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## Correcting Corporate Benefit: How to Fix Shareholder Litigation by Shifting the Doctrine on Fees

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# CORRECTING CORPORATE BENEFIT: HOW TO FIX SHAREHOLDER LITIGATION BY SHIFTING THE DOCTRINE ON FEES

SEAN J. GRIFFITH\*

**Abstract:** The current controversy in corporate law concerns whether firms can discourage litigation by shifting its cost to shareholders. But corporate law courts have long engaged in fee-shifting—from shareholder plaintiffs to the corporation—under the “corporate benefit” doctrine. This Article examines fee-shifting in shareholder litigation, arguing that current practices are unsound from the perspective of both doctrine and public policy. Unfortunately, the fee-shifting bylaws recently enacted in response to the problem of excessive shareholder litigation fare no better. The Article therefore offers a different approach to fee-shifting, articulating three specific reforms of the corporate benefit doctrine to quell the current crisis in shareholder litigation.

## INTRODUCTION

Delaware may at last be on the verge of fixing shareholder litigation. Spurred by the surprise 2014 decision of the Delaware Supreme Court in *ATP Tour, Inc. v. Deutscher Tennis Bund*,<sup>1</sup> the *de facto* national corporate law-maker has launched a thorough examination into fee-shifting in intra-corporate litigation.<sup>2</sup> The current controversy over fee-shifting is an outgrowth of a larger crisis in shareholder litigation. And, just as matters of substance and procedure

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<sup>1</sup> See 91 A.3d 554, 560 (Del. 2014).

<sup>2</sup> Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 350 (2001) (“The aggregated choices of a majority of publicly traded U.S. corporations have resulted in a convergence on the Delaware General Corporation Law as a *de facto* national corporate law.”) More than half of all public companies and over sixty percent of the Fortune 500 are incorporated in Delaware. See *Why Businesses Choose Delaware*, STATE OF DEL. DIV. OF CORP., [http://corplaw.delaware.gov/eng/why\\_delaware.shtml](http://corplaw.delaware.gov/eng/why_delaware.shtml), archived at <http://perma.cc/L59P-KRQS> (last visited Dec. 31, 2014). Delaware law is the basis of the corporate law curriculum in law schools across the U.S. and is widely followed by the courts of other states. John Armour et al., *Delaware’s Balancing Act*, 87 IND. L.J. 1345, 1398–99 (2012) (“Delaware law is a central part of the business law curriculum in most major U.S. law schools . . . Courts in other states often cite and follow Delaware case law when their own case law is sparse.”).

are inextricably interlinked, any examination into fee-shifting must also probe these deeper concerns. Delaware's inquiry into fee-shifting thus presents a unique opportunity to reevaluate the current system of shareholder litigation and to launch appropriate reforms.

The defects of shareholder litigation have long been known.<sup>3</sup> Basically, the problem is one of too much and not enough: too much in the way of filings, and not enough consideration at settlement.<sup>4</sup> In terms of filings, virtually every merger transaction is challenged, and derivative suits attend every corporate crisis, frequently following in the wake of prosecutorial or regulatory interventions.<sup>5</sup> The vast majority of these claims settle, an outcome that is not unusual for civil litigation. What is striking, however, is the predominance of non-pecuniary relief. The vast majority of shareholder litigation settles for no monetary recovery to the shareholder class.<sup>6</sup> Why? Because non-pecuniary relief nevertheless entitles plaintiffs' counsel to recover their fees from the corporate defendant under the "corporate benefit" doctrine.<sup>7</sup> The application of this doctrine has led to the result that *in shareholder litigation, the corporate defendant always pays fees and expenses for both sides*. Defense counsel, for their part, have reconciled themselves to this result by bargaining, in exchange, for a broad release of claims at settlement, immunizing their clients from any and all claims related to the underlying facts, including theories and claims never asserted by the plaintiffs.<sup>8</sup> Having struck this Faustian bargain, attorneys now churn a mass of filings and settlements, the ultimate result of which is over-compensation of attorneys (on both sides) and systematic under-compensation of the plaintiff class.

