.[73] Under their own terms, even a favorable judgment on the merits that obtains something less than "substantially . . . the full remedy sought" would still require the plaintiff to pay legal fees;[74] so would a favorable settlement that falls short of a judgment on the merits. Provisions like these would expose plaintiffs to substantial litigation costs, complicating the positive-value claim calculation. Plaintiffs' lawyers may be willing to bear the risk of a lost lawsuit from which they recoup no legal fee and incur uncompensated out-of-pocket litigation costs, but they may not be willing to bear the high risk of the defendants' legal costs too. They might rationally abandon securities class actions for another field. True, there may be more legal barriers to the institution of fee-shifting provisions than there are for mandatory-arbitration provisions, even apart from a decision by the

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70. John C. Coffee, Jr., *Fee-Shifting and the SEC: Does It Still Believe in Private Enforcement?*, CLS BLUESKY BLOG (Oct. 14, 2014), http://clsbluesky.law.columbia.edu/2014/10/14/fee-shifting-and-the-sec-does-it-still-believe-in-private-enforcement/.

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

72. S.J. Resolution 12 147th Gen. Assemb. (Del. 2014) ("[T]he Governor and the Delaware General Assembly strongly support a level playing field that provides the ability for stockholders and investors to seek relief on its merits in the Courts of this State and believe that a proliferation of broad fee-shifting bylaws for stock corporations will upset the careful balance that the State has strived to maintain between the interests of directors, officers, and controlling stockholders, and the interests of other stockholders.") The Delaware General Assembly will revisit this issue in early 2015.

73. John C. Coffee, *"Loser Pays: Who Will Be The Biggest Loser?"* http://clsbluesky.law.columbia.edu/2014/11/24/loser-pays-who-will-be-the-biggest-loser/; *see also* Lee Rudy, *Litigation Bylaws*, CII (Nov. 19, 2014), http://www.cii.org/files/issues_and_advocacy/legal_issues/Litigation%20Bylaws.pdf?utm_source=12-04-14+CII+Governance+Alert&utm_campaign=12-04-14+CII+Alert&utm_medium=email (documenting 42 companies that adopted fee-shifting bylaws as of Nov. 19, 2014).

74. *ATP Tour*, 91 A.3d at 557.

Delaware legislature to backtrack on them. For example, a federal court could discover a conflict between the fee-shifting provision and the securities laws, thereby preempting the provision, or the Delaware Chancery Court could find that it had an "improper purpose."[75] As discussed below, there is some evidence plaintiffs' lawyers abandoned tort cases for patent litigation in response to state tort reform. Additionally, ISS has recently recommended voting, "against bylaws that mandate fee-shifting whenever plaintiffs are not completely successful on the merits (i.e., in cases where the plaintiffs are partially successful)."[76] And as noted above, ISS generally recommends against voting for directors who voted to unilaterally amend company bylaws without shareholder approval, including unilateral amendments affecting litigation rights.[77] Because these guidelines were recently updated to account for the possible spread of plaintiff pays provisions, it remains to be seen whether the boards at the 42 companies that adopted them prior to the updates will emerge unscathed. ISS itself has endured significant criticism and calls for its regulation by the same groups that have criticized shareholder litigation and advocated for fee-shifting and arbitration provisions.[78] It is possible that under the next Republican \administration in the White House, ISS might see its clout decline. Regardless, the fight over these litigation provisions will continue. These developments in shareholder litigation increasingly look like developments we are seeing in litigation more broadly, specifically, the dilution or elimination of class action incentives through litigation and procedural reform.[79] It is ironic that they should appear now in the shareholder litigation context, considering that the international trend runs in precisely the opposite direction. Australia, Canada, China, The Netherlands, Germany, Israel, and South Korea have all reformed their legal systems to enable the creation of private securities class actions.[80] Many have done so within the past 10–15 years.[81]

But the purpose of this Article is not to make predictions about how the investor politics of mandatory-arbitration and fee-shifting provisions will play out in the United States, whether corporations will adopt them, or whether some other threats to the shareholder class action might emerge. Instead, I begin at the end of the story by imagining the elimination of the shareholder class action, and predicting what shareholder litigation would look like if the class action

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75. Coffee, *supra* note 70.

76. INSTITUTIONAL SHAREHOLDER SERVICES, *United States Concise Proxy Voting Guidelines: 2015 Benchmark Policy Recommendations* 1, 8 (Jan. 7, 2015), *available at* http://www.issgovernance.com/file/policy/usconcisevotingguidelines2015.pdf.

77. *Id.* at 4.

78. Ryan, *supra* note 67.

79. Burbank & Farhang, *supra* note 16, at 1613 ("Litigation seeking to narrow private rights of action, attorneys' fee awards, and standing, and to expand arbitration, achieved growing rates of voting support from an increasingly conservative Supreme Court, particularly over the past two decades.")

80. Paul A. Ferrillo, *A New Playbook for Global Securities Litigation and Regulation*, HARVARD LAW SCH. FORUM ON CORPORATE GOVERNANCE & FIN. REGULATION (Feb. 2, 2012, 9:53 AM), http://blogs.law.harvard.edu/corpgov/2012/02/02/a-new-playbook-for-global-securities-litigation-and-regulation/.

81. *Id.*

disappeared. Much of the critical literature on class actions focuses, quite legitimately, on how they fall short of the ideals of deterrence and compensation.[82] Here, I aim to reframe the debate over shareholder class actions by offering what I hope is informed speculation about what we would be left with if they vanished. There are two purposes to this thought experiment: to imagine the set of possible futures for shareholder litigation without class actions and to offer a basis for assessing not just how shareholder class actions fall short of the ideals of deterrence and compensation, but how they compare to what we will be left with if they disappear.

For the sake of argument, I assume the disappearance of the class action through some type of procedural or substantive reform like adoption of mandatory-arbitration provisions both requiring bilateral arbitration of shareholder claims, and barring consolidation of such claims. The purpose of this assumption is to assess how loss of a viable collective means of pursuing shareholder claims will change the shareholder-litigation landscape. But, because there are many ways for the shareholder class action to perish, I try to maintain flexibility in discussing what a future litigation landscape would look like without it, regardless of exactly how the class action were to disappear.[83] Fee-shifting provisions, for example, would eliminate the class action not by shifting it into arbitration but by rendering the contingency-fee model too risky for any firm to bear. I discuss the economics of fee shifting below in Part IV. Fee shifting might effectively eliminate shareholder litigation by making only overwhelmingly meritorious cases worth bringing. To be sure, the ways in which the shareholder class action might be reduced or eliminated vary, and would have important effects on how a post-shareholder-class-action world would look. But it is not necessary to wait until the exact details are known before making some assessment of how class action restrictions would change shareholder litigation. In making this assessment, one can become mired in describing the many differences between litigation and arbitration generally, something which has been debated at great length elsewhere.[84] To avoid recapitulating these debates here, I aim to confine my analysis to those aspects of shareholder litigation and arbitration that are unique to the shareholder context.

I develop a few main lines of inquiry into the future of shareholder litigation under a legal regime that substantially limits, if not effectively eliminates, the class action device. First, in Part I, I describe the current landscape for shareholder litigation. I then assess what would disappear from it along with the class action. For example, I argue that much of transactional litigation would be eliminated or would shift into appraisal litigation, depending somewhat on whether attorneys' fees and costs would still be available to plaintiffs. In addition, corporate governance reform efforts would all but disappear from these cases,

82. *See, e.g.*, Scott & Silverman, *supra* note 15, at 1194–1203 (discussing how securities class actions fall short of achieving either deterrence or compensation).

83. The content of the arbitration clauses matters, as I discuss in further detail below. *See* discussion *infra* Part II.B.1.

84. *See generally* Barbara Black & Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991 (2002).

perhaps with a handful of such efforts surviving if companies consent to consolidated arbitration proceedings when faced with multiple simultaneous arbitrations. Disclosure-only settlements would also likely disappear. While disclosure settlements are often viewed as frivolous, there is some empirical support for the value of litigated corporate governance reforms.[85]

In Part II, I assess what would remain of shareholder litigation. I describe how the legal architecture of the Employee Retirement Income Security Act ("ERISA"), state pension codes, and the fiduciary duties governing mutual funds, banks, and insurance companies would shape institutional investor litigation behavior in a post-class-action world—at least for the institutions that could plausibly have positive-value claims.[86] I articulate how the class action has historically benefited institutional investors by reducing their monitoring and litigation costs.[87] I argue that institutional investors will be required to create internal monitoring mechanisms that are likely more costly than those they employ now to monitor potential claims in class actions. This is because fund fiduciaries are subject to a clear duty to investigate potentially positive-value claims. I further argue that the fiduciary standards of ERISA and state pension codes likely compel institutions to bring positive-value claims. Fund fiduciaries will retain substantial discretion in deciding whether a particular claim is positive or not, and the litigation risk faced by a trustee for declining to bring a claim after careful deliberation of its merits will be substantially lower than the risk to a trustee for failure to investigate the claim.[88] How many funds will have such positive-value claims, how large those claims will be, and how likely the funds will be to pursue them, are three critically important empirical questions. The answers will determine whether the death of the securities class action means the death of all shareholder litigation, or whether any significant shareholder litigation survives. I offer incomplete, but suggestive evidence on this point. Still, for a variety of reasons discussed below, courts will be less likely to defer to litigation decisions in the shareholder-litigation context than they would be in the context in which failure-to-sue claims have ordinarily been brought, that is, against plan sponsors for failing to make required contributions.[89] And for the most part, such decisions will be evaluated under a less-deferential standard than the business judgment rule,[90] because of the higher fiduciary standards applied under trust law, ERISA, and comparable state pension codes.

In Part III, I discuss the insurance landscape for funds governed by ERISA and state pension codes, particularly the latter, which are more restrictive

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85. See *infra* notes 139–143 and accompanying text for a discussion of pursuing corporate governance reforms through shareholder litigation.

86. *See* discussion *infra* Part II.

87. *See infra* notes 173–176 and accompanying text.

88. *See infra* Part II.B.

89. *See infra* Part II.B.2.

90. The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

and unpredictable than the directors' and officers' insurance with which most corporate law scholars and practitioners are familiar. As I demonstrate below, this is particularly true for public pension-fund fiduciaries who remain largely uninsured and who are told that they are protected from suit by sovereign immunity, even though the decision whether to exercise such immunity is beyond their control.[91] Thus far, the existence of class action settlements whose fairness has been certified by a judge has offered fund fiduciaries de facto immunity from suit for participating in such settlements.[92] The absence of the class action device certifying such fairness creates greater unpredictability for fund fiduciaries. This should make trustees more sensitive to at least investigate potentially positive-value claims. Some of the funds that might otherwise have resisted detecting or bringing positive-value claims will make these decisions in a less secure and predictable insurance environment than that in which directors and officers make similar decisions. I also argue that legal uncertainty may contribute to herding behavior around arbitration decisions. And I argue that the decline of the transactional class action in particular may be offset by, and may enhance, the rise of appraisal litigation, particularly of hedge fund participation in such litigation.

In Part IV, I discuss how loss of the class action device would affect the plaintiffs' bar. I map out a range of scenarios, including the end of the plaintiffs' bar, new competition for plaintiff-side work from the traditional defense bar, and a new world of shareholder arbitration in which only elite firms with established connections to institutional investors survive, while weaker firms tending to bring frivolous cases with individual lead plaintiffs perish.

Finally, in Part V, I argue that shareholder litigation without class actions creates a new market distortion that primarily affects individual investors and small institutional investors, what I call the "semi-circularity problem." Without class actions, negative-value claimants will, in all likelihood, lose the ability to recover their damages in shareholder litigation.[93] But these negative-value claimants will still be forced to subsidize the losses of large institutional investors—positive-value claimants—to the extent that the negative-value claimants own shares in defendant companies that must pay damages claims to

91. *See infra* notes 239–250 and accompanying text.

92. *See infra* notes 120–122 and accompanying text.

93. Professors Myriam Gilles and Anthony Sebok have proposed two potential models under which even small, individual claims might remain economically viable in the arbitration context. These models include litigating an initial case in court to establish a favorable precedent that could then be used serially in arbitration, and utilizing "arbitration entrepreneurs" to purchase small claims and arbitrate them in one action. Myriam Gilles & Anthony Sebok, *Crowd Classing Individual Arbitrations In A Post-Class Action Era*, 63 DEPAUL L. REV. 447, 456–57 (2012). Both of these models seem plausible, though the authors themselves caution, "[n]either is a sure bet; both face serious challenges, and even if used in tandem by sophisticated legal risk takers, these approaches do not provide a very satisfactory substitute for class action litigation." *Id.* at 483. Also, if boards unilaterally adopt mandatory-arbitration provisions, there will be no opportunity to litigate that initial case in court for purposes of establishing a favorable legal precedent, because that initial suit will have to be arbitrated, like all the rest.

institutional investor plaintiffs.[94] Loss of the class action device enshrines this semi-circularity problem into our law, creating a two-tier legal system for investors—one in which, from the same fraud (or mispriced deal), large institutions recover damages while individuals and small institutions do not, and one in which small investors must reach farther into their pockets to compensate large institutional losses for that fraud (or mispriced deal). I argue that this development cuts to the heart of one core purpose of securities regulation: the idea of maintaining a level legal and informational playing field between investors. I also argue that the end of the class action means abandonment of the idea that investors should be compensated for losses due to fraud or other corporate malfeasance, and I demonstrate that loss of the class action leaves investors in smaller firms with no remedy for wrongdoing. It is true that compensation for such harm is already quite small, and its loss might not be missed. But it creates potentially unwelcome incentives favoring large institutional investors over smaller institutions and individuals, rather than maintaining a traditionally more level legal playing field for such investors, regardless of size.

I. THE LITIGATION LANDSCAPE FOR INSTITUTIONAL INVESTORS, WITH AND WITHOUT CLASS ACTIONS

In the past decade, public-pension funds and labor-union funds have obtained lead plaintiff appointments in approximately 40% of both securities-fraud and transactional class actions.[95] Active institutional leadership of these class actions has not always been the norm, but two legal reforms facilitated this change. At the federal level, the PSLRA created a rebuttable presumption—appointing the applicant with the largest loss in the purported fraud as lead plaintiff.[96] This reform was designed to encourage institutional leadership of class actions because, due to their sizable assets, institutions were most likely to have the largest losses.[97] In

94. John C. Coffee, Jr., *Accountability and Competition in Securities Class Actions: Why "Exit" Works Better than "Voice,"* 30 CARDOZO L. REV. 407, 409 (2008) ("Typically, the members of the plaintiff class are paid the settlement by the corporation (and not by the individual defendants). As a result, the cost of recovery falls primarily on those shareholders who are not in the class.").

95. *See* Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315 (2008); Michael A. Perino, *Institutional Activism Through Litigation: An Empirical Assessment of Public Pension Fund Participation in Securities Class Actions*, 9 J. EMPIRICAL LEGAL STUD. 363 (2012); David H. Webber, *Private Policing of Mergers and Acquisitions: An Empirical Assessment of Institutional Lead Plaintiffs in Transactional Class and Derivative Actions*, 38 DEL. J. CORP. L. 907, 934 (2014) (institutions obtain 41% of lead plaintiff appointments in Delaware transactional litigation) [hereinafter Webber, *Private Policing*].

96. 15 U.S.C. § 77z-1(a)(3)(B)(iii) (2012) ("[T]he court shall adopt a presumption that the most adequate plaintiff in any private action arising under this subchapter is the person or group of persons that . . . in the determination of the court, has the largest financial interest in the relief sought by the class . . . .").

97. *See* R. Chris Heck, *Conflict and Aggregation: Appointing Institutional Investors as Sole Lead Plaintiffs Under the PSLRA*, 66 U. CHI. L. REV. 1199, 1204 (1999)

theory, institutional investor lead plaintiffs would carefully and skillfully monitor class counsel, because they would be motivated by their large loss to seek a substantial recovery, and because they are sophisticated enough to police the lawyers' conduct in the litigation.[98] Several years later, the Delaware Chancery Court—the traditional forum for transactional class actions[99]—adopted similar criteria favoring the selection of institutional investor lead plaintiffs.[100] Following these reforms, some institutional investors began participating as lead plaintiffs in both federal securities-fraud and Delaware transactional class actions. Mutual funds and hedge funds avoided taking an active role in these suits, rarely serving as lead plaintiffs, whereas public-pension and labor-union funds frequently obtained lead-plaintiff appointments.[101]

Mutual funds have $15 trillion assets under management; Fidelity, Vanguard, and TIAA-CREF are some of the largest institutional investors in the world, and undoubtedly have enough exposure to obtain lead-plaintiff appointments if they pursue them.[102] But they don't. First, such funds are concerned about the cost of freeriding competitors, who are also likely to be class

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("The core of [Weiss & Beckerman's] argument is that, unlike individual investors who often stand to recover only small amounts from securities fraud litigation, institutions are likely to have suffered large losses from fraud.").

98. 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, 2095 (1995) ("Institutions' large stakes give them an incentive to monitor, and institutions have or readily could develop the expertise necessary to assess whether plaintiffs' attorneys are acting as faithful champions for the plaintiff class.").

99. *See* John Armour et al., *Is Delaware Losing Its Cases?* 1 (Univ. Tex. Law, Law & Econ. Research Paper No. 174 2010), *available at* http://ssrn.com/abstract=1578404 (offering evidence that transactional class actions have been leaving Delaware). *But see* Adam B. Badawi, *Merger Class Actions in Delaware and the Symptoms of Multi-Jurisdictional Litigation*, 90 WASH. U. L. REV. 965, 967 (2013) (suggesting return of transactional class actions to Delaware).

100. Hirt v. U.S. Timberlands Serv. Co., No. CIV.A. 19575, 2002 WL1558342, at *2 (Del. Ch. July 3, 2002); TCW Tech. Ltd. P'ship v. Intermedia Commc'ns, Inc., No. 18336, 18289, 18293, 2000 WL 1654504, at *4 (Del. Ch. Oct. 17, 2000); Webber, *Private Policing*, *supra* note 95, at 910.

101. I have written extensively about why certain fund types avoid leadership roles in these suits while others embrace them. *See* Webber, *Private Policing*, *supra* note 95, at 935 (discussing an empirical study of institutional lead plaintiffs from 2003 to 2009 in Delaware). I summarize the discussion in this paper because understanding the litigation dynamics faced by institutional investors in a world with class actions is crucial to understanding how those dynamics would change if the class action world disappeared.

102. *Compare* INV. CO. INST., 2014 INVESTMENT COMPANY FACT BOOK (54th ed. 2014), *available at* http://www.ici.org/pdf/2014_factbook.pdf (reporting that there were $15 trillion invested in mutual funds worldwide in 2013), *with* U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2012, 753 tbl. 1217 (2012), *available at* http://www.census.gov/compendia/statab/2012/tables/12s1219.pdf (reporting that there were $2.928 trillion invested by state and local public-pension funds in 2010).

members.[103] To the extent that serving as lead plaintiff incurs costs, even reimbursable costs, mutual funds might prefer to remain as passive class members for fear of incurring costs for themselves while conferring benefits on those competitors.[104] Because the PSLRA bars bonus payments for lead plaintiffs, limiting lead-plaintiff recoveries to the lead plaintiff's pro rata share of losses, funds concerned about freeriding competitors may rationally decline to pursue lead-plaintiff appointments, even if their own recoveries would improve by assuming a leadership role in the suit.[105]

There are several other reasons why mutual funds avoid the lead-plaintiff role:

> First, a substantial component of the mutual fund business consists of investing the 401(k) retirement savings of public company employees. These funds will not want to jeopardize this business by suing their customers, the corporate boards, and corporate managers that select which mutual fund options to offer their employees. Second, mutual funds may also avoid litigation for "social network" reasons. Unlike the firefighters, police officers, and teachers who sit on the boards of trustees of public-pension funds, mutual fund managers are more likely to travel in the same business, social, and educational circles as do corporate managers and directors. Such social-network effects may reduce their participation in aggressive activism "within the circle." Because mutual funds diversify their investments, the kind of activism that would be logical for them to pursue bears a closer resemblance to that undertaken by public-pension funds, which is based in part on a strategy of pursuing change at a broad swath of companies, and thereby potentially alienating many people within the social network. In addition, as relayed to me by a director of corporate governance and associate general counsel at a top mutual fund, such funds avoid leading activist campaigns because their financial analysts prize, and guard, their access to senior corporate managers. Such analysts prefer that their employers avoid actions that might alienate corporate managers who might then refuse to respond to their inquiries. This is not to say that mutual funds engage in no activism. But they usually allow public-pension funds and labor-union funds to take

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103. *See* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 461–62 (1991) (discussing the free rider problem and its benefits).

104. *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1052–54 (2007) (concluding that shareholder activism only benefits a mutual fund "to the extent that the fund has a higher stake in the portfolio company (relative to the fund size) than competing funds do and the costs of activism are less than the profits from that differential").

105. 15 U.S.C. § 77z-1(a)(4) (2012) ("The share of any final judgment or of any settlement that is awarded to a representative party serving on behalf of a class shall be equal, on a per share basis, to the portion of the final judgment or settlement awarded to all other members of the class.").

> the lead, to become the public face of activist initiatives, following the lead of these funds by occasionally voting in favor of their activist initiatives. Finally, different mutual fund managers within the same mutual fund family may hold different stakes in the target and bidder companies, and may have adverse interests in the outcome of the suit. Engaging in litigation or activism may raise conflicts within the mutual fund family. Thus, free-riding competitors, business conflicts, social-network conflicts, and conflicts within mutual fund families all deter mutual funds from obtaining lead plaintiff appointments.[106]

Similar conflicts exist for other large private, diversified investors—like banks, insurance companies, and endowments—which rarely assume lead-plaintiff appointments.[107]

Hedge funds also avoid the lead-plaintiff role due to freeriding concerns. In addition, hedge funds tend to be secretive about their trading strategies and, thus, may be reluctant to subject themselves to the type of discovery that lead plaintiffs typically endure.[108] As I discuss further below, the existence of class actions allows such funds to remain passive in the face of known positive-value claims, because the claims will be resolved in a class action, for which the funds can collect their pro rata share of losses.[109] Elimination of the class action may place such funds in more of a legal quandary than they currently face with regard to litigation.

In contrast to mutual funds and hedge funds, the free-rider problem is of less concern to public-pension funds and labor-union funds. This is because these funds lack true competitors.[110] I proposed in *Private Policing* that these funds lack true competitors:

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106. Webber, *Private Policing*, *supra* note 95, at 941–43.

107. *See* James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 415 (2005) ("[P]rivate and public-pension funds, [such as] life and casualty insurance companies, mutual funds, bank trust departments, and various endowments . . . share a common bond: wise stewardship of the portfolio managed by each financial institution redounds to the benefit of another, be that person a pensioner, policyholder, stockholder, beneficiary, or even a faculty member. For this reason, the managers of each type of financial institution are subject to variously expressed fiduciary obligations that compel their prudent stewardship of their portfolio.").

108. *See, e.g.*, *Hedge Fund Trading Styles Overview*, MACROPTION, http://www.macroption.com/hedge-fund-trading-styles-overview/ (last visited Oct. 14, 2014) ("Due to tough competition, a viable [hedge fund] trading strategy requires a lot of details and nuances . . . . Hedge fund managers often keep their trading strategies secret to preserve their competitive advantage and the strategy's profitability.").

109. *See infra* notes 120–121 and accompanying text.

110. *See* Kahan & Rock, *supra* note 104, at 1065–66 (discussing the strategic and financial reasons that contribute to a hedge funds ability to "not worry much about competitor funds free riding on their governance activism and getting higher returns with lower costs").

> Individuals employed by a state or local government entity, or in certain capacities by a private company, have their retirement savings automatically invested in the public-pension fund or labor-union fund associated with their employer. If a fund beneficiary is unhappy with the fund's performance, the beneficiary's only option is to change jobs, not move one's retirement savings to a competitor. Thus, while public-pension funds and labor-union funds still face the free rider problem when serving as lead plaintiffs, or engaging in any activism, they incur fewer costs from such free riding than do mutual funds.[111]

These funds are able to incur lower costs because they do not experience "outflows" (or "inflows") on a quarterly or yearly basis in response to fund performance.[112] Such funds are also not dependent on revenues from class action defendants (such as the fees mutual funds earn for managing defendant 401k plans). Public-pension funds are funded by government employers and employees,[113] while labor-union funds are funded by private employers and workers, and face fewer economic constraints on suing companies other than their own employers.[114] Thus, public-pension funds and labor-union funds lack the major disincentives to participate in these suits that prevent mutual- and hedge-fund participation. Their substantial involvement as lead plaintiffs may also be explained by their prior success in bringing such suits. Public-pension lead plaintiffs have been found to correlate with higher recoveries and lower attorneys' fees in both securities-fraud and transactional class actions.[115] Many of these funds have also signed up for portfolio monitoring by plaintiffs' law firms.[116] Outside law firms directly monitor the portfolios of such funds for exposure to securities fraud or transactional claims, placing the funds on notice that they may be eligible to serve as lead plaintiffs in such actions.[117]

Two benefits of the class action device described above are that: it lets these institutions recover for claims that would otherwise be negative-value and it

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111. David H. Webber, *The Plight of the Individual Investor in Securities Class Actions*, 106 NW. U. L. REV. 157, 206 (2012) [hereinafter Webber, *Plight*].

112. *See* Kahan & Rock, *supra* note 104, at 1052–53.

113. Jonathan Barry Forman, *Funding Public Pension Plans*, 42 J. MARSHALL L. REV. 837, 837 (2010) ("State and local government employers typically fund . . . pension plans through a combination of employer and employee contributions . . . .").

114. David H. Webber, *Is "Pay-to-Play" Driving Public-Pension Fund Class Activism in Securities Class Actions?*, 90 B.U. L. REV. 2031, 2071–72 (2010) [hereinafter Webber, *Pay-to-Play*] (describing the role unions play in securities actions).

115. C.S. Agnes Cheng, et al., *Institutional Monitoring Through Shareholder Litigation*, 95 J. FIN. ECON. 356, 356–62 (2010) (using a database from 1996 to 2005 and controlling for case determinants of having an institutional lead plaintiff, found that institutional investors, including public-pension funds, decrease the probability of a case being dismissed, increase monetary recoveries, and improve the independence of boards at defendant companies); Perino, *supra* note 95; Webber, *Private Policing*, *supra* note 95, at 924–25.

116. Webber, *Plight*, *supra* note 111, at 167.

117. *Id.* (describing the benefits of having plaintiffs' firms monitor portfolios).

lets them choose to remain passive about positive-value claims. There are more than 4,000 public-pension funds in the United States.[118] Obviously, the vast majority are not going to lead class actions, even if they wanted to. In a prior study, I found that 79 public-pension funds had obtained a lead-plaintiff appointment between 2003 and 2006, and that 20 of the 53 largest funds by asset size had obtained at least one lead-plaintiff appointment.[119] Thus, the vast majority of public-pension funds—and even a simple majority of the very largest public pensions (with $10 billion or more in assets) that are most likely to have positive-value claims—remain passive in class actions.

Passivity has its benefits. It reduces the cost of monitoring and litigating a claim. Funds can remain passive because when they are exposed to a purported fraud or a rigged transaction, it is nearly certain that a class action will be filed.[120] Therefore, there is almost nothing that a fund must do with regard to its claim other than file a claim form to recover in the class action.[121] As a theoretical matter, it is true that fiduciaries should review the size of their claim and consider opting out, rather than remaining class members.[122] But as a practical matter, the

118. *Survey of Public Pensions: State- and Locally-Administered Defined Benefit Data*, U.S. CENSUS BUREAU, https://www.census.gov/govs/retire/ (last visited Oct. 14, 2014) ("There were 227 state-administered and 3,771 locally-administered defined public pension systems . . . .").

119. Webber, *Pay to Play*, *supra* note 114.

120. It is true, as a theoretical matter, that a fund could have a positive-value claim for securities fraud or a *Revlon* violation in which no class action has been filed. But most of the evidence points to an excess rather than a dearth of class actions, at least in deal cases. *See* Matthew D. Cain & Steven Davidoff Solomon, *A Great Game: The Dynamics of State Competition and Litigation*, 99 IOWA L. REV. (forthcoming 2015), *available at* http://ssrn.com/abstract=1984758. I have found no examples of pension trustees being sued for failing to bring a positive-value claim for securities fraud or *Revlon*, though that could change if the class action disappears, as I argue in Part II.A.

121. Of course, the institution must still follow through and actually file the claim to recover its pro rata share of the settlement. In two surprising and revealing studies, Cox and Thomas demonstrated that a large percentage of institutional investors failed to file claims for their pro rata shares of securities class action settlements. *See* Cox & Thomas, *supra* note 107. Cox and Thomas argued that such a failure to file claims constituted a breach of the duty of care. 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 (2002). In so doing, they surveyed a broad array of institutional investor types—ranging from public-pension funds, labor-union funds, and mutual funds, to insurance companies, banks, and others—to argue the potential consequences to them of failing to file a claim, or failing to seek a lead plaintiff appointment. They based their argument, in part, on Chancellor Allen's opinion in *In re Caremark International Inc. Derivative Litigation*, stating that directors have "a good faith [duty] to be informed and to exercise appropriate judgment . . . ." *In re* Caremark Int'l, Inc. Derivative Litig., 698 A.2d. 959, 968 (Del. Ch. 1996).

122. *Securities Litigation Settlement Costs if Large Shareholders Opt Out*, CRA INSIGHTS: FIN. MARKETS (June 2013), http://www.crai.com/sites/default/files/publications/Securities-litigation-settlement-costs-if-large-shareholders-opt-out.pdf ("[O]pting out of a class may considerably increase the recovery in certain securities litigation. However, opting out . . . involves bearing the costs

risk of a fiduciary being held liable for failing to opt out is close to zero.[123] That is because the institutions' passive participation is ratified by judicial approval of both class certification and class settlement. Such approval offers almost complete immunity to fund boards for any claim that the board failed to identify or to litigate a positive-value claim; claims which could be made by fund participants and beneficiaries, fund investors, government entities like the U.S. Department of Labor for funds governed by ERISA, or state attorneys general. As long as the fund filed its claim form, the potential defendants in such an action can claim that the recovery it obtained was certified as fair by a judge. There would seem to be no better defense to a breach of fiduciary duty claim than the argument that a judge certified that the collected settlement was fair. The only cases in which fund boards have been sued for failing to opt out of a class action are those involving unique and exceptional circumstances.[124]

Elimination of the class action removes this legal insulation for fund boards, exposing them more directly to liability for failure to identify, or litigate, positive-value claims. In the next Part, I discuss the requirement that fiduciaries monitor their portfolios for potential claims, their duty to act on positive-value claims, and how each of these duties will become more expensive and time consuming in the absence of a class action regime. Of course, active, individualized pursuit of such claims could also result in better recoveries to the fund—a point I consider further below.[125] The point here is that, if the class action disappears, many institutional investors that passively participate in class actions by collecting their pro rata share of settlements—like mutual funds, banks, and insurance companies—may be forced to vindicate their fiduciary duties by monitoring their portfolios for positive-value claims and potentially acting on those claims. While such entities may not wish to devote resources to these endeavors, it's not clear that this development would be wholly unwelcome. Litigation by sophisticated players like these could not only improve their own recoveries in class actions, but could have positive externalities (like deterrence) for other investors, including individual investors. But before turning to what institutions will do in the absence of a class action, and consequently what litigation will survive, I discuss briefly what litigation will disappear without the class action device.

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of filing and pursuing litigation, the publicizing of potentially embarrassing internal analysis and communications, and the risk that the claims may be dismissed due to specific individual issues.").

123. Harris v. Koenig, 602 F. Supp. 2d 39, 48 (D.D.C. 2009) (denying in part motion to dismiss ERISA breach of fiduciary duty claims against pension fiduciaries and sponsor for, *inter alia*, "failing to conduct an adequate review and evaluation of the fairness of the [securities class action] settlement . . . in light of The Plan's unique ERISA claims").

124. *See infra* text accompanying note 163.

125. *See supra* note 122.

II. HOW LOSS OF THE CLASS ACTION WILL RESHAPE SECURITIES LITIGATION

A. What Disappears

It is possible that virtually all private-shareholder litigation will disappear without the class action. Even claimants with large losses that would more than justify the ordinary litigation costs might balk at the contingent liability of paying defendants' legal bills in the presence of a plaintiff-pays provision. The unpredictability of arbitration awards could similarly lead potential plaintiffs with sizeable claims to demur litigation. These points are debatable, and I address them more fully in the next Part, where I explore the options for institutional investors with large losses in a post-class-action world. In this Section, I focus on what will most certainly be eliminated from shareholder litigation without the class action, including the pursuit of corporate governance reform, most M&A litigation in its current form, and most of the positive externalities of litigation, which, in many respects, outweigh the positive externalities of arbitration.

If courts were to uphold mandatory-arbitration provisions in corporate bylaws, particularly bylaws that would require bilateral arbitration and bar consolidation of claims, this would eliminate the shareholder class action for any company that adopted them.[126] This would bar redress for most investors with negative-value claims against the company. Because these cases are expensive to litigate or arbitrate, most claims by individual investors would become economically unviable, as would most claims by institutional investors that have low stakes in particular companies. It is true that some negative-value claims might still be brought. The literature on negative-value claims suggests that they still have settlement value because it might be cheaper for defendants to settle rather than litigate a case that they are certain to win.[127] Also, informational asymmetries may make the plaintiffs' threat to take the case to trial credible, particularly when they have private information about damages.[128] Still, the economic models that explore the bringing of negative-value suits envision problems like the defendants' lack of information about the plaintiffs' damages. In securities-fraud suits, the damages are transparent. The defendants know exactly what the claimed losses can be, because the stock price drop is public. The only information they lack is how many shares the plaintiffs own. To prevent defendants from settling securities-fraud cases due to discovery costs, Congress

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126. *See supra* text accompanying notes 22–36.

127. *See* Randy J. Kozel & David Rosenberg, *Solving the Nuisance-Value Settlement Problem: Mandatory Summary Judgment*, 90 VA. L. REV. 1849, 1856 (2004) ("A profit maximizing defendant rationally would settle for any amount up to the cost of defeating the plaintiff's claim."); David Rosenberg & Steven Shavell, *A Model In Which Suits Are Brought for Their Nuisance Value*, 5 INT'L REV. L. & ECON. 3 (1985).

128. Lucian Arye Bebchuck, *Suing Solely To Extract A Settlement Offer*, 17 J. LEGAL STUD. 437, 440 (1986).

banned discovery prior to the motion to dismiss in the PSLRA.[129] Moreover, these lawsuits are dominated by repeat players, experts who often litigate nothing other than securities-fraud and merger class actions. The lawyers can easily size up the comparative strength of their opponents' position. Plaintiffs with negative-value claims are more poorly positioned to extract settlements in the shareholder litigation context than they might be in the generic litigation context because defense lawyers are so often sophisticated repeat players. It is also true that large institutional investors that can afford the legal fees might still bring negative-value claims if they believe it will help discipline managers, although free-rider problems could hamper such efforts. Most likely, negative-value claimants would be left with no recourse for fraud, and the overall damages claims in securities-fraud cases would drop substantially.[130] Loss of the class action would eliminate more than just negative-value claims. It would also substantially reduce, and possibly eliminate, actions and remedies that are only rationally pursued in the class action context, even by investors with positive-value claims.

For example, corporate governance reform has been pursued in the class action context, rarely as the primary objective of such litigation, but as an alternative to damages or other relief.[131] Governance reform is rooted in the idea that increasing managerial accountability to shareholders improves firm value and share price.[132] Declassifying boards, creating a shareholder director-nomination committee, and splitting the role of the CEO and the Chairman of the Board, are all examples of governance reforms that tend to be pursued in litigation.[133] To the extent that they improve the investment's value, investors that hold shares in the defendant company post-fraud might benefit from such reforms. In the class action context, the class's damages may be large enough to materially harm the company—thus, shareholders with an ongoing stake in the defendant corporation

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129. *See* 15 U.S.C.A. § 78u-4(b)(3)(B) (West 2014) ("In any private action arising under this chapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.").

130. As described more fully below in Part II.B, damages claims must be distinguished from damages awarded. There is some evidence that institutional investors who have opted out of class actions have obtained substantially higher recoveries as a percentage of their losses than are normally obtained in class actions, suggesting that damages awarded might not drop as far as damages claimed in a post-class-action world.

131. *See, e.g.*, *In re* Cendant Corp. Litig., 264 F.3d 201, 219 (3d Cir. 2001) (noting as a cause for objection that "the lead plaintiff negotiated as part of the settlement certain governance changes").

132. *See generally* Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009).

133. *See, e.g.*, *In re* United Health Grp. Inc. PSLRA Litig., 643 F. Supp. 2d 1094 (D. Minn. 2008); Press Release, CalPERS, *UnitedHealth Group Reach $895 Million Settlement in Class-Action Case – Includes Landmark Corporate Governance Reforms* (July 2, 2008), http://www.calpers-governance.org/marketinitiatives/initiatives/press-releases/unitedhealth-reach-settlement; *Cendant*, 264 F.3d at 246.

might prefer governance reform to the maximum immediate damages payment.[134] But that is no longer true when institutional investors separately arbitrate their fraud claims. No single investor's claim can threaten a large publically traded company the way a class action can. And even if the separate arbitration of many institutional investors add up to damages that could materially harm the defendant, each plaintiff faces a prisoner's dilemma, it will not reduce its own claim in the hope that others will do the same and thus it is rational for a plaintiff to seek the largest damage claim it can get. Each institution also faces the free-rider problem in seeking governance reform. If it arbitrates such reform, all investors would benefit, in contrast to a damages payment made directly and solely to the arbitrating plaintiff in compensation for its losses. Finally, even if an institution were to seek reform in arbitration, it is doubtful that a defendant would agree to it, because the plaintiff cannot speak for the whole class of shareholders and therefore cannot bind it to one set of reforms.[135] A defendant could theoretically face multiple, conflicting reform proposals from multiple arbitration plaintiffs.