The opportunity to do something about this situation arose suddenly, in late spring 2014, in a surprise decision of the Delaware Supreme Court. In *ATP Tour, Inc. v. Deutscher Tennis Bund*, the Delaware Supreme Court held as a matter of law that Delaware corporations can adopt bylaws to shift attorneys'

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<sup>3</sup> See, e.g., *Hirschfeld v. Fitzgerald*, 51 N.E. 997, 999 (N.Y. 1898) (noting the risk that a shareholder plaintiff might be bought out, thereby leading to undercompensation of the class interest).

<sup>4</sup> See Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 153 (2004) (identifying frequent filings and low value settlements as key indicia of litigation agency costs).

<sup>5</sup> See *infra* notes 59–104 and accompanying text (discussing merger litigation); *infra* notes 37–58 and accompanying text (examining derivative litigation).

<sup>6</sup> See Jill E. Fisch & Sean J. Griffith & Steven Davidoff Solomon, *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform*, 94 TEX. L. REV. (forthcoming 2015) (manuscript at 2) (on file with authors) (supplying statistics on settlements of merger litigation); Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, 51 WM. & MARY L. REV. 1749, 1802–04 (2010) (supplying statistics on settlements of derivative litigation).

<sup>7</sup> See *infra* notes 105–137 and accompanying text (studying the role of the corporate benefit doctrine); *infra* notes 195–252 and accompanying text (exploring its doctrinal origins).

<sup>8</sup> See *infra* notes 88–104 and accompanying text (discussing the litigation release).

fees and litigation costs to unsuccessful plaintiffs in intra-corporate litigation.<sup>9</sup> Delaware corporations, in other words, can use bylaw amendments to enact the English (“loser pays”) Rule for shareholder suits.<sup>10</sup>

Because most shareholder plaintiffs sue in a representative capacity, fee-shifting would have an especially pronounced effect on shareholder suits. Current fee-shifting proposals would force the representative litigant, suing on behalf of the corporation or the class, individually to bear the corporation’s full cost of defending the suit.<sup>11</sup> The individual litigant’s upside, meanwhile, would remain limited to a *proportional* share of the recovery. By imposing the full downside risk on a litigant whose upside must be shared proportionally with the class, fee-shifting makes the bringing of representative shareholder actions economically irrational, even in cases involving potentially significant recoveries.<sup>12</sup>

The bar, understanding the threat posed by fee-shifting to shareholder litigation, reacted immediately.<sup>13</sup> In the space of two weeks, the Delaware Bar

<sup>9</sup> 91 A.3d at 560. The bylaw provision provided that claimants were obligated to pay “all fees, costs, and expenses of every kind and description (including, but not limited to, all reasonable attorneys’ fees and other litigation expenses)” of the opposing party in the event that the claimant “does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought.” *Id.* at 556.

<sup>10</sup> The question in *ATP Tour* concerned a Delaware non-stock corporation, not a stock corporation. *Id.* at 557. This, however, is likely a distinction without a difference. See Herbert F. Kozlov & Lawrence J. Reina, *Delaware Supreme Court Approves Fee-Shifting Bylaw for Non-Stock Corporations*, BUS. L. TODAY, June 2014, at 1, 1 (emphasizing that “the court’s decision in *ATP Tour* relies on and refers to other provisions in the Delaware General Corporation Law . . . and cases involving bylaws adopted by ‘regular’ stock corporations”). Perhaps more significantly, *ATP Tour* involved a closely held, member-managed organization, not a diffusely-held public corporation. For further discussion of this distinction, see *infra* notes 146–165 and accompanying text.

<sup>11</sup> See *infra* notes 143–194 and accompanying text. Some fee-shifting provisions also seek to impose costs on the lawyers bringing the claims on behalf of the representative plaintiff with similar results. See *infra* notes 143–194 and accompanying text.