Lawsuits seeking governance reforms are often depicted as frivolous, although one might draw a distinction between cases in which reform is the only remedy versus cases in which reform is a small part of the remedy. In the case of the former, while reforms might plausibly be value enhancing, there is justifiable concern that they might be largely cosmetic, designed to justify a legal fee rather than enhance value. In contrast, consider a case like the UnitedHealth Stock Options Backdating case (full disclosure: I worked on this case). There, the cases settled for $970 million and governance reforms like splitting the role of CEO and Chair and reforming the compensation committee to prevent the corporate breakdown that led to backdating in the first place. Perhaps I am biased because of my own work on this case, but it strikes me as plausible that the reforms secured in this case could have had a salutary effect on governance that would have helped the company avoid future accounting improprieties. Regardless, for the reasons just described, it is difficult to see how such reforms might be pursued in the arbitration context.[136]

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134. *Cendant*, 264 F.3d at 243 (arguing that "a lead plaintiff who retains a substantial investment in a defendant corporation . . . will naturally be conflicted between trying to get maximum recovery for the class and trying to protect its ongoing investment in the corporation").

135. *Cf.* Black & Gross, *supra* note 84, at 992 (noting that arbitration awards "do not serve as precedent—future arbitration panels cannot rely on previous awards as a source of authority").

136. One potential exception to the above description would be if institutions pursued, or if defendants consented to, consolidated arbitration cases. Consolidated arbitration is distinct from class arbitration. In class arbitration, as with the class action, self-selected lead plaintiffs represent others seeking similar recoveries. Park, *supra* note 49 at 847 ("In 'class' arbitration, self-selected claimants represent others entitled to similar or analogous recovery."). Consolidation involves independent but related actions that may involve representation by the same counsel, but with no entity representing any other. *Id.* In one recent case, *Blue Cross Blue Shield of Massachusetts v. BCS Insurance Co*., the U.S. Court of Appeals for the Seventh Circuit declined to hear an interlocutory appeal from a defendant seeking to deconsolidate an arbitration proceeding, reasoning that, under *Animal*

For similar reasons, disclosure-only settlements in mergers and acquisitions ("M&A") cases will likely die with the class action. In such actions, plaintiff shareholders obtain additional disclosure about the deal in the proxy statement.[137] Theoretically, such disclosures allow shareholders to make a better-informed decision about whether to vote in favor of the merger. In practice, such settlements have been widely derided as frivolous.[138] The additional disclosures are often economically insignificant.[139] A recent study found that 85% of all transactional class actions result in disclosure-only settlements, and that additional disclosures have no measurable impact on shareholder voting.[140] This undermines

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Feeds, it could not proceed in consolidated form without the defendant's consent. 671 F.3d 635, 636–38 (7th Cir. 2011). The court denied the appeal on procedural grounds, pointing to the movants' failure to raise the issue at the outset of the arbitration, prior to selection of the first arbitrator. *Id.* at 638. Professors Myriam Gilles and Anthony Sebok have pointed out that, "the rules governing the dominant arbitral bodies do not provide for consolidation of related cases before a single arbitrator, nor is there any intra-arbitration res judicata effect awarded to prior victories." Myriam Gilles & Anthony Sebok, *Crowd Classing Individual Arbitrations In A Post-Class Action Era*, 63 DEPAUL L. REV. 447, 449 (2012). Arbitrators could also decide to grant prior arbitration awards preclusive effect, but they are not required to do so. *Blue Cross Blue Shield*, 671 F.3d at 639 ("Not even BCS denies that a panel of arbitrators could resolve one plan's claim and then apply that decision to the others via doctrines of claim preclusion or issue preclusion."); *see also* Bhd. of Maint. of Way Emps. v. Burlington N. R.R., 24 F.3d 937 (7th Cir. 1994); Prod. & Maint. Emps. v. Roadmaster Corp., 916 F.2d 1161 (7th Cir. 1990). Consolidation is available under the rules of the London Court of International Arbitration or the International Chamber of Commerce, and may remain a viable option, as indicated in *Blue Cross Blue Shield*. *See* LCIA Rules, Art. 22; ICC Rules, Art. 10; *Blue Cross Blue Shield*, 671 F.3d at 640. Boards revising their corporate bylaws to require arbitration of claims against them or the company will likely draft those bylaws to bar the possibility of consolidation, thereby eliminating negative-value claims. Permitting consolidation would defeat the purpose of adopting the clause in the first place, because, in this context, the purpose of such clauses is not to shift shareholder litigation from courts to arbitrators, but to eliminate the claims altogether by undermining their economic viability. Yet it is possible that companies facing simultaneous arbitrations against large institutional investors might waive their right to oppose consolidation vis-à-vis those investors if it reduced their own costs to do so. Should this occur, some corporate governance reform in litigation/arbitration might be preserved, should the consolidated institutions choose to pursue it in this context.

137. *See generally* Phillip R. Sumpter, *Adjusting Attorney's Fee Awards: The Delaware Court of Chancery's Answer to Incentivizing Meritorious Disclosure-Only Statements*, 15 U. PA. J. BUS. L. 669, 676–81 (2013).

138. *Id.* at 689 (discussing the court's criticism of disclosure-only settlements).

139. *Id.* at 674 ("[T]he Court has noted that there is a disturbing trend where plaintiffs viciously attack a deal and then settle for only marginal disclosures . . . . Additional criticism targets the problem that deal litigation often nitpicks otherwise good disclosures.").

140. Steven Davidoff Solomon, et al., *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform*, TEX. L. REV. (forthcoming) (manuscript at 24), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2398023.

the argument that such disclosures are value enhancing.[141] Even if one takes the view that such disclosure-only settlements are value enhancing, it is difficult to discern how they would remain economically feasible without the class action device. Because of the evidence suggesting that such disclosure is likely useless, elimination of such suits is an argument in favor of mandatory-arbitration or fee-shifting provisions. For similar reasons, amendment lawsuits would also be eliminated in arbitration. In amendment suits, the defendants amend the terms of the merger agreement, presumably to make it easier for a second bidder to emerge.[142] The literature on such suits is more favorable than disclosure-only suits, although it is difficult to price their actual value, and hence difficult to assess the harm caused by their loss.[143] Moving beyond disclosure and amendment settlements, clearly meritorious M&A litigation that results in an increase in price for target shareholders might also face extinction in the face of mandatory-arbitration provisions. Part of the problem stems from loss of the class action, and part from the loss of access to courts. Most of the plaintiffs' leverage in deal litigation derives from the threat of obtaining a court-ordered injunction postponing the shareholder vote, without which the deal cannot close. Deals often cannot close without shareholder approval, and thus the threat of an injunction may make defendants improve the offer price or make concessions regarding the bidding process.[144] Denial of the injunction means the deal will most likely close without a remedy for shareholders, leaving only the *ex post* remedies of litigation. Arbitrators lack the power to issue injunctions (unless the parties grant them that power), thereby depriving plaintiff shareholders of their strongest leverage. Even if an arbitrator would be empowered to issue an injunction, it is not clear how a single institutional investor—acting alone, rather than in a representative capacity—would have standing to enjoin a shareholder vote, which is a class-wide remedy. Finally, even if a single institution could obtain such an injunction in the face of a loser-pays or plaintiff-pays provision, the free-rider problem persists: there is no incentive for a single institutional investor to incur all litigation costs in order to benefit all other investors, including its competitors. Instead, it will pursue a monetary claim on its own behalf alone, if at all. Such funds might shift into bringing appraisal claims.[145]

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141. Cain & Solomon, *supra* note 120 (manuscript at 16) (discussing "the principle that 'disclosure-only' settlements are not highly valued by the litigant participants or the courts"); *see also* Solomon et al., *supra* note 140 (manuscript at 4).

142. Solomon et al., *supra* note 140 (manuscript at 3).

143. *Id.*

144. Robert M. Daines & Olga Koumrian, *Shareholder Litigation Involving Mergers and Acquisitions, Review of 2012 M&A Litigation*, CORNERSTONE RESEARCH (February 2013), https://www.cornerstone.com/getattachment/9d8fd78f-7807-485a-a8fc-4ec4182dedd6/Shareholder-Litigation-Involving-Mergers-and-Acqui.aspx.

145. Shareholders who abstained or voted no in a merger agreement have the option of foregoing the merger consideration and filing an appraisal claim requesting a judicial proceeding to determine the fair value of their shares. *See* Charles Korsmo & Minor Myers, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 WASH. U. L. REV. (forthcoming 2015) (manuscript at 23), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2424935.

Beyond loss of the injunction, the dynamics of M&A litigation remain largely similar to those described for securities-fraud litigation above, with one potentially significant difference. In contrast to fraud litigation, deal litigation is about deprived gains, not incurred losses. To the extent that loss aversion[146] makes trustees, fund participants, and beneficiaries more sensitive to frauds than reduced premiums, marginally positive deal cases may be less likely to be brought than marginally positive fraud cases. This dynamic may already exist under the status quo. Otherwise, the institutional dynamics remain quite similar in both deal and fraud cases. As I found in a prior study, public-pension and labor-union funds are more likely attain lead-plaintiff appointments in deal cases,[147] and in a post-class-action world would likely continue to be the most active participants—be it pursuit of breach of fiduciary duty or perhaps appraisal claims in the arbitration context. The latter would not be unprecedented; witness T. Rowe Price's recent pursuit of appraisal in the management buyout of Dell.[148] Recent evidence suggests that mutual funds have increasingly brought appraisal actions.[149] Hedge funds have also become active appraisal litigants, prompting questions about the rise of "appraisal arbitration" as a viable trading strategy.[150] Appraisal is a narrow remedy, potentially offering a higher price to shareholders who believe they were paid too little for their shares, but depriving them of the potential to stop a deal, or to improve the informational environment for shareholders.[151]

Thus, mandatory arbitration eliminates negative-value claims, and even certain substantive claims and remedies by positive-value claimants. Apart from eliminating types of claims, it is important to note what else disappears with loss of the class action. To the extent that arbitration provisions keep these actions out of court, or that plaintiff-pays provisions keep these actions from being heard in any forum, many of the positive externalities of litigation disappear or are substantially limited. First and foremost is the production of a relevant, current, and vibrant body of corporate case law, described by one commentator as the "decree effect."[152] As has so often been observed, the ongoing publication of legal

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146. Loss aversion is the principle that people prefer avoiding loss to acquiring gains. Eyal Zamir, *Loss Aversion and the Law*, 65 VAND. L. REV. 829, 838 (2012).

147. Webber, *Pay to Play*, *supra* note 114, at 2033 ("In recent years, [public pension] funds, or their sister union funds, have obtained as much as forty percent of lead-plaintiff appointments in securities class actions.").

148. Steven Davidoff Solomon, *A New Form of Shareholder Activism Gains Momentum*, N.Y. TIMES Mar. 5, 2014, at B5 (noting that "about 2.7 percent of shareholders exercised appraisal rights [against Dell], including T. Rowe Price").

149. *See* Korsmo & Myers, *supra* note 145.

150. *Id.*

151. *Id.*

152. *See, e.g.*, William B. Rubenstein, *Why Enable Litigation? A Positive Externalities Theory of the Small Claims Class Action*, 74 UMKC L. REV. 709, 723–24 (2006) (describing this as the "decree effect": "The legal principle developed in the case will create more certainty in structuring social behavior and lower the need for future adjudication concerning the decided issue. If future litigation does arise, the decree from the initial case will serve as stare decisis, hence making resolution of later cases more efficient. Beyond these general legal effects, the decree in the initial case could also be used to

opinions offers guidance to lawyers, businesses, and transaction planners of all types on how to structure their conduct or their clients' conduct.[153] The skill of the Delaware judiciary in interpreting and developing a body of corporate law has been cited as a key factor in the reason why half of U.S. public companies incorporate there, and why many states cite Delaware law as authoritative in construing their own corporate-law codes. Arbitration is private as are opinions issued by arbitrators, thereby eliminating the decree effect of litigation. And while it is true that most civil actions settle, undermining the decree effect of litigation, settled lawsuits still produce meaningful opinions on motions to dismiss or summary judgment motions, for example. Actually arbitrated cases would still have settlement effects, albeit ones that disproportionately favor large institutional investors with positive-value claims over smaller investors with negative-value claims, as discussed in Part V.[154] And settlement effects obviously disappear to the extent that arbitration or plaintiff-pays provisions render previously economically viable actions unviable. Litigation also has "threat effects" to the extent that the mere threat of suit, and its attendant costs, affects actors.[155] And finally litigation has institutional effects, in that it leads to the creation of a plaintiffs bar whose existence would be threatened by loss of the class action. I discuss this final point in detail in Part IV, where, I also discuss what would remain of shareholder litigation (or arbitration) if the class action disappeared.

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preclude re-litigation of factual issues in future cases among the same or similarly situated litigants. And most immediately, the decree may actually require a party to cease a practice affecting a group of individuals, even though the initial case was prosecuted by only one of them. An individual lawsuit that produces a judicial decision thereby has generated significant social benefits in terms of shaping conduct, reducing litigation costs, and preserving judicial resources.").

153. *See, e.g.*, *id.* at 723 ("[Litigation] establishes rules of conduct designed to shape future conduct, not only the present disputants' but also other people's.").

154. *See, e.g.*, Rubenstein, *supra* note 152, at 724 (defining "settlement effects": "[I]f one litigant successfully challenges a policy that affects many persons, a defendant may agree to change its behavior as to the entire class. Even if a defendant does not agree as a formal matter to change its general policy as a consequence of the initial case, it may nonetheless do so informally lest it be faced with repeated lawsuits . . . The converse is true as well: shared information about a weak settlement may deter future litigants. Similarly, settlements by some defendants within an industry could encourage other defendant/competitors to settle. The information externalities of settlements are well known and account for much of the attempt to both publicize and keep confidential such information . . . ." (citing Blanca Fromm, Comment, *Bringing Settlement out of the Shadows: Information About Settlement in an Age of Confidentiality*, 48 UCLA L. Rev. 663 (2001))).

155. *Id.* ("The risk of litigation is a cost that parties must factor into decision-making in any sphere." (citing GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS (1970))).

B. How the Fiduciary Duty of Prudence Leads to a Duty to Investigate and Bring a Positive-Value Claim Under Trust Law and ERISA

Under trust law generally, and under ERISA in particular, trustees owe beneficiaries the duties of loyalty and prudence.[156] The duty of prudence requires that:

> [A] fiduciary shall discharge his duties with respect to a plan . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.[157]

The duty of loyalty requires that "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries."[158] Courts have found that when "supervising pension assets, plan trustees have fiduciary obligations described as 'the highest known to the law.'"[159] Review of fiduciary decisions under ERISA has become more stringent in recent years. Up until 1989, ERISA fiduciaries' actions were reviewed under the highly deferential "arbitrary or capricious" standard where there was no conflict of interest.[160] In *Firestone Tire & Rubber Co. v. Bruch*,[161] the Supreme Court rejected this deferential standard, stating that it was not supported by the text of ERISA.[162] "In evaluating fiduciaries' administration of ERISA plans, courts have typically applied the stricter, statutory standard of care, limiting the applicability of the more lenient, arbitrary and capricious standard only to cases where the legality of the trustees' benefit determination was at issue."[163] In the remainder of Part II, I outline how these duties, particularly the duty of care, have led courts to find that fund trustees have a duty to investigate and litigate positive-value claims on behalf of fund participants and beneficiaries.

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156. George Gleason Bogert et al., *The Law of Trusts and Trustees, in* BOGERT'S TRUSTS AND TRUSTEES § 543 (2014) ("Perhaps the most fundamental duty of a trustee is that he must display throughout the administration of the trust complete loyalty to the interests of the beneficiary and must exclude all selfish interest and all consideration of the interest of third persons.").

157. 29 U.S.C. § 1104(a)(1)(B) (2012).

158. 29 U.S.C. § 1104(a)(1)(A) (2012).

159. Flanigan v. Gen. Elec. Co., 242 F.3d 78, 86 (2d Cir. 2001) (quoting Donovan v. Bierwirth, 680 F.2d 263, 272 n.8 (2d Cir. 1982)).

160. Moore v. Reynolds Metals Co. Ret. Program for Salaried Emps., 740 F.2d 454, 457 (6th Cir. 1984) ("[A court's review of trustees' decisions] is limited to a determination of whether the trustees' actions in administering or interpreting a plan's provisions are arbitrary and capricious.").

161. 489 U.S. 101 (1989).

162. *Id.* at 113–14 ("Adopting [a deferential arbitrary and capricious standard] would require us to impose a standard of review that would afford less protection to employees and their beneficiaries than they enjoyed before ERISA was enacted.").

163. Ches v. Archer, 827 F. Supp. 159, 165 (W.D.N.Y. 1993).

1. The Duty to Investigate Potentially Positive-Value Claims

For fund beneficiaries to succeed on a duty to investigate claim, showing the trustee's inaction with respect to a potential claim is sufficient. For example, in *Donovan v. Brians*,[164] a trustee failed to take any action to recover a delinquent loan. The court evaluated the trustee's behavior according to a "reasonable efforts" standard in investigating the claim.[165] In finding that the trustee failed to meet the "reasonable efforts" standard, the court shifted the burden to the defendant to show that the trust would *not* have recovered the loss to the trust even if it exerted "reasonable efforts."[166] Other courts have made similar findings. In *Ches v. Archer*,[167] the court denied defendants' motion for summary judgment because "[t]he officers' apparent failure to investigate available options for recovering delinquent contributions to the plan . . . would, if proven, have shown a breach of fiduciary duties."[168] The court stated that failure to investigate the possibility of a lawsuit and/or other actions would represent a breach of fiduciary duty.[169] Similarly, the U.S. Court of Appeals for the Third Circuit stated that "trustees have a duty to investigate the relevant facts, to explore alternative courses of action and, if in the best interests of the plan participants, to bring suit against the employer."[170] Thus, the duty to investigate potentially positive-value claims is clearly established. Note that once plaintiffs establish this failure to investigate, the burden shifts to the defendant to show that the trustee would not have been successful in the suit.[171] Barring such a showing, the trustee who fails to investigate will be found liable for breaching its duty of care.

Trustees have successfully defended against failure to sue claims by: (1) establishing a paper trail documenting their deliberations over whether to bring the claim; (2) concluding that the claim would not be in the best interests of the trust for a variety of reasons—including that the lawsuit would disrupt the functioning of the trust, create bad publicity, or discourage qualified trustees from seeking the position; and (3) explaining that the decision not to bring suit was based in part on anticipated legal fees and the uncertainty of victory.[172] In short, trustees are

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164. 566 F. Supp. 1258 (E.D. Pa. 1983).

165. *Id.* at 1262.

166. *Id.* at 1265 ("Once failure to make reasonable efforts to recover the loan has been established, the burden of persuasion is on the defendants to show the loss to the plan would have occurred even if they had.").

167. 827 F. Supp. 159.

168. *Id.*

169. *Id.* at 167.

170. McMahon v. McDowell,794 F.2d 100, 112 (3d Cir. 1986).

171. *See Ches*, 827 F. Supp. at 165.

172. *See, e.g.*, Pillsbury v. Karmgard, 22 Cal. App. 4th 743 (Cal. Ct. App. 1994); Axelrod v. Giambalvo, 472 N.E.2d 840, 843 (Ill. App. Ct. 1984) (ruling in favor of the defendants where defendants' affidavits stated in part that the lawsuit would be a "disruption to the Trust's orderly procedure," be bad for publicity, and "the benefits which might be achieved for the Trust could not possibly compensate for the time and expense of litigation").

justified in declining to sue if they have reason to believe that the claim is negative value.