<sup>12</sup> See *infra* notes 153–156 and accompanying text; see also Motion to Invalidate Retroactive Fee-Shifting and Surety Bylaw or, in the Alternative, to Dismiss and Withdraw Counsel at 8–9, *Kastis v. Hemispherx Biopharma, Inc.*, No. 8657-CB (Del. Ch., July 21, 2014) (“Plaintiffs and their counsel cannot pursue . . . claims if they will be at risk for hundreds of thousands or even millions of dollars in Defendants’ litigation costs. By enacting this draconian Bylaw, the Board imposed a risk that [no] economically rational stockholder or lawyer, could accept.”).

<sup>13</sup> Plaintiffs’ lawyers decried the “potentially devastating impact on shareholders’ rights” and quipped that the court’s endorsement of the English Rule had “caused Delaware to secede from the union.” Liz Hoffman, *Shareholder Suits May Prove Costly: Ruling Upholds Bylaw Requiring Loser to Pay Winner’s Legal Fees*, WALL ST. J., May 18, 2014, <http://www.wsj.com/news/articles/SB10001424052702304908304579565850165670972>, archived at <https://perma.cc/27FD-34NQ?type=pdf> (quoting Randall Baron); Tom Hals, *Delaware Upholds Fee-shifting Bylaw, Could Upend Class Actions*, REUTERS, May 9, 2014, <http://www.reuters.com/article/2014/05/09/delaware-courts-fees-idUSL2N0N V1PK20140509>, archived at <http://perma.cc/8F78-PF6B> (quoting prominent shareholder attorney Stuart Grant). The defense-side reaction was generally muted. Stephen F. Arcano et al., *Fee-Shifting Bylaws: The Current State of Play*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM (June 20, 2014), <https://www.skadden.com/insights/fee-shifting-bylaws-current-state-play>, archived at <https://perma.cc/8F78-PF6B>.

Association proposed an amendment to the Delaware General Corporation Law to restore the *status quo ante*.<sup>14</sup> The amendment proposed a *per se* ban on fee-shifting, barring corporations, whether by bylaw or charter, from imposing liabilities on shareholders.<sup>15</sup> The proposed amendment was formally introduced into the Delaware State Senate on June 3, 2014, with every expectation that it would pass by the end of the legislative session and be effective as of August 1, 2014.<sup>16</sup> After significant corporate lobbying,<sup>17</sup> however, the legislative process was halted by a resolution calling for “continued examination” into the issue.<sup>18</sup>

Because the policy issues underlying fee-shifting cannot be understood without taking into account current patterns and practices in shareholder litiga-

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cc/8ZGN-CLAA (“[T]here is a significant risk that adoption of fee-shifting bylaws . . . could generate a meaningful adverse reaction from, among others, governance advocates, proxy advisory firms and some stockholders.”); Theodore Mirvis et al., *With a Note of Caution, Delaware Rules Fee-Shifting Bylaws Facially Permissible*, WACHTELL, LIPTON, ROSEN & KATZ (May 21, 2014), <http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.23341.14.pdf>, archived at <http://perma.cc/Q7Y8-R6ZQ> (“We believe caution is in order . . . [I]n the public company context [there is] an inherent tension between the goal of deterring litigation and the danger of self-interested director action . . .”). However, some firms did advertise fee-shifting as a tool their clients ought to consider. Ronald O. Mueller & Jason J. Mendro, *The Supreme Court of Delaware Upholds Fee-Shifting Bylaws as Facially Valid*, GIBSON, DUNN & CRUTCHER (May 13, 2014), <http://www.gibsondunn.com/publications/Documents/Supreme-Court-of-Delaware-Upholds-Fee-Shifting-Bylaws-as-Facially-Valid.pdf>, archived at <http://perma.cc/U6RF-MRSQ> (noting that the opinion “may give Delaware corporations an important tool to discourage meritless shareholder litigation”); *WSGR ALERT: Delaware Supreme Court Endorses “Fee-Shifting” Bylaw in Certified Question of Law*, WILSON, SONSINI, GOODRICH & ROSATI 2 (May 12, 2014), <https://www.wsg.com/WSGR/Display.aspx?SectionName=publications/PDFSearch/wsgalert-fee-shifting.htm>, archived at <https://perma.cc/2CFF-LXBL> (stating that “boards of directors of private and public Delaware corporations should seriously consider adopting fee-shifting bylaws of their own”).

<sup>14</sup> S.B. 236, 147th Gen. Assemb., Reg. Sess. (Del. 2014) (noting that the amendment “is intended to limit applicability of [ATP Tow] to non-stock corporations”).

<sup>15</sup> See S.B. 236 § 331 (“Notwithstanding any other provision of this chapter, neither the certificate of incorporation nor the bylaws of any corporation may impose monetary liability . . . on any stockholder of the corporation . . .”).

<sup>16</sup> S.B. 236 (contemplating an August 1 effective date); see Daniel Fisher, *Is Delaware Law a Favor to Plaintiff Lawyers, or Shareholder Protection?*, FORBES (June 10, 2014), <http://www.forbes.com/sites/danielfisher/2014/06/10/is-delaware-law-a-favor-to-plaintiff-lawyers-or-protection-for-capitalists/>, archived at <http://perma.cc/D6K8-LXRF> (describing path of Senate Bill 236 through the Delaware legislature, including that S.B. 236 was “drafted with near-unanimous approval by the members of the Council and Senate sponsors”).

<sup>17</sup> See, e.g., Letter from C. Michael Carter, President & Chief Operating Officer, Dole Food Co., Inc., to Bryan Townsend, Senator, Del. Gen. Assembly (June 9, 2014) (on file with author); Letter from Lisa A. Rickard, President, Inst. for Legal Reform, U.S. Chamber of Commerce to Members of the Del. Gen. Assembly (June 9, 2014) (on file with author); Letter from Andrew Wynne, Dir. of State Legislative Affairs, U.S. Chamber of Commerce, to Bryan Townsend, Senator, Del. Senate (June 5, 2014) (on file with author).

<sup>18</sup> S.J. Res. 12, 147th Gen. Assemb., Reg. Sess. (Del. 2014), (calling upon “the Delaware State Bar Association, its Corporation Law Section, and the Council of that Section . . . to continue its ongoing examination of the State’s business entity laws with an eye toward maintaining balance, efficiency, fairness and predictability”).

tion, Delaware's inquiry into what to do about fee-shifting cannot proceed without also addressing the chronic problems in this area. Indeed, the question begged by fee-shifting in all of its forms—whether and how allocation of cost ought to be used to control the flow of litigation—begs the question of whether shareholders ought to be encouraged to sue or whether and in what situations shareholder suits ought to be discouraged.<sup>19</sup> This, in turn, depends upon the public policy goals of shareholder litigation and how well (or poorly) the current system achieves them. As a result, Delaware's "continued examination" is not and cannot be of fee-shifting alone. Rather, policy-makers must evaluate the system of shareholder litigation as a whole in order to understand what, if anything, ought to be done.

This Article offers guidance in that project. Its aims are threefold. First, Part I offers a comprehensive overview of current practices in shareholder litigation, detailing its typical patterns and probing underlying problems.<sup>20</sup> This analysis reveals courts' current application of the corporate benefit doctrine as the principal enabler of the systemic overcompensation of lawyers and undercompensation of plaintiffs. Next, Part II of the Article argues that fee-shifting bylaws, as they have so far been proposed, cannot fix what is fundamentally wrong with shareholder litigation because they target effects (excessive litigation) rather than the cause (misapplication of the corporate benefit doctrine).<sup>21</sup> As a result, they overreach, discouraging potentially valuable shareholder claims and failing to achieve the policy goals of shareholder litigation. Finally, this Article seeks to refocus the debate on the real cause of the present crisis in shareholder litigation. Part III demonstrates how misapplication of corporate benefit has transformed the principle of fee-sharing into a doctrine of fee-shifting.<sup>22</sup> And Part IV provides a concrete set of policy recommendations that target the fundamental cause—that is, the unconstrained generosity of current interpretations of the corporate benefit doctrine.<sup>23</sup>

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<sup>19</sup> Avery Wiener Katz & Chris William Sanchirico, *Fee-Shifting*, in *PROCEDURAL LAW & ECONOMICS, ENCYCLOPEDIA OF LAW AND ECONOMICS* 271, 303 (Chris William Sanchirico ed., 2d ed. 2012).