Under the duty to investigate, fiduciaries must institute procedures to detect potentially positive-value claims. The ostrich approach will not work: a trustee cannot avoid litigating a positive-value claim by blinding herself to its existence. Such procedures themselves incur costs, and while these should not be overstated, they would likely increase in a post-class-action world. Under the current legal regime, institutions should monitor their own portfolios for their exposure to class action claims.[173] The duty actually requires fund fiduciaries to monitor their portfolios for potential claims, not simply to monitor their portfolios for existing class action claims that have already been filed. But there is little evidence suggesting that a fund would have a securities-fraud or transactional claim against a public company for which no class action has been filed.[174] Today, custodial banks and class action monitoring services conduct most ongoing monitoring for fiduciaries. These institutions do not independently assess claims available to the portfolio and, instead, they track claims in existing class actions.[175] Nonlawyer portfolio monitors, or custodial banks that provide such services for institutional clients, monitor filed class actions (both domestically and, increasingly, internationally) and determine whether their clients are class members. If so, they also determine how much their clients ought to claim from the settlement.[176]

Under the current legal regime, should the institution identify a claim, the decision to file a claim form in a settled class action is obvious.[177] It requires a

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173. Cox & Thomas, *supra* note 107, at 445 ("All institutions should seriously reevaluate their systems, and . . . most institutions should consider adopting more aggressive monitoring systems.").

174. *See generally* Cain & Solomon, *supra* note 120.

175. Securities class action recovery firms such as Financial Recovery Technologies, Battea, and ISS' Securities Class Action Services do not independently analyze securities for potential class actions. Instead, they maintain databases of both active and settled class actions against which they match an institutional investor's trading history to identify potential claims. *See, e.g.*, FIN. RECOVERY TECH., *What We Do*, http://frtservices.com/what-we-do/ (last visited Mar. 13, 2014); *see also* ISS SECURITIES CLASS ACTION SERVICES, http://www.issgovernance.com/governance-solutions/securities-class-action-services/ (last visited Oct. 11, 2014); *see also* BATTEA, *What We Do*, http://www.battea.com/what-we-do/wwd-class-action-data-processing.html (last visited Mar. 13, 2014). This portfolio analysis then enables the firms to submit claims on behalf of the institutional investor in the existing active and settled class actions. *Id.* The situation is different for funds whose portfolios are monitored by plaintiffs' lawyers, in which case the lawyers search portfolios for 10b-5 losses or exposure to transactional claims to find eligible lead plaintiff applicants. As I will argue below, one possible consequence of declining class actions would be increased portfolio monitoring of this type, seeking out positive-value claims, not lead-plaintiff applicants.

176. FIN. RECOVERY TECH., *supra* note 175.

177. *See* Cox & Thomas, *supra* note 107 at 424–25 (stating that there are substantial returns for submitting claims in settled securities class actions, providing significant returns at little cost).

relatively quick calculation to determine the size of the claim, followed by the cost of a postage stamp to mail in the claim form. The costs of attorneys' fees are baked into the claim.[178] Because the class action has been filed, the institution knows exactly where to look to identify the size of its exposure. It requires comparatively little independent legal or financial analysis.[179] And, as noted earlier, there is little (but not zero) reason to fear judicial second-guessing of the decision to file a claim in the settled class action instead of opting out and bringing a separate action, though one might question whether this should be the case, given the prospects for greater recoveries in an opt-out action and the size of some of the losses for which institutions only file claim forms. Still, current practices largely insulate these decisions unless the firm would be settling other unique claims it has against the defendant by accepting its pro rata share of the settlement.[180]

In the absence of a class action, the decision-making landscape shifts considerably. The first question becomes how an institution (or a third-party portfolio monitor) should search for potential claims in its portfolio (or how, given that it does not have filed class actions to tell it where to look). In fraud cases, the fund might examine large losses it incurred in a particular stock. Echoing the stock-drop cases of the pre- (and some would say post-) PSLRA era, substantial losses in any holding should automatically trigger an examination of whether the losses could have been caused by fraud.[181] Smaller losses are less likely to yield positive-value claims. That said, large institutional investors with scores of outside managers might not automatically be aware that they have such losses. Press reports, governmental investigations, and information about litigations or arbitrations initiated by other funds should trigger the funds to examine their own portfolios for exposure to potentially meritorious claims. Even so, looking for stock drops alone is insufficient because plaintiffs can recover for gains they were deprived of by fraud.[182] In the transactional context, funds should automatically examine their exposure to transactions over a particular dollar threshold, ones in which the fund held a substantial stake. For example, California State Teachers'

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178. *See* Russell Kamerman, *Securities Class Action Abuse: Protecting Small Plaintiffs' Big Money*, 29 CARDOZO L. REV. 853, 889 n.65 (2007) ("Generally, however, attorney fees in class actions are usually between 20–30% of the amount recovered, but it is not uncommon for the fee to reach 50%.").

179. While it is theoretically the case that an institution could have a positive-value claim in which no class action has been filed, failure to detect and bring such an action could be all the monitoring that is required under the current legal regime—including class actions—in the monitoring of filed class actions.

180. Harris v. Koenig, 602 F. Supp. 2d 39 (D.D.C. 2009).

181. *See, e.g.*, Reed v. Prudential Sec. Inc., 875 F. Supp. 1285, 1289 (S.D. Tex. 1995), *aff'd*, 87 F.3d 1311 (5th Cir. 1996) ("[C]ourts throughout the United States have held that a sharp drop in the price of stock triggers an investor's duty to make diligent inquiry to discover the existence of possible fraud.").

182. *See In re* Cigna Corp. Sec. Litig., 459 F. Supp. 2d 338, 349 (E.D. Pa. 2006) ("In a fraud on the market case, a plaintiff must show that, as a result of alleged misrepresentations and in reliance on an honest market, the plaintiff purchased shares which, when the alleged fraud was revealed, were worth less than the plaintiff had paid for those same shares.") (citing Basic Inc. v. Levinson, 485 U.S. 224, 241–42 (1988)).

Retirement System maintains a policy of seeking lead-plaintiff appointments in cases in which its stake is greater than $5 million, although it is the second-largest fund in the country and would therefore be expected to maintain a high absolute threshold for litigation.[183] Similarly, press reports or other publicly available information about actions brought by other institutional plaintiffs in the transactional context—including arbitrations or appraisal claims—should trigger an examination of the fund's position in the target's stock. It may well be the case that, without a class action, institutional investors will have to deploy claims-monitoring systems to monitor their portfolios, similar to the practice used by plaintiffs' lawyers that are seeking out claims. In that case, lawyers themselves may need to be involved in the monitoring.

2. The Duty to Bring a Positive-Value Claim

Generally, under trust law, a trustee's failure to pursue a "valuable" legal claim is a breach of fiduciary duty.[184] The Restatement (Third) of Trusts states: "A beneficiary may maintain a proceeding related to the trust or its property against a third party only if . . . the trustee is unable, unavailable, unsuitable, or *improperly failing to protect the beneficiary's interest*."[185] The beneficiaries have standing to sue fund trustees and the third party that committed the tort.[186] Case law supports the assertions made in the Restatement and treatises.[187] For example, the Court of Appeals of Utah held that beneficiaries may "bring an action against a third party when the beneficiary's interests are hostile to those of the trustee," and noted that many other jurisdictions also allow for beneficiary standing—consistent with the Restatements.[188] Likewise, ERISA fiduciaries generally have a fiduciary duty to pursue valuable claims of the plan.[189]

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183. Webber, *Pay-to-Play supra* note 114, at 2040.

184. Tittle v. Enron Corp. (*In re* Enron Corp. Sec., Derivative & ERISA Litig.), 284 F. Supp. 2d 511, 555 n.60 (S.D. Tex. 2003) ("In *Harris Trust* . . . the Supreme Court turned to the Restatement (Second) of Trusts as its source for the common law of trusts.").

185. RESTATEMENT (THIRD) OF TRUSTS § 107 (2012) (emphasis added).

186. N.J. Carpenters Health Fund v. Philip Morris, Inc., 17 F. Supp. 2d 324, 338 (D.N.J. 1998) (stating that fiduciaries of trust funds are obliged to sue perpetrators of fraud directed at the fund).

187. *See, e.g.*, Wolf v. Mitchell, Silberberg & Knupp, 76 Cal. App. 4th 1030, 1037 (1999) ("California has adopted the rule of the Restatement (Second) of Trusts, section 282, subdivision (2), which states that '[i]f the trustee improperly refuses or neglects to bring an action against the third person, the beneficiary can maintain a suit in equity against the trustee and the third person.'") (citing RESTATEMENT (SECOND) OF TRUSTS § 282 (1959)).

188. Anderson v. Dean Witter Reynolds, Inc., 841 P.2d 742, 745 (Utah Ct. App. 1992) (citing Alioto v. United States, 593 F.Supp. 1402, 1412 (N.D. Cal. 1984); Booth v. Sec. Mut. Life Ins. Co., 155 F.Supp. 755, 761 (D.N.J. 1957); Hoyle v. Dickinson, 155 Ariz. 277, 279, 746 P.2d 18, 20 (Ariz. Ct. App. 1987); Apollinari v. Johnson, 104 Mich. Ct. App. 673, 305 N.W.2d 565, 567 (1981)).

189. *See* Donovan v. Bryans, 566 F. Supp. 1258, 1262 (E.D. Pa. 1983) (holding that among the general "prudent man" standards, the fiduciary has a "duty to take reasonable steps to realize on claims held in trust"); Freund v. Marshall & Ilsley Bank, 485

Note that treatises and case law reference the idea of a "valuable" claim, or a claim in the "best interests" of plan participants.[190] Although these sources do not specifically define what constitutes a "valuable" or "best interests" claim, it is implicit that these terms reference positive-value claims. Positive-value claims are claims whose expected value is positive once accounting for the probability of winning, the anticipated award, and litigation or arbitration costs.[191] It would be irrational for treatises and case law to support the bringing of claims that, for example, were strong on the merits, but which involved paltry damages and high litigation costs that ultimately outweighed the suit's reward. Such claims could be meritorious, but they are neither "valuable" nor in the "best interests" of plan participants and beneficiaries because they would leave the latter worse off than if the claim had never been brought. Thus, for example, Comment C to § 177 of the Restatement (Second) of Trusts states that a trustee will not be liable for failing to bring a cause of action "if it is reasonable not to bring such an action, owing to the probable expense involved in the action or to the probability that the action would be unsuccessful or that if successful the claim would be uncollectible owing to the insolvency of the defendant or otherwise."[192] Whether such a calculation is "reasonable" will undoubtedly be shaped by the trustees' degree of risk aversion. Furthermore, as noted above, other considerations like legal fees, publicity concerns, and concerns about whether the litigation would disrupt the core operations of the fund, may all be taken into account in weighing the value of the claim.[193]

So far, courts have been reluctant to find that trustees have breached the duty of care by failing to bring a positive-value claim. The legal risk to fiduciaries for failing to investigate appears to be higher than the risk of failing to litigate, so long as it is clear that the decision not to litigate resulted from a deliberative process. However, the litigation posture of almost all of the "failure to sue" cases is one in which courts would be less likely to find a breach of duty than in the

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F. Supp. 629, 641 (W.D. Wis. 1979) (finding that by failing to take any action to recover on outstanding notes, the trustee breached his fiduciary duty); Harris v. Koenig, 602 F. Supp. 2d 39, 55 (D.D.C. 2009) ("When, as in this case, a plan has potential claims against a third party, the 'trustees have a duty to investigate the relevant facts, to explore alternative courses of action, and, if in the best interests of the plan participants, to bring suit . . . .'" (quoting McMahon v. McDowell, 794 F.2d 100, 112 (3d Cir. 1986))).

190. *See Harris*, 602 F. Supp 2d at 55.

191. "For example, a victim of wrongful conduct will have an incentive to file an individual suit when the expected recovery exceeds the cost of the litigation." Linda Sandstrom Simard, *A View From Within the Fortune 500: An Empirical Study of Negative Value Class Actions and Deterrence*, 47 IND. L. REV. 739, 742 (2014) (explaining what a positive-value claim is).

192. RESTATEMENT (SECOND) OF TRUSTS § 177 cmt. C ("When trustee need not bring an action. It is not the duty of the trustee to bring an action to enforce a claim which is a part of the trust property if it is reasonable not to bring such an action, owing to the probable expense involved in the action or to the probability that the action would be unsuccessful or that if successful the claim would be uncollectible owing to the insolvency of the defendant or otherwise.").

193. *See* discussion *supra* p. 230.

shareholder-litigation context. Almost all of the relevant cases contained claims brought against trustees who failed to sue an employer or plan sponsor that did not make required contributions to the pension fund.[194] These cases implicate the duty of loyalty in addition to the duty of care because ERISA trustees often serve as sponsor managers too.[195] Courts have been reluctant to find liability against trustees in this context because the defendant trustees had other means available to enforce their beneficiaries' rights.[196] In addition to suing the delinquent employer, trustees may randomly audit the employer's records, threaten work stoppages, picket the employer, or engage in other actions depending upon the circumstances.[197] When trustees have several options to remedy the beneficiaries' harm, courts do not find a broad-based duty to litigate.[198]

The shareholder-litigation context is different in several key ways. First, unlike the cases just described, it is less likely that a claim for breach of the duty of loyalty would play a prominent role in shareholder litigation. A pension trustee who also serves as a company manager faces a clear loyalty conflict, and a decision to favor the company over the trust by failing to bring a positive-value claim for the trust against the company, leaves a trustee exposed to a claim that she failed to make that decision "solely in the interest[s] of participants and beneficiaries and [for the exclusive purpose of providing benefits]."[199] The same decision by a trustee in the context of a tort committed by a third party, like a securities fraud, is less fraught with loyalty concerns. Although claims like these always turn on the particular facts of the case, a trustee's loyalties are less likely to be questioned in the context of a fraud committed, or poor deal terms offered, by third parties other than the plan sponsor.

The analysis for breach of the duty of care comes out differently. As noted above, plan participants and beneficiaries have forms of recourse other than litigation against a recalcitrant plan sponsor. Consequently, courts have been reluctant to find trustees liable for breach of the duty of care for failing to bring a positive-value claim.[200] Yet in the shareholder-litigation context, participants and

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194. *See, e.g.*, Hartline v. Sheet Metal Workers' Nat'l Pension Fund, 134 F. Supp. 2d 1, 17 (D.D.C. 2000) ("Under ERISA, trustees have a fiduciary duty to 'act to ensure that a plan receives all funds to which it is entitled, so that those funds can be used on behalf of participants and beneficiaries.'" (citation omitted)); *McDowell*, 794 F.2d at 112 ("Indeed, whenever an employer seeks to avoid making its pension plan payments . . . trustees have a duty to investigate the relevant facts, to explore alternative courses of action and, if in the best interests of the plan participants, to bring suit against the employer.") (citing *Bierworth* and *N.J. Brewery*)); Herman v. Mercantile Bank, N.A., 137 F.3d 584, 586 (8th Cir. 1998).

195. *See Hartline*, 184 F. Supp. 2d at 17–18.

196. *Id.* at 17 ("There is no duty to take any particular course of action if another approach seems preferable.") (citing Alfarone v. Bernie Wolff Constr. Corp., 788 F.2d 76, 79–80 (2d Cir. 1986)).

197. *Id.*

198. *Id.*

199. 29 U.S.C. § 1104(a)(1) (2012).

200. *See, e.g.*, Alfarone v. Bernie Wolff Constr. Corp., 788 F.2d 76, 79–80 (2d Cir. 1986) (holding that a trustee's refusal to file a suit to recover contributions alone does not constitute a breach of fiduciary duty).

beneficiaries have no form of recourse against a third-party fraudster or against boards that breach the standard set forth in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[201] of failing to maximize share price in a merger. Litigation is their only option, and plaintiff beneficiaries will have a comparatively easy time distinguishing the prior cases that have tilted against finding a breach in this context.

Thus, the answer to whether funds will bring an independent shareholder action when there is no class option will depend, in large part, upon the trustees' assessment of whether the potential claim is positive. This leads to an empirical question as to how many funds would be likely to have positive-value claims, and what types of funds might be inclined to bring them. Litigating shareholder lawsuits is expensive and time consuming. Potential plaintiffs' exposure to any one fraud or any one transaction may be relatively small, and these suits tend to be of negative value when accounting for legal fees and costs—though recovery of such fees and costs is available to plaintiffs, and might remain so in a post-class-action environment.[202] For example, among public-pension funds, the top 50 or so with assets in excess of $10 billion would be most likely to have positive-value claims.[203] These funds would be likely to incur either substantial losses in securities frauds, or have significant exposures to transactions, that might make a claim worthwhile.

As stated earlier, what shareholder litigation (or arbitration) would look like without class actions depends on two critical questions: how many funds will have positive-value claims, and how sizable are those claims likely to be? These questions are worthy of comprehensive empirical study in a separate empirical project. To attain an informal sense of whether it is plausible to believe that any funds would have positive-value claims, I spoke with the heads of two portfolio-monitoring companies that monitor their clients' claims in existing class actions. On October 20, 2014, I interviewed Michael Egan, the president and founder of Class Action Claims Management, based in Charlotte, North Carolina.[204] He told me that one of his clients had a $350 million loss in the Schering-Plough/Merck shareholder class action. He described the process the company went through in deciding whether to opt out of the class action, and the ultimate decision not to remain in the class. According to Egan, the client's legal department wanted to opt out, but the portfolio managers were more reluctant to do so—in part because the losses reflected performance from years before, and also because the company had no systems in place for making this decision. In the end, the company decided to just file a claim form in the class action. But according to Egan, having gone through the opt-out process once, the company has now developed a system for making such a decision the next time, and it has identified the people who need to

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201. 506 A.2d 173 (Del. 1986).

202. *See* Simard, *supra* note 191.

203. *See* Webber, *Pay-to-Play*, *supra* note 114, at 2046, n.60.

204. Interview with Michael Egan, President and Founder of Class Action Claims Management, in Charlotte, N.C. (Oct. 20, 2014); *see also*, CLASS ACTION CLAIMS, *About Us*, https://www.securitiesclaims.com/page/about_us_main.html.

be part of the decision-making process. Egan thinks the company has "warmed up" to the idea of opting out, and that it will do so next time. The company has established a $50 million threshold for doing so.

Egan also told me that clients with assets ranging $10–$50 billion should have sufficient claims to opt out—or, for purposes of this paper, to bring an arbitration—if the class action route was no longer available. Such clients, he stated, "could easily have claims in the $10–$20 million range," not only because of their size, but because they tend to have more concentrated investments than funds in the range of $100 billion or more in assets. Egan told me that he had multiple clients with losses in the range of $30–$50 million in securities class actions against Hewlett Packard, JP Morgan, and the Citigroup Bonds class action.[205]

I also spoke with the CEO of another claims-monitoring firm, who wishes to remain anonymous. He emailed me the following on March 30, 2014:

> As promised, I could give you some quick anecdotal info regarding client losses in potential actions . . . [I]n the last six months we've looked at at least 3 cases where we thought clients with large losses might consider opting out, and so I can tell you that, for instance, in [the] Massey Energy [class action] we had 5 client[s] with losses between $8 m[illion] and $16 m[illion] each. In [the] Facebook [class action] we had one client with close to $20 m[illion] in losses. And in [the] Best Buy [class action] we had more than 10 clients with losses between $1 and $10 m[illion].
>
> I know we've had instances where the losses were more substantial than this, but I can't recall the exact numbers . . . . But this gives you a sense that at least among [our] clients . . . the losses often exceed $5 m[illion] if not a multiple of that.[206]

While the above statements do not resolve the empirical questions I pose, they do suggest that the number of institutional investors with positive-value claims could be substantial enough to maintain the viability of at least some shareholder litigation outside the class action context. In assessing the economic viability of such actions, firms must inquire into the total damages claimed and the litigation costs.

It is clear that, because small claims become economically unviable outside the class context, the total damages claimed would be reduced in a post-class-action world. Moreover, because the threat of fiduciary liability for close calls is low, and the hassle of litigation too great, many marginally positive-value claims might similarly vanish. It is tempting to think that reduced damage claims will necessarily lead to reduced damages, but some caution is merited here. Currently, total recoveries in securities class actions hover in the pitiful range of

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205. Interview with Michael Egan, *supra* note 204.

206. E-mail from Anonymous to David H. Webber, Associate Professor of Law, Boston University School of Law (March 30, 2014) (on file with author) (firm name redacted).).

7% of damages claimed.[207] Yet there have been several class actions from which institutional investors have opted out and recovered a far higher percentage of their damages.[208] Several institutions claim to have recovered 100% of their losses from opting out, and others have claimed recovering far higher damages from opting out than they would have had they remained in the class action.[209] There are several reasons why opting out might have resulted in higher recoveries. For instance, companies might be more willing to pay higher damages to large institutional investors, like pension funds, that will maintain a substantial stake in the company.[210] It may be that institutional investors are more deeply engaged in monitoring their counsel and prosecuting the case when they are pursuing a separate opt-out action, than when they are passive class members or even lead plaintiffs—though many of the successful opt outs occurred in cases in which dozens of institutions opted out together, resulting in a quasi-class action. [211]

A second issue is litigation costs. As discussed above, for cases to be positive value, the expected value of the suit must be positive net of legal fees and costs.[212] Currently, litigation costs are quite substantial for both plaintiffs and defendants. Dealing with the analysis under arbitration provisions first, most

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207. Scott & Silverman, *supra* note 15, at 1192.

208. Joseph Grundfest, *Damages and Reliance Under Section 10(b) of the Exchange Act* 9 (Rock Ctr. for Corporate Governance at Stanford University, Working Paper No. 150, 2013), *available at* http://ssrn.com/abstract=2317537; *see also* Blair A. Nicholas & Ian D. Berg, *Why Institutional Investors Opt-Out of Securities Fraud Class Actions and Pursue Direct Individual Actions*, BERNSTEIN LITOWITZ BERGER & GROSSMAN LLP, 1 (2009) *available at* http://www.blbglaw.com/news/media_mentions/00104/_res/id=sa_File1/PLIreprint7_22_09 ("As a recent example, in the *Qwest* securities litigation, the total publicly disclosed opt-out settlements exceeded the settlement of the entire securities class action."); Stephen Taub, *Shareholders Abandon Qwest Settlement*, CFO, May 5, 2006, *available at* http://ww2.cfo.com/risk-compliance/2006/05/shareholders-abandon-qwest-settlement (Bill Lerach, attorney for plaintiffs who opted out of the WorldCom class action suit: "Our clients' net recoveries on their WorldCom bond losses are substantially higher than the estimated recovery for the same bond losses in the WorldCom class action"); Joshua H. Vinik et al., *Why Institutional Investors Are Opting Out of Class-Action Litigation*, PENSIONS & INVESTMENTS, July 25, 2011, *available at* http://www.pionline.com/article/20110725/PRINTSUB/307259985 ("Sixty-five investors opted out of the $6.1 billion WorldCom class settlement approved in 2005; more than 100 opted out of the $2.65 billion AOL Time Warner securities class settlement approved in 2006; and more than 288 opted out of the $3.2 billion Tyco International settlement approved in December 2007.").

209. *See* Nicholas & Berg, *supra* note 208.

210. *Id.* ("Defendant companies understand that institutional investors typically maintain a long-term position in their company . . . . [I]nstitutional investors can potentially leverage their size and position to incorporate important governance reforms in a direct action settlement.").

211. *Id.* ("By opting-out, an institutional investor has complete control over the prosecution of its own unique claims, including the selection and direction of legal counsel, negotiation of attorneys' fees, absolute settlement authority, and utilization of its size and stature as leverage in settlement negotiations or at trial.").

212. *See* Simard, *supra* note 191.

commentators expect that arbitration reduces these costs.[213] The fact that arbitration would limit recovery for negative-value claims is frequently cited as a virtue of arbitration because it would eliminate what critics view as frivolous litigation against companies—litigation that harms shareholders big and small.[214] Also, arbitration claims tend to be resolved more rapidly than litigation, benefitting plaintiffs who recover earlier and may also pay lower attorneys' fees on account of lower costs.[215] Greater engagement by shareholders overseeing attorneys in an individual arbitration may lead to higher recoveries as a percentage of damages claimed.[216] The opportunity to select arbitrators allows parties to choose decision-makers with relevant legal or judicial experience, rather than expose themselves to the judicial lottery.[217]

Still, some commentators have challenged the view that arbitration reduces litigation costs.[218] For defendants, there are several reasons to believe that such costs may rise in arbitration. First, defendants have no "off ramps" in arbitration, no motion to dismiss, no motion for class certification, and no motion for summary judgment. There is no obvious, early opportunity to get rid of arbitration. Arbitrators are paid hourly, often at high rates, they have no incentive to end early, and there are usually three of them.[219] In contrast, judges with full dockets have the opportunity, and perhaps the inclination, to grant motions to dismiss, to deny class certification, or to grant summary judgment motions. Judges are compensated by taxpayers, rather than by arbitrating parties.

Second, plaintiffs in 10b-5 securities-fraud class actions face a bar on discovery. While it is true that discovery is generally not available in arbitration, arbitrators may choose to order it, thus giving plaintiffs discovery that would not have been available to them in a class action.[220] Third, expensive as it may be to defend a securities class action, at least that action typically resolves all the claims at once. In the kind of bilateral arbitration that bars consolidation that corporations would most likely choose, each party arbitrates separately. Thus, defendant companies might face dozens of separate arbitrations against large institutional investors, in dozens of forums stretching out over extended periods of time. Of

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213. Barbara Black, *Arbitration of Investors' Claims Against Issuers: An Idea of Whose Time Has Come?*, 75 LAW & CONTEMP. PROBS. 107, 107–08 (2012) ("All proponents emphasized the traditional benefits of arbitration, namely, a faster, less expensive, and more flexible process in which arbitrators possessing expertise in the subject matter resolve the parties' dispute.").

214. *Id.* at 108, n.5 ("Many [proponents of arbitration] advocated for arbitration as an antidote to perceived abuses of federal securities class actions.").

215. Scott & Silverman, *supra* note 15, at 1209–10.

216. *Id.*

217. *Id.*

218. *See* Black & Gross, *supra* note 84, at 1004.

219. *Why And When It Might Pay To Arbitrate*, WARREN GORHAM & LAMONT, 2000, *available at* 2000 WL 33990947.

220. Robert E. Benson, *The Power of Arbitrators and Courts to Order Discovery in Arbitration—Part II*, 25 COLO. LAW. 35, 35 (Mar. 1996) ("Indeed, most courts have held that they do have inherent power to order discovery in aid of arbitration in some circumstances.").

course, if overall recovered damages drop in the presence of arbitration clauses, then the tradeoff would be worth it, even if arbitration actually increased litigation costs. But even if both litigation costs and overall costs were to defy expectations and increase in arbitration, companies might still not drop mandatory-arbitration provisions because managers might prefer that allegations against them be aired in confidential arbitration proceedings rather than in open court.

In the deal context, mandatory arbitration would make it impossible for plaintiffs to enjoin a shareholder meeting, which is the source of much of plaintiffs' settlement leverage. This could then shift the focus of institutional investors to appraisal proceedings. Lately, such proceedings have attracted increased attention from investors and the loss of a meaningful remedy under *Revlon* might force more institutions to seek out appraisal remedies, particularly in cases where institutional lead plaintiffs have had success in litigating transactional class actions in the past.[221]

Plaintiff-pays provisions change the analysis somewhat. The cost of litigating a claim in court now bears the increased risk of having to assume the defendants' costs too.[222] On the other hand, a standalone plaintiff-pays provision would still enable consolidation of claims, and sharing of litigation costs, unless it were twinned with an arbitration provision. These provisions increase claims costs even further, and render fewer claims of positive value at the margins, allowing only the strongest claims to proceed. As noted earlier, while they might reduce the number of suits, they would also incentivize plaintiffs to vigorously litigate the cases they do bring to the end.

One would expect that the types of funds that would be most likely to avoid this litigation would be similar to the ones that avoid lead-plaintiff appointments now, and for similar reasons. For example, mutual funds avoid obtaining lead-plaintiff appointments in securities and transactional class actions, as noted above.[223] A mutual fund might have a strong claim for securities fraud against a Fortune-100 company that utilizes the mutual fund's platform of 401(k) offerings for its employees' retirement savings. Mutual funds would rationally consider the detrimental impact of a lawsuit or arbitration against the company on its future business with that company. So might intrafund conflicts in which different funds might have different stakes in the defendant, or in the deal context, different stakes in the target and the acquirer.[224] Such considerations could transform what might otherwise have been a positive-value claim into a negative-value one, just as they might incline such funds to shun lead-plaintiff appointments.

But there are meaningful distinctions between obtaining a lead-plaintiff appointment or opting out of a class action and declining to pursue a claim when

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221. *See* Webber, *Private Policing*, *supra* note 95, at 968–69; s*ee also* Korsmo & Myers, *supra* note 145.

222. Korsmo & Myers, *supra* note 145 (manuscript at 10).

223. *Id.* (manuscript at 21).

224. Webber, *Private Policing*, *supra* note 95, at 943.

no other recourse exists. In arbitration, the free-rider problem is neutralized. Only the arbitrating plaintiff benefits from a settlement or verdict, not a class that includes the plaintiff's competitors—who, if they so choose, can arbitrate on their own behalf.[225] Also, arbitration proceedings are confidential, and decisions have no precedential value, reducing the free-rider problem to something close to zero.[226] Furthermore, while mutual funds would be right to consider their ongoing business relationship with a potential defendant, and intrafund-family conflicts, it must occasionally be true that the size of the loss due to fraud must outweigh these competing considerations and compel a lawsuit. Nor should the costs of suing a client be overstated. A defendant corporation that removes a mutual fund from its employees' 401(k) platform in retaliation for the mutual fund's credible fraud claim might face questions about whether the company's actions are consistent with its duties of loyalty and prudence it owes to plan participants and beneficiaries. Similar arguments could be made for banks, insurance companies, and other institutional investors that currently remain passive in securities and transactional class actions. These entities have business relationships with corporate defendants that they will want to safeguard, and which would rightly count against bringing claims. But the scope of these limitations should not be overstated, particularly in the face of a substantial fraud.

Still, to the extent that shareholder litigation continues without class actions, it is likely that its leading participants will remain public-pension funds and labor-union funds, the same funds that serve as the most frequent lead plaintiffs today. According to my own research, 127 public-pension funds served as lead plaintiffs in securities class actions between 2003 and 2006,[227] while 32 public-pension funds and 28 labor-union funds served as lead plaintiffs in Delaware deal cases between 2003 and 2009.[228] There have also been a few instances of cases in which there were a substantial number of opt-outs by institutional investors that received wide coverage—for example, the *In re Worldcom & Qwest Communications* litigation.[229] Public-pension funds have a total of $3 trillion under management.[230] As noted earlier, more than 50 public-pension funds manage in excess of $10 billion, making them plausible candidates to be repeat players with positive-value claims.[231] Because they lack many of the conflicts that other investors do, we might still expect to see them as active players in shareholder litigation, even without class actions. Labor-union funds have been similarly active, though they are far smaller on average, and are less likely to have positive-value claims. Accordingly, they may be less significant players in a post-class-action world than they are now.

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225. *Cf.* Black & Gross, *supra* note 84, at 992 ("[Arbitration] awards do not serve as precedent—future arbitration panels cannot rely on previous awards as a source of authority.").

226. *Id.*

227. Webber, *Pay-to-Play*, *supra* note 114, at 2051.

228. Webber, *Private Policing*, *supra* note 95, at 935.

229. Grundfest, *supra* note 208; *see also* Nicholas & Berg, *supra* note 208.

230. *See* Webber, *Private Policing*, *supra* note 95, at 939, n.21.

231. *See supra* text pp. 20–21.

III. MAPPING THE INSURANCE LANDSCAPE FOR PUBLIC-PENSION-FUND FIDUCIARIES

In this Part, I discuss the somewhat unusual insurance landscape for fiduciaries of public-pension funds. I raise this point because these funds have historically been the most active lead-plaintiff participants in transactional class actions in Delaware, the second most active participants in securities-fraud class actions, and by far the largest and most successful class representatives, correlating with better outcomes for shareholders.[232] To the extent that any institutions will remain active in a world of shareholder arbitration instead of litigation, public-pension funds are among the most likely candidates. And because of the arguments outlined above, demonstrating how such fiduciaries could be held liable for failing to adequately monitor fund portfolios, or failing to litigate positive-value claims, the insurance landscape in which they will make litigation decisions is relevant. This landscape also differs greatly from the world of directors' and officers' liability insurance with which most corporate-law academics and practitioners are familiar.

I recently discussed fiduciary liability insurance for public-pension trustees with Daniel Aronowitz, managing principal of Euclid Specialty Managers, LLC—leading provider of such insurance.[233] I also discussed this topic with an executive at one of the leading insurance companies who requested anonymity ("the Executive"). According to Aronowitz's estimation, at least half of all U.S. public-pension plans do not have fiduciary insurance for their board members; he estimates the actual number of uninsured public-pension plans at more than 60%.[234] The Executive concurred with this figure. To the extent it is accurate, this astonishing percentage of uninsured pension fiduciaries is likely the product of several factors, according to both Aronowitz and the Executive. First, many of the largest insurers avoid providing fiduciary insurance for underfunded (less than 80% funded) pension funds for fear that the trustees will be held liable for such underfunding—as has already occurred in cases like *L.I. Head Start Child*

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232. C.S. Agnes Cheng et al., *Institutional Monitoring Through Shareholder Litigation*, 95 J. FIN. ECON. 356, 356–62 (2010); Perino, *supra* note 95; Webber, *Private Policing*, *supra* note 95.

233. I also made inquiries about fiduciary liability insurance for public-pension funds with two leading insurance companies. One refused to speak with me, and the other did not reply to my inquiry.

234. This estimate is based on an internal Euclid calculation, and I have not been able to identify public sources to check it. Aronowitz says there are no nationwide sources, though California publicly tracks the issue. Interview with Daniel Aronowitz, Managing Principal, Euclid Specialty Managers, LLC (Mar. 13, 2014); *see also Survey of Fiduciary Liability Insurance Coverage*, STATE UNIV. RET. SYS., *available at* http://www.surs.com/pdfs/minutes/x_bot/ex12_02_a.pdf (noting several large pension funds who do not have fiduciary liability insurance and their reasons for not having such); Salar Ghahramani, *Protecting Public Pension Funds from Divestment-Related Lawsuits: Exploring the State Laws of the United States*, 16 PENSIONS: AN INT'L J. 212 (2011) (noting that many states do not indemnify fiduciaries for divesting from Cuba, Iran, Sudan, and Syria, even while requiring these divestments under state law).

Development Services, Inc. v. Economic Opportunity Commission of Nassau County, Inc.[235] Similarly, many of the large insurers are wary of writing policies for these funds because of the liability concerns associated with widespread changes to benefits in the aftermath of the recent financial crisis.[236] For example, the Illinois Teachers Retirement System, which was significantly underfunded until recently, solicited bids for fiduciary liability insurance coverage from more than 20 insurance companies.[237] In response, only two bothered to offer a quote, and neither of these were major insurance companies.[238]

While obtaining insurance may be difficult for some funds, many funds also decline to obtain insurance because their state, county, and municipal sponsors can assert sovereign immunity for public-pension trustees acting within the scope of their duties.[239] Other states waive sovereign immunity and allow indemnification for fiduciary violations as long as the conduct was not willful or grossly negligent.[240] Unfortunately, neither option offers particularly robust protection to pension trustees.

First, whether the state or municipality will assert sovereign immunity in response to any particular lawsuit is not a decision that is made by the pension board, but usually by the state attorney general or the city attorney.[241] This

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235. 710 F.3d 57 (2d Cir. 2013) (affirming underfunding-related liability judgment against fund fiduciaries and denying that underfunding claims were barred by the statute of limitations).

236. Thomas J. Fitzpatrick IV & Amy B. Monahan, *Who's Afraid of Good Governance? State Fiscal Crises, Public Pension Underfunding, and the Resistance to Governance Reform*, 66 FLA. L. REV. 1317 (May 2014).

237. By November of 2013, it was reported that the "Illinois' teacher fund is worth $40 billion, but it is also underfunded by $5 billion." Benjamin Yount, *Disappearing Pensions? Illinois Teachers Get Halloween Scare*, WATCHDOG (Nov. 1, 2013) http://watchdog.org/113855/disappearing-pensions-illinois-teachers-get-halloween-scare/.

238. *See* Interview with Aronowitz, *supra* note 234.

239. *Id.*; *see also* Interview with Executive (on file with author); FLA STAT. ANN. § 768.28 (West 2012) ("No officer, employee, or agent of the state or of any of its subdivisions shall be held personally liable in tort or named as a party defendant in any action for any injury or damage suffered as a result of any act, event, or omission of action in the scope of her or his employment, or function, unless such officer, employee, or agent acted in bad faith or with malicious purpose . . . ."); N.Y. PUB. OFF. LAW § 17(3) (McKinney 2014).

240. Interview with Aronowitz, *supra* note 234; *see e.g.*, FLA STAT. ANN. § 768.28 (West 2012); *see also* Interview with Executive, *supra* note 239. As an example, the Chicago Teachers Pension Fund's Investment Management Agreement includes a clause that "the Investment Manager shall indemnify and hold harmless the Board of Trustees and the Fund . . . . Notwithstanding the foregoing, no indemnified party hereunder shall be entitled to indemnification to the extent that any such loss was directly caused by the party's own gross negligence or willful misconduct." *Investment Management Agreement*, CHI. TEACHERS PENSION FUND 1, 7–8, *available at* http://www.ctpf.org/general_info/investments/standard_ima.pdf.

241. Interview with Aronowitz, *supra* note 234; *see also* N.H. REV. STAT ANN. § 99-D:2 (2014) (describing the role of the Attorney General in indemnification cases in New Hampshire).

introduces uncertainty and political considerations into the assertion of sovereign immunity.[242] In the most prominent example of this uncertainty, five trustees of the San Diego County Employees Retirement System were sued in 2005 for breaches of their fiduciary duties in connection with the city's inability to fund pensions.[243] The defendants were charged with allowing the city to limit funding of the retirement system while increasing pension payments to city employees, which included the defendants.[244] The City Council and then the City Attorney both declined to provide a defense for the fiduciaries, who ultimately sued the city to seek indemnification of their costs.[245] Similarly, in *Estes v. Anderson*,[246] plaintiffs sued the pension-fund trustees of the Detroit General Retirement System, the Detroit Police and Fire Retirement System, and the systems' investment advisors, for gross negligence and breaches of fiduciary duty in connection with investments by the fund. The defendants pleaded sovereign immunity as a defense.[247] Although the Court of Appeals of Michigan affirmed dismissal of most of the plaintiffs' claims on these grounds, the gross negligence claim survived because immunity does not extend to gross negligence.[248] Thus, *Estes* illustrates a clear way to plead around an immunity defense.