[R]ules of cost allocation feed back through the selection of cases to influence the development of other areas of substantive and procedural law. Rules that encourage parties to raise relatively innovative claims and defenses help to break down precedent, while rules that penalize risk-taking and novel arguments help to preserve traditional formal categories. Given the pervasive influence of ostensibly procedural rules on substantive outcomes, it may not be possible to separate the policy of fee-shifting from deeper questions of what the law ought to be.

*Id.* at 303.

<sup>20</sup> See *infra* notes 24–142 and accompanying text.

<sup>21</sup> See *infra* notes 143–194 and accompanying text.

<sup>22</sup> See *infra* notes 195–252 and accompanying text.

<sup>23</sup> See *infra* notes 253–311 and accompanying text.

The reforms ultimately urged by this Article can be seen as a kind of fee-shifting, not to the English Rule, but rather back to the American Rule, where each side finances its own litigation costs, and away from the current Delaware Rule, under which the corporation always pays. Specifically, this Article recommends: (1) that corporate benefit no longer be recognized as a basis for awarding attorneys' fees in non-derivative suits; (2) that the burden for establishing causation of the benefit be shifted to plaintiffs in certain cases; and (3) that the scope of the litigation release received by defendants in connection with settlement be proportional to the value recovered for the plaintiff class. Although each of these proposed rules must be put into operation by courts, legislative action may be needed to define the contours of the rules and to determine the limits of judicial discretion. The current moment provides the ideal opportunity to consider these reforms.

### I. PATTERNS AND PROBLEMS IN SHAREHOLDER LITIGATION

Shareholder litigation is intra-corporate litigation brought by shareholders, typically alleging a breach of fiduciary duties on the part of the board.<sup>24</sup> Individual shareholders may bring suits on their own.<sup>25</sup> Except in the case of activist investors, however, they rarely do.<sup>26</sup> Instead, most shareholder litigation is representative litigation, brought by a single shareholder or group of shareholders on behalf of an interest common to all.<sup>27</sup>

Plaintiffs' lawyers, here, as in other contexts, typically bring representative actions under contingency fee arrangements. Lawyers find their clients either by maintaining long-term relationships with institutional investors or by actively soliciting smaller investors.<sup>28</sup> Having found their client, the lawyers

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<sup>24</sup> This definition excludes private securities law cases, especially 10b-5 class actions, which can be understood as a form of shareholder litigation. It also excludes all other actions that might be brought against a corporation (e.g., employment, environmental, or products liability claims) that do not principally involve investor protection or shareholder rights.

<sup>25</sup> Thus, appraisal claims as well as takeover cases involving frustrated bidders, may be understood as forms of shareholder litigation, but they are excluded from this Article because they lack the "litigation agency costs" that are the subject of the analysis here. See, e.g., Minor Myers & Charles R. Korsmo, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 WASH. U. L. REV. (forthcoming 2015) (showing that appraisal actions have fewer indicia of litigation agency costs than fiduciary duty suits).

<sup>26</sup> For reasons why individual actions have not proliferated, see *infra* notes 246–248 and accompanying text.

<sup>27</sup> Formally, the shareholder claimant represents a class interest of shareholders, in the case of a class action, and the interest of the corporation itself in the case of a derivative suit. See *infra* notes 37–58 and accompanying text (discussing derivative suits); *infra* notes 59–104 and accompanying text (examining class actions).