Similar logic applies to indemnification clauses. Typically, these indemnification clauses are limited by public policy concerns.[249] Statutes governing public-pension funds often preclude indemnification for a wider range of actions than prohibited in the general trust context, but still allow it in certain circumstances. In California, public-pension plans are prohibited by statute from obtaining insurance that will immunize the fiduciary from liability stemming from its breaches.[250] Delaware allows indemnification, but limits it to "[good-faith]

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242. Interview with Aronowitz, *supra* note 234.

243. *See Euclid Specialty Managers White Paper on Governmental Benefit Plans: Who pays When a Trustee is Sued?*, EUCLID SPECIALTY MANAGERS (May 28, 2013), *available at* http://www.euclidmanagers.com/pgprofliab/pdfs/esm_ pdfs/The_Euclid_Perspective_White_Paper_on_Governmental_Fiduciary_Liability_052813_Final.pdf [hereinafter *Euclid Specialty Managers*].

244. *Id.* ("Lexin and five other employees on the SDCERS Board were charged with felony violations of state conflict of interest statutes . . . . The City Attorney alleged that Lexin and her fellow city employees on the SDCERS Board had voted to authorize an agreement allowing the City to limit funding of its retirement system in exchange for the City's agreeing to provide increased pension benefits to City employees, including themselves."); Jennifer Vigil, *Aguirre Sues to Shift Control of Pension System*, U-T SAN DIEGO, July 9, 2005, http://www.utsandiego.com/uniontrib/20050709/news_7m9pension.html ("Aguirre argues that the city did not have the funding to pay for the new benefits but approved them anyway . . . .").

245. *Euclid Specialty Managers*, *supra* note 243.

246. No. 294515, 2012 Mich. App. LEXIS 2236 (Mich. Ct. App. Nov. 15, 2012).

247. *Id.* at *5.

248. *Id.* at *6.

249. *See, e.g.*, 29 U.S.C. § 1110 (2012); MD. CODE. ANN., State Personnel and Services § 21-208 (West 2014).

250. CAL. GOV. CODE § 7511 (West 2014).

conduct reasonably believed in the 'best interest' of the state."[251] Nearly half the states explicitly authorize indemnification insurance.[252] ERISA does not govern public-pension funds, but it may be cited as persuasive authority in interpreting state pension codes.[253]

ERISA demands that trustees be held personally liable for breaches of fiduciary duty to the plan:

> Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.[254]

ERISA prohibits all exculpatory and indemnity provisions that relieve fiduciaries from their duty or liability as against public policy.[255] ERISA, however, does allow for insuring against breaches of fiduciary duties, conditional upon the insurance still allowing for ultimate recourse against the fiduciary.[256] If this insurance is purchased by the plan (as opposed to by the employer or the fiduciary himself), the insurance company must ultimately have recourse against the fiduciary.[257] It is true that the plan may utilize plan assets to purchase insurance for its trustees, but plan assets may not be used to directly settle liability judgments against trustees. As mentioned above, public-pension funds are not bound by ERISA and have taken varied approaches to curtailing and/or indemnifying

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251. *See Euclid Specialty Managers*, *supra* note 243, at 5; DEL. CODE ANN. tit. 29, § 8308 (West 2014).

252. *See* Daniel Aronowitz, Trends in Fiduciary Liability 12, ULLICO CASUALTY GRP. (2010) available at www.fppta.org/Gateway/GetBinaryFile.aspx?FID=240; *Euclid Specialty Managers*, *supra* note 243, at 7 (stating that nearly half of the states expressly authorize or require fiduciary liability insurance, including Alaska, Arizona, California, Colorado, Georgia, Idaho, Illinois, Kansas, Louisiana, Maryland, Missouri, North Carolina, Ohio, South Carolina, Texas, Utah, Virginia, and West Virginia).

253. *See* David H. Webber, *The Use and Abuse of Labor's Capital*, 89 N.Y.U. L. REV. 2106, 2119–20 (2014).

254. 29 U.S.C. § 1109.

255. 29 U.S.C. § 1110. Indemnification provisions are only null if they relieve a fiduciary from responsibility or liability. *See, e.g*, Packer Eng'g, Inc. v. Kratville, 965 F.2d 174 (Cal. Ct. App. 1992) (finding valid a provision indemnifying the legal costs of fiduciaries found by a court *not to* have breached their fiduciary duty).

256. 29 U.S.C. § 1110(b).

257. 29 U.S.C. § 1110(b)(1).

fiduciary liability. Some invoke sovereign immunity as noted above;[258] while other plans have specific exculpation clauses, indemnification provisions, or both.[259]

Thus, plan sponsors could purchase insurance for their trustees, but may prefer not to assume a cost they view as unnecessary in light of their ability to shield their trustees from liability by invoking sovereign immunity for all but the most egregious behavior. As the Executive told me, "[T]hey are reluctant to be questioned later about expenses that may be mistakenly viewed as unnecessary." Thus, pension trustees face a quandary. In the absence of fiduciary liability insurance, they are only protected if the plan sponsor chooses to protect them. The lack of predictable insurance coverage may have unpredictable effects on trustee behavior. A few developments suggest that the dearth and uncertainty of coverage could prompt trustees, at the margins, to favor litigating over not litigating fraud and deal cases. First, in the aftermath of the financial crisis, many public-pension funds have faced unprecedented criticism and scrutiny over underfunding issues.[260] Although pension-fund balance sheets have improved in recent years, many remain underfunded, and even those that are no longer underfunded operate in a political environment in which elected officials and voters are newly sensitized to the dangers of such underfunding.[261] In this environment, doing nothing in the face of fraud becomes politically risky. Without insurance, the risk of suit for failing to sue, and certainly for failing to monitor, might incline trustees with nonfrivolous claims to proceed with such claims. Another development that might affect trustee decision-making is the recent sharp increase in ERISA litigation, particularly breach of fiduciary duty lawsuits brought on behalf of fund beneficiaries.[262] Large damages payouts likely lead firms to devote more resources to bringing these cases, and enable them to develop the war chests required to finance them.[263] They may seek out similar problems in the public-pension space. Increased stress placed on retirement funds by the retirement of the Baby Boomers may be a further spur to such litigation.

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258. Estes v. Anderson, No. 294515, 2012 Mich. App. LEXIS 2236 at *4 (Mich. App. Nov. 15, 2012).

259. *Id.* at *5.

260. *See, e.g.*, Robert Novy-Marx and Joshua Rauh, *The Liabilities and Risks of State-Sponsored Pension Plans,* 4 J. ECON. PERSP. 23, at 191–210 (2009) (criticizing the current incentive structure that promotes investment in risky but higher-yielding assets).

261. *Id.*

262. *See ERISA Litigation*, VINSON & ELKINS, http://www.velaw.com/practices/ERISALitigation.aspx (last visited Nov. 20, 2014) ("The downturn in the economy has ushered a substantial increase in ERISA litigation . . . . There is approximately $10 trillion in pension plan assets nationwide, which has spawned a surge in class action lawsuits against pension plans and their fiduciaries.").

263. *See, e.g.*, Howard M. Erichson, *The End of the Defendant Advantage in Tobacco Litigation*, 26 WM. & MARY ENVTL. L. & POL'Y REV. 123, 129 (2001) ("Fees from Agent Orange, Dalkon Shield, and various other matters, but above all, asbestos, filled the war chests of the mass tort plaintiffs' bar.").

The dearth and uncertainty of insurance coverage may also result in an unusually high degree of herding behavior over litigation/arbitration.[264] Because of the threat of personal liability for getting this decision wrong, trustees might best protect themselves by doing whatever their peer institutions do. It might be unusual to see cases in which just a few pension funds file suit; rather, we might see zero arbitrations or a large number of institutional investors bringing arbitrations.

Of course, a pension trustee could breach her fiduciary duties by filing a frivolous suit just as much as by failing to file a meritorious one.[265] Undoubtedly, trustees should be reasonable in documenting why they opted to sue or not. But the probability that they will be found liable for filing a frivolous suit is extremely low unless the court states on the record that the suit is frivolous, or there is some type of sanction. Presumably, the lawyers bringing the suit will also be constrained by the threat of Rule 11 sanctions.[266] It might come down to little more than a question of who is more likely to sue you: a beneficiary who thinks you failed to act in the face of fraud, or one who is upset that you tried and failed to recover in the face of fraud. In the face of uncertainty, trustees may find action more defensible than inaction.

As discussed more fully below in Part IV, a second development that could affect trustees is how that bar would respond to loss of the class action device. These firms are armed with substantial resources they will deploy to maintain their practices. They will need a broad pool of institutional clients—not just the largest ones that can win lead-plaintiff appointments, but also those that are large enough to have positive-value claims. Given the potential for bankruptcy faced by plaintiff firms without class actions, it is not too farfetched to imagine that they themselves would target a fund's trustees for failure to bring suit over a positive-value fraud claim, perhaps a fund controlled by elected officials who would be strongly disinclined to become a client of such firms. One can also imagine good-cop/bad-cop dynamics taking hold. A small firm affiliated with plaintiff law firms brings an action against trustees for failure to sue, thereby not soiling the plaintiff firms' reputation with pension funds, while creating incentives for funds to monitor and perhaps bring arbitrations of their own.

The insurance environment leaves public-pension trustees unusually vulnerable to litigation. This is not to suggest that such vulnerability is a bad thing. It may make such trustees more sensitive to their fiduciary duties than comparable agents at other funds that are more insulated. The class action has rendered these trustees largely impervious to claims against them for their portfolio-monitoring and litigating conduct, perhaps helping to conceal an unusual, and potentially unstable, insurance situation. Loss of the class action could prompt reform of how such pension trustees are insured but, in the meantime, it should lead to careful

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264. *See* Christopher Avery & Peter Zemsky, *Multidimensional Uncertainty and Herding Behavior in Financial Markets*, 88 AM. ECON. REV. 724, 730–31 (1998) (discussing herding behavior).

265. *Cf. supra* Part II.B.2.

266. *See* FED. R. CIV. P. 11(c).

portfolio monitoring, prosecution of positive-value claims, and herding behavior by funds seeking to justify their fiduciary choices through reference to the actions of other trustees.

IV. HOW LOSS OF THE CLASS ACTION WOULD AFFECT THE PLAINTIFFS' BAR

There is a broad array of potential outcomes for the plaintiffs' bar should the class action be eliminated, ranging from dissolution to thriving practices representing institutional investors in shareholder arbitration, to new competition from traditional law firms. Below, I will sketch out some of the ways that loss of the class action could impact the plaintiffs' bar. Before doing so, I note some recent empirical research on plaintiffs' law firms that accounts for their quality. In *Zealous Advocates or Self-Interested Actors: Assessing the Value of Plaintiffs' Law Firms in Merger Litigation*, C.N.V. Krishnan, Steven Davidoff Solomon, and Randall Thomas evaluate 1,739 merger class actions in five states between 2003 and 2012.[267] They find that, after controlling for selection bias, top plaintiffs' law firms correlate with a higher probability of lawsuit success.[268] They also suggest that this success stems from more active case prosecution by such firms, more documents filed, and more motions for an injunction.[269] Similarly, in *Law Firm Quality, Deal Litigation, and Firm Value*, Adam Badawi and I study all merger class actions in Delaware from 2003 to 2008.[270] In our event study, we find a positive market reaction to deal lawsuits filed by top law firms, and a negative reaction to suits filed by poor quality firms.[271] We find this effect both for conflicted transactions like management buy-outs and controlling shareholder transactions.[272] As for 10b-5 securities class actions, several studies have found that institutional investors generally, and public-pension lead plaintiffs in particular, correlate with better outcomes for shareholders.[273] Other studies have found these results for merger class actions too.[274] In combination, these studies suggest that at least a subset of this litigation performs as designed and enhances shareholder value (or at least target shareholder value in deal cases). They also point to one of the deep flaws of mandatory-arbitration or fee-shifting provisions—they are blunt instruments that threaten meritorious and frivolous suits alike, high and low quality firms alike.

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267. C.N.V. Krishnan, et al., *Zealous Advocates or Self-Interested Actors? Accessing the Value of Plaintiffs' Law Firms in Merger Litigation*, 1 (European Corp. Gov. Inst., Working Paper No. 265/2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2490098.

268. *Id.* at 11.

269. *Id.* at 25.

270. David H. Webber & Adam Badawi, Deal Litigation, Law Firm Quality, and Firm Value, (unpublished manuscript) (on file with author).

271. *Id.*

272. *Id.*

273. *See* Cheng et al., *supra* note 232; Perino, *supra* note 95.

274. *See* Adam Badawi & Daniel Chen, *The Shareholder Wealth Effects of Delaware Litigation*, (forthcoming); Webber, *Private Policing*, *supra* note 95.

A. The Economic Status Quo for Shareholder and Transactional Litigators

Assessing how loss of the class action would affect the plaintiffs' bar requires assessment of why we have a separate plaintiffs' bar in the first place. Many practice areas dominated by class actions subdivide into plaintiffs' and defense firms, including mass-tort, consumer, antitrust, employment, and securities/transactional.[275] Law-firm economics, path-dependent historical circumstances, conflicts of interest, and the politics of class actions all explain these plaintiff/defense schisms. First, class action dynamics, including aggregation of negative-value claims, tilt in favor of plaintiff-lawyer compensation by contingency fee because the clients will not rationally pay their legal fees out of pocket.[276] Law firms that are compensated by contingency fees organize themselves differently than firms compensated under the billable-hour model. Contingency-fee arrangements require considerable risk taking and reward.[277] In the securities space, it may involve incurring five years (on average) of litigation expenses with the possibility of zero compensation, or a large payoff that can be several times the hourly wage of even the most highly compensated partners at defense firms.[278] Plaintiffs' lawyers select and maintain a portfolio of cases in various stages of development. Risk taking, managing a portfolio of cases, and assuming the costs of litigation directly distinguish the economics of plaintiffs' firms from defense firms. Defense firms mostly operate on the billable-hour model. They are compensated monthly for legal expenses incurred, and they rarely assume either the risk or the rewards of the cases they litigate—being compensated on effort rather than outcomes. While some firms have taken to blending these two compensation models, for the most part, firms tend to adopt one or the other. A firm's choice of a compensation model may be "sticky" in that it may create incentives within the firm to avoid work that operates on a different billing model.

Beyond compensation dynamics, there are marketing and social-network reasons why traditional law firms have shunned plaintiff-side class action practice.

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275. Many of these fields are already adjusting to a post-class-action world. The Supreme Court's ruling in *Concepcion* directly applied to the consumer context, and *American Express* applied to antitrust.

276. Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiff's Attorney's Role in Class Actions and Derivative Litigation: Economic Analysis and Reform*, 58 U. CHI. L. REV. 1, 17–18 (1991) (noting that the contingency fee also "partially aligns the interests of lawyer and client by giving the lawyer an economic interest in the outcome of the case, resulting in the sharing of risk").

277. David L. Schwartz, *The Rise of Contingent Fee Representation in Patent Litigation*, 64 ALA. L. REV. 335, 337 (2012) ("[T]he lawyer shares in the litigation risk because she only receives compensation for her legal work if the client wins the case or receives a settlement.").

278. *See* Janet Cooper Alexander, *Contingent Fees and Class Actions*, 47 DEPAUL L. REV. 347, 347 (1998) (describing "no win no pay" as a defining characteristic of the contingency fee); *see also About Class Actions*, SPECTOR ROSEMAN KODROFF & WILLIS, http://www.srkw-law.com/about-class-actions.html (noting that "[w]hile every case is different, it is not unusual for a class action to take 2–4 years from the filing of the complaint to a final resolution").

These firms sell their services to large, multinational corporations, offering a full suite of legal services.[279] Transactional services include IPOs, M&A, and corporate restructurings; litigation services include intercompany lawsuits, defense of criminal and civil governmental investigations, and other regulatory actions; both practice areas require related legal service like tax, bankruptcy, trusts and estates, employment, etc.[280] These firms operate globally to meet the demands of their clients—sometimes with offices in dozens of cities on multiple continents. Suing these same clients in class actions would fit poorly into this marketing scheme. It potentially undermines a firm's pitch to corporate managers when the firm itself regularly sues such managers on behalf of investors.[281] Perhaps more importantly, representation of a class against one large multinational corporation could create conflicts of interest that might prevent the firm from offering any of its remaining services to that corporation, assuming the defendant were still interested in hiring a firm that had sued it.

These are some of the reasons why legal representation of plaintiffs in class actions has remained distinct from traditional law practice. And, while still true for securities and transactional litigation, the plaintiff side of the business has recently begun to more closely resemble the traditional litigation model. Historically, securities class actions were litigated with individual investor lead plaintiffs, prompting famed plaintiffs' lawyer and convicted felon, Bill Lerach, to quip: "I have the greatest practice in the world. I have no clients."[282] Lawyers brought cases and handpicked their clients.[283] Only with passage of the PSLRA did institutional investors assume a commanding role in these actions.[284] A specific goal of these reforms was to make plaintiff-side representation more closely resemble traditional legal representation. In this respect, the lead-plaintiff and lead-counsel reforms of the PSLRA succeeded by empowering institutional clients to select counsel, negotiate legal fees, and monitor law firm performance.[285] These

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279. Examples of such firms that do not take plaintiffs' cases are: DLA PIPER, http://www.dlapiper.com/en/us/ (last visited Oct. 15, 2014); BAKER & MCKENZIE, http://www.bakermckenzie.com/ (last visited Oct. 15, 2014); SKADDEN http://www.skadden.com/ (last visited Oct. 15, 2014).

280. *E.g.*, *Corporate*, SKADDEN, http://www.skadden.com/practice/corporate (describing Skadden's corporate practices); *Litigation*, SKADDEN, http://www.skadden.com/practice/litigation (describing Skadden's litigation practice).

281. Intercorporate litigation rarely involves claims against individual corporate defendants, unlike securities and transactional class actions.

282. James R. Copland, *Pension Politics Foils Curbs on Shareholder Strike Suits*, INVESTOR'S BUS. DAILY, Manhattan Institute for Policy Research (Sept. 23, 2004), http://www.manhattan-institute.org/html/miarticle.htm?id=6014#.VD70Hq3wvIU (quoting Bill Lerach).

283. Coffee, *supra* note 94, at 411 ("[T]he plaintiff's attorney can behave less as an agent serving a principal and more as an independent entrepreneur, one who in fact often hired the client.").

284. *See supra* notes 96–97, and accompanying text; Webber, *Private Policing*, *supra* note 95, at 911.

285. *See* Webber, *Private Policing*, *supra* note 95; Heck, *supra* note 97, at 1204 ("Both the structure of the PSLRA and its legislative history show that Congress designed it

reforms only partially transformed these cases, in part because most cases still proceed with an individual lead plaintiff, and in part because the cases may still be lawyer-driven—albeit with greater and more informed client input when led by institutional plaintiffs.[286] But the PSLRA did not transform (and was not intended to transform) the underlying contingency-fee-based economic model for plaintiffs' firms. Many of the dominant pre-PSLRA plaintiffs' firms remained dominant post-reform, and for straightforward reasons: they had the most expertise and experience to litigate such cases.[287] They continued operating on the pre-PSLRA compensation model. In theory, plaintiffs' law firms could collect billable-hour compensation at the end of the case, paid out from settlement funds, but that would fail to compensate the attorneys for the risk incurred in litigating a case with no assurance of payment. The "lodestar method," by which courts check the plaintiffs' firms' requested legal fee by breaking it down into an hourly wage plus a multiplier for risk, is one way that courts, in effect, translate the plaintiffs' lawyers' fee into the more familiar billable hour in order to assess the fee's appropriateness.[288] Even under the status quo, these lawyers bill their time, and are overseen by institutional clients that can actually pay their bills directly. Still, the contingency fee reigns, as it should, when there are a large number of negative-value claimants.

Loss of the class action poses two potential threats to the class action plaintiffs' bar: it might render plaintiff-side shareholder litigation economically unviable, and to the extent that it remains viable, it could attract new competitors. It is also possible, that loss of the class action could leave the field to meritorious, high-dollar arbitration with generous legal fees led by the same firms that currently dominate securities class action practice, while eliminating many of the firms that specialize in nuisance suits. I entertain each of these possibilities in the ensuing Sections.

B. Loss of the Class Action Eliminates Shareholder Litigation and, by Extension, the Plaintiffs' Bar

There are several ways that the elimination of the class action would lead to the elimination of a separate plaintiffs' bar. Some of these have already been noted. Overall damages claims could fall far enough to sharply reduce legal fees. Likewise, there could be a dearth of institutional investors with positive-value claims, particularly if plaintiff-pays provisions are not eliminated by the Delaware legislature, or halted by opposition from ISS.[289] Without claims or clients, the

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to achieve two interrelated objectives: (1) to encourage institutional investors to become lead plaintiffs and (2) to reduce the amount of control attorneys wielded over securities fraud litigation.").

286. See Webber, *Private Policing*, *supra* note 95*;* Perino, *supra* note 95.

287. *See* Coffee, *supra* note 94, at 420 (noting that after the PSLRA "the plaintiff's bar learned to develop relationships with public pension funds, unions and other organizations that held large stock positions" in an effort to represent lead plaintiffs).

288. Alexander, *supra* note 278 (describing the lodestar method).

289. *See supra* note 37 and accompanying text regarding plaintiffs-pay or loser-pays provisions.

plaintiffs' bar would disappear. Fund trustees and investment staffs might resist the amount of time, effort, and expertise that go into monitoring lawyers in litigation. This would be particularly true if the only successful business model would require a shift from a contingency to an hourly fee, with the institution writing monthly checks for substantial legal fees.

Further, even if there were a sufficient number of positive-value claimants, loss of the class action would still pose significant challenges to the traditional plaintiffs' bar. Rather than facing an early, decisive skirmish for control over the class action at the lead-plaintiff/lead-counsel selection stage, multiple firms might find themselves representing institutional clients in multiple arbitration proceedings over the same set of facts. For example, rather than be appointed lead counsel or co-lead counsel for the Enron securities class action, several firms would represent institutions in multiple arbitrations against Enron, its accountants, and its underwriters. This poses some risk that the available legal fees would be spread too thinly among a set of firms, rendering unviable the traditional model—particularly contingency-fee-based compensation. Economic theory might predict that a few firms would win this tournament—those with the strongest relationships with institutional investors and, hopefully, the best litigation track records. Because overall damages claims necessarily drop without the class action, much of the economic viability of shareholder arbitration would depend upon the ability of plaintiffs' firms to recover a far higher percentage of claimed damages than they do currently. As noted, some of the results for institutional opt-outs suggest that sharply higher recoveries might be possible,[290] although these opt-outs had the benefit of being able to rely on the work done in the class action.

In sum, loss of the class action could translate into only a small number of shareholder litigations or arbitrations on behalf of institutional investors, with cases being too infrequent to support a law firm or practice devoted exclusively to the field. Decline of the relevant plaintiffs' bar may be one goal of mandatory-arbitration and fee-shifting provisions. Legal reforms have led to a decline in plaintiffs' bars that were once active in other fields. Some academic and popular sources have suggested that the recent increase in patent litigation might be due to state-level tort reform, which they argue has substantially limited profits for plaintiffs' law firms, possibly leading them to seek out alternative fields like patent litigation.[291] One might ask where plaintiffs' law firms might turn if they can no longer bring shareholder class actions. One potential candidate might be ERISA litigation, under which plaintiffs have statutory rights and the potential defendants are trustees, operating under trust law, and therefore may face legal barriers to

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290. *See, e.g.*, Catherine Fredenburgh, *With Billions at Stake, Class Action Plaintiffs Opt Out*, Law 360 (Feb. 10, 2006, 12:00 AM), http://www.law360.com/articles/5295/with-billions-at-stake-class-action-plaintiffs-opt-out ("While the class action case netted a $651 million settlement, a judge ordered WorldCom to pay $78.9 million in damages to the five pension funds . . . .").

291. *See, e.g.*, Ronen Avraham and John M. Golden, *From PI to IP: Yet Another Unexpected Effect of Tort Reform*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1878966; Julie Creswell, *So Small a Town, So Many Patent Suits,* N.Y. TIMES Sept. 24, 2006, at B1.

adopting mandatory-arbitration or fee-shifting procedures against their own beneficiaries.[292]

C. Loss of the Class Action Leads to Replacement of Contingency Billing with the Billable Hour, and Potentially New Competitors

It is also possible that sufficient positive-value claims will exist to justify the ongoing existence of shareholder litigation without class actions, but that immense payoffs in the form of high legal fees in class actions that settle for billions of dollars will disappear. And even if substantial legal fees could be cobbled together across a dozen or more arbitrations, the cost of litigating those could still be higher than litigating one class action; even if each individual arbitration is less costly than a class action. Should such large payoffs cease to exist, or should the cost of litigating numerous arbitrations exceed the costs of one class action for the lawyers, then the contingency-fee model might no longer be viable. The risk-reward calculation could be altered. Here, a billable-hour model might become more viable, or at least a blended model involving some billable hours and an outcome-dependent bonus. The potential rise of a billable-hour model and a client base that consists exclusively of institutional investors raises the possibility of new entrants into the field, assuming, again, that there are sufficient positive-value claims to support it.

It is true that a billable-hour model would not eliminate the marketing challenges and conflicts of interest generated by suing the kinds of large corporate defendants that are, and would be, targeted in shareholder arbitration. But for reasons previously described, many large institutional investors that collect their pro rata share of settled class actions, but never participate as lead plaintiffs—like mutual funds, insurance companies, banks, hedge funds, and others—could be forced into more costly portfolio monitoring than they currently undertake, and even litigation, over positive-value claims. As fiduciaries, they face potential liability to their clients, customers, and shareholders if they fail to litigate potential fraud claims or cannot show that they were aware of the fraud and made a reasonable and conscious decision not to litigate it.[293] Many of the same outside counsel that serve multinational corporate defendants in shareholder litigation also serve large institutional investor clients that could have positive-value claims. These law firms might then be forced to choose: help their clients monitor and litigate such claims, or send that business out of the firm; perhaps to a competitor or a satellite firm. One can imagine that traditional law firms might opt to keep this business. Representing large institutions in litigation or arbitration against other large institutions is what these firms do already, and it fits better with their marketing goals than class actions do. Such institutional clients may very well employ former associates of the law firms. Social-network effects, a converging

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292. *See supra* notes 189–195 and accompanying text (discussing ERISA fiduciary duty, and the beneficiary's right to sue for breach).

293. *See* N.J. Carpenters Health Fund v. Philip Morris, Inc., 17 F. Supp. 2d 324, 338 n.18 (D.N.J. 1998); Wolf v. Mitchell, Silberberg & Knupp, 76 Cal. App. 4th 1030, 1037 (Cal. Ct. App. 1999).

compensation model, and eased marketing challenges make it conceivable that traditional plaintiff-side shareholder litigation and arbitration could be absorbed into traditional defense firms as part of their securities and transactional practices.

Another alternative is that this work could also be absorbed by ERISA and labor law firms that currently serve public-pension- and labor-union-fund clients, although this would require acquisition of completely new skill sets and practice areas by these firms.

D. Loss of the Class Action—A New Normal for Leading Plaintiffs' Law Firms

Finally, it remains possible that the loss of the class action will eliminate plaintiffs' firms that bring nuisance suits, while allowing top firms with institutional clients to continue practicing their trade in a new, but still somewhat familiar, litigation environment. Currently, nuisance firms bring cases with individual investor lead plaintiffs, mostly because they cannot find an institution that is interested enough in litigating the case. These firms survive by bringing cases no one else is interested in bringing, or by finagling their way onto lead counsel teams in substantial cases run by top firms, often by threatening to object to the settlement.[294] Results for shareholders in cases brought by such firms are almost always disappointing.[295] Some of the law firms that bring such cases have even been openly criticized on the record by judges. For example, in *Revlon*, Vice Chancellor Laster heavily criticized the original class counsel before finding that they failed to adequately represent the plaintiff–shareholder class and thus should be replaced.[296] The class action enables nuisance firms to continue to bring suit without any screening by a sophisticated, motivated lead plaintiff. They must simply identify one individual investor who is willing to serve as a lead plaintiff, and file a class action on his or her behalf. Without the class action device, nuisance firms would have to secure representation of an institutional investor with a positive-value claim, something that might be difficult to do if the firms have an established track record of poor performance.

Yet there is a small set of plaintiffs' firms that regularly appear at the top of rankings like the Legal 500 and Securities Class Action Services.[297] These firms earn significantly higher fees in shareholder and transactional litigation, presumably because they obtain better results for shareholders.[298] These same firms provide portfolio-monitoring services to their institutional investor clients, whom they notify of exposure to claims, and on whose behalf they bring such

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294. *See* Webber & Badawi, *supra* note 270.

295. *Id*.

296. *In re* Revlon, Inc. Shareholders Litig., 990 A.2d 940 (Del. Ch. March 16, 2010); *see also* Ann Woolner et al., *When Merger Suits Enrich Only Lawyers*, BLOOMBERG (Feb. 16, 2012, 1:59 PM), http://www.bloomberg.com/news/2012-02-16/lawyers-cash-in-while-investor-clients-get-nothing-in-merger-lawsuit-deals.html (Laster critiqued plaintiff's attorneys for having "claimed undeserved credit for changes in the deal's terms, exaggerat[ing] the benefits of 'tweaks' and fail[ing] to notice red flags pointing to the transaction's unfairness").

297. *See* Webber & Badawi, *supra* note 270.

298. Woolner, et al., *supra* note 296.

claims.[299] These relationships could persist in arbitration. Instead of notifying their institutional clients when they have a large enough loss to obtain a lead-plaintiff appointment, they could notify them of positive-value claims, and aid them in deciding whether to proceed with such claims. Assuming that a significant number of such claims can be identified and prosecuted, it is possible that the firms could continue to exist without much change to their business models, including continued pursuit of a contingency-fee-based compensation model. Plaintiff-pays or loser-pays provisions make this less possible because plaintiffs' lawyers might be unwilling to bear the risk of having to pay defense-counsel fees, unless perhaps the institutional clients are willing to engage in risk-sharing, or coalitions of plaintiffs firms agree to bear the risks together.

Crucial to the ongoing success of such firms will not only be the question of whether there are a sufficient number of positive-value claims, but whether plaintiffs' law firms will be able to substantially increase their recoveries as a percentage of damages claimed over what they obtain in class actions today. There are several reasons to believe that they might be able to do so, apart from the aforementioned success of institutional investors in opt-out actions.[300] Many of the legal barriers erected against plaintiffs in the PSLRA and in a series of cases will not directly apply in arbitration. Corporate defendants may be more willing to settle on more favorable terms with large, well-connected institutional investors that have personal relationships with boards and senior managers, carry weight in the proxy proposal process and with shareholder voting, and could be sources of future capital. The confidential nature of arbitration proceedings might further pry open defendant purses, both because there will be less stigma to a high settlement that, if it were public, might be interpreted as being tantamount to an admission of liability, and because individual defendants can spend other people's money, i.e., the corporate shareholder's, to make the suit go away.[301] That's true now, but at least it's public—it may not be in arbitration. It may also be that institutions writing substantial monthly checks to their lawyers in these cases may monitor those lawyers more closely and may themselves be more engaged in the litigation, producing better results.

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299. *See, e.g.*, *Portfolio Monitoring*, SPECTOR ROSEMAN KODROFF & WILLIS, http://www.srkw-law.com/portfolio-monitoring.html ("Our complimentary, customized portfolio monitoring service is designed to . . . provid[e] a 'one-stop shop' for securities class actions and corporate governance matters globally . . . .").

300. *See supra* note 208 and accompanying text (discussing the values received by institutional investors after opting out of a class action and filing their own separate claim).

301. *See* Coffee, *supra* note 94 (noting that "recovery in securities class actions is ultimately funded by the shareholders themselves . . . .").

V. FROM THE CIRCULARITY PROBLEM TO THE SEMI-CIRCULARITY PROBLEM, AND OTHER POLICY CONCERNS OF SHAREHOLDER LITIGATION WITHOUT CLASS ACTIONS

A. The Semi-Circularity Problem

Critics of the securities class action frequently point to the "circularity problem."[302] Large, diversified, institutional shareholders still own the defendant company they sue in these actions.[303] Consequently, settling a securities class action is tantamount to shareholders transferring money from their left pocket to their right, minus attorneys' fees.[304] Such critics argue that shareholders would be better off had they never filed suit at all.[305] Critics similarly argue that diversified investors are as likely to benefit from fraud as they are to be harmed by it.[306] There have been several critical responses to the circularity problem. Professor James Park has argued that diversified investors benefit when there is less fraud in the market overall, and has further argued that securities class actions are no more circular than dividends, which also trigger transaction costs in the form of taxes, while still playing an important signaling role.[307] Diversified shareholders may still benefit from bringing such actions to the extent they deter fraud in the market generally, even if they do not profit from them in specific cases. Professor Jill Fisch has argued that even if diversified investors do not benefit from the securities class action, concentrated investors do, and are the ones deserving protection.[308] Concentrated investors make markets efficient.[309] Rather than aiming to capture the overall market rate of return—minimizing firm-specific risk and research costs—concentrated investors "seek alpha," that is, they aim to beat the

302. James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 509 (1997); Scott & Silverman, *supra* note 15, at 1194.

303. Cox, *supra* note 302 ("The degree of circularity involved by such a settlement depends primarily on what portion of the company is owned by the members of the class action, a consideration that likely is dependent on the length over which the fraud was committed, the relative turnover of the company's shares, and the number of class members who pursued a buy-and-hold-strategy versus an in-and-out-strategy.").

304. Coffee, *supra* note 94, at 409–410 ("Because most shareholders are diversified and, over time, will fall into both groups, even meritorious securities class actions may simply transfer wealth among diversified shareholders, thus producing neither net compensation nor real deterrence. Worse yet, on each such wealth transfer among shareholders, lawyers for both sides extract their fees . . . .").

305. *Cf.* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1535–36 (2006) (asserting that a "fundamental problem" of filing securities class action is that "[a]s presently constituted, securities class actions produce wealth transfers among shareholders that neither compensate nor deter.").

306. Scott & Silverman, *supra* note 15, at 1194.

307. James J. Park, *Shareholder Compensation as Dividend*, 108 MICH. L. REV. 323, 347 (2009).

308. Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 346.

309. *See* Webber, *Plight*, *supra* note 111, at 169.

market.[310] To do so, they incur substantial research costs and make concentrated bets.[311] These investors trade on public information, impounding it into stock prices.[312] These are the investors—and not necessarily the diversified investors—that we want to protect from fraud. The ability to rely upon public statements made by companies in the reporting context and outside it is necessary for concentrated investors to continue to profit from their trading strategies.[313]

Elimination of the securities class action replaces the circularity problem with a semi-circularity problem, assuming any litigation continues. Instead of an overlapping set of investors standing on both sides of the litigation as harmed plaintiffs and as ongoing owners of the defendant, the plaintiff profile shifts. Only investors with positive-value claims can sue and recover their damages.[314] Thus, for the most part, this group will be composed of large institutional investors. Conversely, many smaller institutional investors—and most, if not all, individual investors—will have negative-value claims. Consequently, they will have no remedy for their wrong. Yet they may very well remain invested in the defendant company after the fraud.

Thus, if there is a fraud or a mispriced deal, positive-value claimants can sue and recover, while negative-value claimants cannot. But the asymmetry runs deeper than just who can and cannot sue. As ongoing owners of the defendant, negative-value claimants still contribute their pro rata share of settlements obtained by positive-value claimants in arbitration. So, negative-value claimants are not only defrauded, but they must pay to compensate positive-value claimants for that fraud. This is the semi-circularity problem.

In the most basic sense, this subsidy is unfair; it allows some investors to be reimbursed for their losses by payments from other investors who incurred the same losses. The subsidy also introduces a distortion in which the exact same trade for the same sum would be actionable if made through a large institution, but not through a small institution or an individual. A $5 million loss incurred by ten different individual investors would not create economically viable claims, whereas that same loss incurred by one institution would be economically viable. Unless we have some reason to believe that it is always better to invest through large institutions, loss of the class action needlessly introduces a distortion in the marketplace. It gives large institutions an unmerited legal advantage over smaller investors.

The subsidy, and the loss of any remedy for smaller investors, also cuts against core, historical missions of securities regulation: the protection of individual investors, and what we might call "level playing field values."[315]

310. *Id.*
311. *Id.*
312. *Id.*
313. *Id.*
314. *See* Simard, *supra* note 191.
315. *See, e.g.*, S. Con. Rep., 104th Cong., 141 CONG. REC. S17965-03 (1995) (statement of Sen. Carol Moseley-Braun) (stating that the PSLRA "was designed to maintain strong investor protection").

Current and prior SEC chairpersons have made protecting individual investors a priority.[316] The protection of individual investors was one of the original animating purposes of the Securities Act and the Securities Exchange Act.[317] It has remained an important feature of securities regulation up until the present day. To illustrate this, consider three cornerstones of government enforcement of the securities laws: the disclosure rules, insider trading prosecutions, and Regulation Fair Disclosure ("Regulation FD").

Companies can issue securities to large, sophisticated institutional investors under a variety of exemptions[318] that allow the companies to avoid the most burdensome and costly disclosure rules because these investors are sophisticated enough to "fend for themselves."[319] When selling to the investing public as a whole, companies must disclose more than when selling under an exemption.[320] It follows that the investing public, which includes individual investors and smaller institutional investors, should have actual remedies for violations of the very rules of heightened disclosure that are designed to protect them in the first place. Here, loss of the class action deprives these investors of a remedy—particularly in the set of cases where we see only class actions, rather than SEC actions.[321] In short, loss of the class action provides a litigation subsidy to funds that are the most capable of protecting themselves, while denying a remedy to those whom the rules are designed to protect.

Insider trading takes place when either corporate insiders trade on material nonpublic information, or when corporate outsiders who have misappropriated information in breach of a fiduciary duty trade on that information.[322] The direct economic harms of such trading may sometimes be trivial, but their direct economic harm is often not what motivates insider-trading enforcement. These cases are brought to maintain the public perception, and hopefully the reality, that investors trade on a level playing field, or something

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316. Christopher Cox, Chairman, SEC, Address Before the U.S. House Committee on Financial Services: Improving Financial Disclosure for Individual Investors (May 3, 2006) ("[A]n overall strategy to make the individual investor – the average American – the ultimate beneficiary of all that we do at the SEC."); Mary L. Schapiro, Chairwoman, SEC, Consumer Federation of America 21st Annual Financial Services Conference: The Consumer in the Financial Services Revolution (Dec. 3, 2009) (stating that she believes individual investors are the constituency to which the SEC must be most attuned to providing protection).

317. *See* Scott D. Museles, *To Be or Note to Be a Security: Reves v. Ernst & Young*, 40 CATH. U. L. REV. 711, 711 (1991) (stating that one of the main goals of the Securities Act of 1933 and Securities Exchange Act of 1934 was to "instate investor confidence in the markets").

318. *See, e.g.*, 17 C.F.R. § 230.144 (2012).

319. JAMES D. COX ET. AL., SECURITIES REGULATIONS: CASES AND MATERIALS 7, 268 (Vicki Been et al. eds., 7th ed. 2013).

320. *Id.* at 249.

321. *See infra* Part V.D.

322. *See, e.g.*, *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961), Dirks v. SEC, 463 U.S. 646 (1983).

approximating a level playing field.[323] Ideally, markets should be able to rely on publicly disclosed information. This allows value investors, or concentrated investors, to weigh investment risks in making investment allocation decisions. [324] The perception that it is impossible to trade successfully without access to insider information would undermine value investors from making trades, thereby reducing the availability of capital and liquidity.[325] There is little point engaging in research and investment calculations when you cannot trust the numbers.[326] High profile, insider-trading prosecutions are means of maintaining the perception that investors, particularly individual investors, are not trading in a rigged game.[327]

Similarly, the SEC recently adopted Regulation FD for fair disclosure.[328] In the late 1990s, evidence emerged that corporate insiders were sharing material nonpublic information, like earnings reports, with favored analysts and institutional investors prior to disclosing such information via the formal reporting process.[329] Such disclosures did not violate insider-trading rules because the information was not misappropriated, but was freely given, and the institutions breached no duty in trading on that information.[330] But the SEC saw it as problematic, and rightly so. "Investors who see a security's price change dramatically and only later are given access to the information responsible for that move rightly question whether they are on a level playing field with market

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323. James P. Jalil, *Proposals for Insider Trading Regulation After the Fall of the House on Enron*, 8 FORDHAM J. CORP. & FIN. L. 689, 692–93 ("One such perspective that endures to this day is that if confidence and trust are to be restored to the securities market, the investing public must correctly perceive that the securities markets are indeed a level playing field, and that investors privy to information not available to the investing public will not use that information to gain an advantage.").

324. *See* Basic Inc. v. Levinson, 485 U.S. 224, 259 (1988) ("[D]isclosure ... is crucial to the way in which the federal securities laws function.... [T]he federal securities laws are intended to put investors into a position from which they can help themselves by relying upon disclosures that others are obligated to make.") (quoting Shores v. Sklar, 647 F.2d. 462, 483) (White, J., concurring in part and dissenting in part).

325. *See generally* Michael J. Fishman & Kathleen M. Hagerty, *Insider Trading and the Efficiency of Stock Prices*, 23 RAND J. OF ECON. 106 (1992).

326. *Id.*

327. *See generally* George W. Dent, Jr., *Why Legalized Insider Trading Would Be a Disaster*, 38 DEL. J. CORP. L. 247 (2013).

328. Anthony T. Horgan, *Regulation FD Provides Firm Footing on Selective Disclosure High Wire*, 46 VILL. L. REV. 645, 646 (2001) ("The SEC adopted a scheme of regulations, known as Regulation FD (Fair Disclosure), to specifically address selective disclosure, regarding the practice as abusive because of the unfair advantage bestowed upon traders privy to the selectively disclosed information, and viewing its occurrence as frequent.").

329. SEC. & EXCH. COMM'N RELEASE NOTICE, Release No. 33-7881, Selective Disclosure and Insider Trading (Aug. 15, 2000).

330. *See* Dirks v. SEC, 463 U.S. 646, 665 (1983) (holding that there were no insider-trading violations where the tippee did not misappropriate or illegally obtain the information, did not wrongfully induce the information, and had no pre-existing fiduciary duty to disclose to its shareholders).

insiders."[331] The background section accompanying the announcement of Regulation FD drew the connection between Regulation FD and insider trading regulations: "Issuer selective disclosure bears a close resemblance in this regard to ordinary 'tipping' and insider trading.[332] In both cases, a privileged few gain an informational edge—and the ability to use that edge to profit—from their superior access to corporate insiders, rather than from their skill, acumen, or diligence."[333] The notion that investors make money through insider connections, rather than investment skill, implicates more than just basic fairness concerns. The widespread perception that one can only profit from trading with access to insiders would rationally deter anyone without connections from investing and trading.

It seems unlikely that individual investors would immediately stop trading if they lost their right to participate in class actions, although it would create an additional incentive to shift their funds into institutional investors. Whether this would be a positive development is not clear. Despite the widespread perception that individual investors are "at best uninformed, at worst fools" there is some evidence in the finance literature that a subset of such investors is sophisticated and may outperform the market.[334] Recent research has also suggested that individual investors serve the market by improving share price accuracy.[335] It is true that there are already good reasons for individuals to stop trading and invest through institutions, such as lower trading costs and improved diversification tools.[336] And while institutional investors have dramatically increased their market share in recent decades, a substantial minority of the market is still comprised of individual investors.[337] They might just incur more unsubsidized losses, subsidize institutional losses, and invest in a market with less deterrence.

Class action critics will point out, as I have already noted above, that class action recoveries are so small as to be of negligible value to investors, particularly individual investors. First, while that is true, that does not justify making these investors even worse off than they are now by barring the little

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331. *See* SEC. & EXCH. COMM'N RELEASE NOTICE, *supra* note 329.

332. *Id.*

333. *Id.*

334. Webber, *Plight*, *supra* note 111, at 178 ("Current financial scholarship supports [the] notion that there are undiversified yet skilled individual investors who outperform the market.").

335. Alicia J. Davis, *Do Individual Investors Affect Share Price Accuracy? Some Preliminary Evidence* 1 (Univ. Mich. Empirical Legal Studies Ctr., Working Paper No. 07-018, 2010), *available at* http://ssrn.com/abstract=998093 ("[C]ontrary to the received wisdom, retail trading increases share price accuracy." (emphasis omitted)).

336. *Cf.* Erik R. Sirri, *Trading Foreign Shares*, 26 ANN. REV. BANKING L. 315, 318 (2007) ("Demand has risen across the board (institutional and retail) as transactions costs have fallen. Institutional trading costs appear to have declined by about 23 basis points (roughly 5 cents per share) after the securities markets shifted in 2000 from trading in fractions, to trading in pennies—an average monthly savings of about $133 million in institutional trading costs.").

337. As of 2007, at least 26% of the public equities market was comprised of individual investors. SEC. INDUS. & FIN. MARKETS ASS'N, FACT BOOK 2007, 65 (2007).

compensation they do receive and forcing them to subsidize the losses of large institutions. But more importantly, if the goal is to get individual investors to stop investing because it would be in their own interests to invest through institutions, then perhaps we should consider outright banning individual trading—or at least openly dissuading individuals from trading—rather than inducing them to shift to institutions by continuously degrading their rights, undermining their ability to assert them, and penalizing them for trading in the first place.

B. The End of Pro Rata Compensation as a Goal of Shareholder Litigation

Critics often mock the compensation rationale for securities class actions. Recoveries as a percentage of damages claims have often been pitifully small, in the single-digit percentage range.[338] Judge Richard Posner argued almost 40 years ago that the purpose of such actions was not compensation but deterrence, and numerous other scholars have conceded that it is deterrence, and not compensation, that matters in these actions.[339] Securities fraud suffers from the problem of asymmetric harms and rewards; a CEO who nets millions of dollars for herself by inflating a firm's revenues can cause billions of dollars in harm when the truth is revealed.[340] This asymmetry of harms and rewards makes adequate compensation difficult to obtain.[341] Still, as I noted earlier, in the past two decades, courts and policymakers have not helped matters, by taking every opportunity to reduce compensation in such actions by: (1) placing a ceiling on damages;[342] (2) eliminating aiding and abetting liability;[343] (3) eliminating liability for fraud participants who were nonspeakers;[344] (4) denying discovery prior to a ruling on the motion to dismiss;[345] (5) instituting a higher pleading standard for scienter (the

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338. Patrick M. Garry et. al., *The Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform*, 49 S.D.L. REV. 275, 299 n. 176 (2004) (stating that settlement recovery of any shareholder class action was around eight percent of investor losses).

339. RICHARD POSNER, AN ECONOMIC ANALYSIS OF LAW 398 (3d Ed. 1988); *see also* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Practice,* 1992 U. ILL. L. REV. 691, 720 (1992).

340. *See* Ella Mae Matsumura & Jae Yong Shin, *Corporate Governance Reform and CEO Compensation: Intended and Unintended Conseuqences,* 62 J. OF BUS. ETHICS 101, 106 (2005) ("Moreover, self-serving CEOs opportunistically time good or bad news to maximize the value of stock options . . . there exists evidence suggesting that some CEOs attempt to maximize their wealth with stock prices boosted by accounting earnings, sometimes fraudulently.").

341. *See generally id.* (discussing various corporate governance to address adequate forms of compensating CEOs).

342. 15 U.S.C. § 78u-4(e) (2012).

343. Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

344. Stonebridge Inv. Partners, LLC v. Scientific-Atlanta, 552 U.S. 148 (2008) (finding respondents not liable to petitioner because respondents' deceptive acts were not relied upon by petitioners); Janus Capital Grp. Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011) (limiting primary liability under Rule 10b-5 to those persons who "made" the alleged misstatement).

345. *See* 15 U.S.C. § 78u-4(b)(3)(B) (2012).

highest pleading standard in civil procedure);[346] (6) narrowing the scope of causation;[347] (7) barring the litigation of securities cases by classes of 50 or more people in state court;[348] and (8) allowing defendants to contest the efficiency of the market for purposes of fraud-on-the-market theory.[349] Some academics have argued that compensation still plays an important role, that it reduces agency costs, and also serves a loss spreading function.[350]

As discussed above, institutional investors might see their compensation improve in arbitration. Thus, loss of the class action does not so much put an end to the concept of compensation itself, as it puts an end to the idea that investors should be compensated proportionally to their losses. This departs from the traditional securities regulation goals of individual investor protection and "level playing field values" discussed above.[351]

The loss of small compensation for individual investors might be outweighed by the benefits of institutional investor arbitration of shareholder claims. This would be particularly true if arbitration were to preserve or even enhance a deterrence function for private rights of action. Institutional investors with real losses may engage in appropriate case selection, bring meritorious cases, and vigorously litigate those cases. They might even improve the compensation they obtain in such actions over what they get now in class actions, although as noted, compensation for negative-value claimants will disappear altogether. It is also possible that institutional investors will demand, as a condition for settling an arbitration, that individually culpable defendants make personal payments towards the settlement. This has occurred on occasion, most notably in the WorldCom settlement.[352] In most instances, the benefits of private rights of action will inure primarily to institutions, if the class action ceases to exist. Individuals might still benefit from whatever deterrence institutions are able to obtain from arbitrating their claims. But that will likely only be true for the very largest defendants. As I discuss in the next Section, loss of the class action may eliminate any deterrent or compensatory tools for smaller actions. These losses will tend to

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346. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007). *See* Bell Atl. Corp. v. Twombly, 550 U.S. 544 (2007); Ashcroft v. Iqbal, 566 U.S. 662, 678 (2009) (raising pleading standards from a "possibility" to a "plausibility" standard asking "for more than a sheer possibility that a defendant has acted unlawfully." (citing *Twombly*, 550 U.S. at 556)).

347. Dura Pharm., Inc. v. Broudo, 544 U.S. 336 (2005).

348. *See* 15 U.S.C. § 77p(c) (stating that "any covered class action in any state court involving a covered security . . . shall be removable to the Federal district court in which the action is pending").

349. *See In re* Initial Pub. Offerings Sec. Litig., 471 F.3d 24 (2d Cir. 2006).

350. Park, *supra* note 307, at 325.

351. *See* Jalil, *supra* note 323.

352. *Implications of Demands for Personal Contributions to Securities Settlements by Defendant D&O's*, DUANE MORRIS 1, 1 (Jan. 25, 2005), http://www.duanemorris.com/alerts/static/A_InsEnron012505.pdf ("First WorldCom, now Enron – institutional lead plaintiffs are increasingly demanding that individual defendants pay out of their own pockets for corporate frauds.").

disproportionately harm individual investors, who are less diversified and therefore less able to withstand them.

CONCLUSION

Collective prosecution of securities-fraud and transactional claims has faced repeated threats in the past two decades. These threats have offered frequent opportunities for academics and practitioners to debate the merits of such actions and how they measure up to their deterrent and compensatory goals. These debates, in turn, have filtered back into the legislative and judicial arenas. The most recent, and potent threat, to shareholder and transactional class actions has emerged from a combination of recent Supreme Court cases like *Concepcion*, *American Express*, and *Animal Feeds*, along with Delaware cases like *Boilermakers* and *ATP*. These cases have opened the door to unilateral board adoption of mandatory-arbitration provisions requiring bilateral arbitration of nonconsolidated, individual shareholder claims against the company. *ATP* has permitted plaintiff-pays provisions that might render contingency-fee arrangements too risky, though the Delaware legislature is currently considering legislation to overrule the case. Dozens of companies have already adopted such provisions, which may effectively eliminate the shareholder class action or other means of collectively pursuing shareholder claims, or at least cause a substantial restructuring of the plaintiffs' bar.

This Article contributes to two decades of debate about shareholder class actions by describing what shareholder claims would look like without the class action device. I demonstrate that loss of the class action would eliminate most, if not all, negative-value claims, thereby eliminating any remedy for substantial investor losses. Further, I show that certain types of remedies would cease to be pursued without class action litigation. Specifically even positive-value claimants would no longer pursue remedies such as corporate governance reform and disclosure-only or amendment settlements. The value of these remedies, particularly disclosure-only lawsuits, may be so marginal or even negative that their loss would not be missed. I point out that, without the class action, most transactional litigation would disappear, and would shift into appraisal arbitration, if it were to persist in any form. I argue that loss of the class action would eliminate a layer of legal insulation for fiduciaries of large institutional investors with positive-value claims. Such institutions might see increases to their monitoring and litigation costs, and perhaps their recoveries too, while potentially coercing them into bringing actions they might otherwise prefer not to bring. I offer some suggestive evidence tending to show that there will be at least a subset of institutions that will have large enough claims to maintain the viability of some form of shareholder litigation or arbitration without class actions. I also raise the possibility that overall damages might not drop as much as anticipated, even as overall damages claims do, because institutions with positive-value claims might be able to recover more in arbitration than they do today in class actions. The logic of fee-shifting provisions plays out somewhat differently, substantially increasing the costs to plaintiffs, placing great and perhaps unbearable strain on plaintiffs' law firms, and deterring all but the most obviously meritorious lawsuits. I show that the bizarre insurance landscape for public-pension funds, currently the most active lead plaintiffs in shareholder class actions, may make them more inclined than not to pursue marginally positive-value claims, particularly in the face of mandatory arbitration, and to engage in herding behavior around claims activity. I assess the range of possible effects that loss of the class action will likely have on the plaintiffs' bar, from elimination of plaintiffs' firms, to new competition from traditional law firms, to thriving practices for a small set of firms with established relationships to institutional clients. While loss of the class action could prompt enhanced public enforcement via the SEC and other regulatory bodies, resource constraints suggest that public actors may be limited in their ability to fill the void.[353]

Finally, I assess how loss of the class action would clash with traditional policy goals of securities regulation, particularly its preoccupation with maintaining a level playing field for investors and protecting individual investors. I show that loss of the class action would create a "semi-circularity problem" where individual and other small investors not only are barred from recovering their losses, but are further burdened by having to subsidize the losses of institutional plaintiffs pursuing positive-value claims against companies still owned by individual and small institutional investors. This semi-circularity problem creates a distortion favoring large institutional investors at the expense of smaller institutions and individuals, although smaller investors might still benefit from any deterrence obtained by larger institutions bringing their own actions. I illustrate how loss of the class action is tantamount to abandonment of one traditional goal of shareholder litigation—compensation for injuries incurred—a goal that has been much maligned in recent years and may mostly matter insofar as it creates the aforementioned distortion. And I demonstrate that loss of the class action will eliminate any remedy for fraud or other corporate wrongdoing committed by smaller firms that today are targeted by class actions alone, and not the SEC.

These points demonstrate that loss of the class action would mark a dramatic change to shareholder rights, to shareholder regulation more generally, and to the private attorney-general model that has served as a cornerstone of securities enforcement policy for decades. Some may welcome these developments, while others condemn them. There is enough uncertainty, enough flexibility in any fair-minded person's assessment of the costs and benefits of such a momentous change, for reasonable people to disagree about its soundness. But there is substantial evidence that at least a subset of existing class actions are meritorious and value enhancing, that top firms and institutional lead plaintiffs, particularly public-pension funds, correlate with better outcomes for

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353. *See, e.g.*, Stephen Choi & Adam Pritchard, SEC Investigations and Securities Class Actions: An Empirical Comparison 11, 40 (U of Mich. Law & Econ. Research, Working Paper No. 12-022, 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2109739 (finding that median market capitalization for defendant firms in cases targeted by class actions alone ($765 million) is substantially smaller than median market capitalization in cases pursued by the SEC alone ($1.35 billion) or by both the SEC and class actions ($1.39 billion)). Choi and Pritchard conclude that the resource-constrained SEC avoids smaller cases.

shareholders.[354] An optimal reform to shareholder litigation would offer flexibility and nuance, allowing preservation of meritorious, value-enhancing actions while eliminating frivolous ones. It is true that there is some reason to believe that arbitration could at least preserve some of these actions for large institutional investors, and that those actions might have some advantages over class actions, while also retaining some of the disadvantages noted above. Fee shifting may eliminate claims by all but the least risk-averse investor. Perhaps the Delaware legislature will attempt to place the fee-shifting genie back in its jar; opposition from ISS might also prevent the widespread adoption of these provisions. Overall, the prospect for nuanced legislative action seems dim, both because of institutional barriers to legislative reform and the current dysfunctional state of Congress. In the final analysis, the fate of the shareholder class action may be decided by the same corporate boards of directors who are the defendants in these suits, and who bear the state law fiduciary duties and the securities law obligations that these actions are designed to enforce.

354. Cheng et al., *supra* note 232; Perino, *supra* note 95; Webber, *Private Policing*, supra note 95; Webber & Badawi, *supra* note 270; Badawi & Chen, *supra* note 274; Badawi, *supra* note 99; Krishnan et al., *supra* note 267.