<sup>28</sup> Nicholas Politan, *Mediating Securities Class Actions: A View from the Captain's Quarters*, INSTITUTIONAL INVESTOR ADVOC., 4th Quarter, 2005, at 1. For an example of a plaintiffs' firm soliciting individual clients, see *Family Dollar Stores, Inc.*, FARUQI & FARUQI, <http://www.faruqilaw.com/>

are more or less fully in control of the litigation.<sup>29</sup> Non-institutional investors with diffuse shareholdings are rationally indifferent to the conduct of the litigation,<sup>30</sup> and institutional investors, once thought to be the solution to the problem, have likewise shown themselves to be inconsistent monitors of shareholder litigation.<sup>31</sup> This results in the familiar problem of “litigation agency costs,” where the attorney conducts (and concludes) the litigation in ways that may depart from plaintiff interests.<sup>32</sup>

None of that, however, is especially unique to shareholder litigation. What is unique is the tendency of shareholder litigation to settle for non-pecuniary relief. In order to understand how and why this occurs, it is necessary to descend into the details of typical filing and settlement patterns. That is the work of the sections that follow. Sections A<sup>33</sup> and B<sup>34</sup> outline the paradigmatic forms of representative shareholder litigation—the derivative suit and the merger class action—discussing common claims under each. The aim of these sections is not to provide a comprehensive analysis of substantive corporate law, but rather to provide enough detail concerning each claim that patterns begin to emerge. After describing typical claims and settlement patterns, Section C then analyzes the judicial role in review and approval of settlement.<sup>35</sup> It is here that the causal role of the corporate benefit doctrine begins to

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FDO, *archived at* <http://perma.cc/SV6T-PPQL> (last visited Dec. 30, 2014) (soliciting clients for a class action involving the sale of Family Dollar Stores).

<sup>29</sup> As described by a prominent mediator of securities class actions:

[T]he mediator would ask the plaintiff’s lawyer to go out in the hall and speak to the client about a proposed offer. Perplexed, the plaintiff’s lawyer would respond, “I don’t have a client here.” “Well then,” the mediator would respond, “why don’t you go to the restroom, look in a mirror, talk to yourself, and come back here and tell me whether you want to accept the settlement or not.”

Politan, *supra* note 28, at 1.

<sup>30</sup> ROBERT CHARLES CLARK, *CORPORATE LAW* 389–94 (1986) (discussing phenomenon where each shareholder’s stake in the corporation is too small to justify the cost in terms of time and attention of actively engaging in corporate affairs).

<sup>31</sup> Compare Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 *YALE L.J.* 2053, 2121 (1995) (discussing promise of institutional lead plaintiffs), with 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, 934–35 (2014) (reporting results of empirical study of different types of institutional lead plaintiff).

<sup>32</sup> See John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 *L. & CONTEMP. PROBS.* 5, 23 (1985) (demonstrating the problem); Randall S. Thomas & Robert B. Thompson, *Empirical Studies of Representative Litigation*, in *RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW* 152, 154 (Claire A. Hill & Brett H. McDonnell eds., 2012) (summarizing recent empirical work on the scope of the problem and noting that “representative litigation introduces factors that can put daylight between the interests of lawyers and investors”).

<sup>33</sup> See *infra* notes 37–58 and accompanying text.

<sup>34</sup> See *infra* notes 59–104 and accompanying text.

<sup>35</sup> See *infra* notes 105–137 and accompanying text.



emerge. Section D closes this Part by highlighting the public policy challenge posed by shareholder litigation in its present state.<sup>36</sup>

### A. Derivative Suits

The derivative suit is the original form of representative action in the corporate context.<sup>37</sup> It is a suit brought by the shareholder on behalf of the corporation, which is to say the corporation is in fact the plaintiff, urged into action by the shareholder complainant.<sup>38</sup> As described in an old opinion of the Delaware Court of Chancery:

A bill filed by stockholders in their derivative right therefore has two phases—one is the equivalent of a suit to compel the corporation to sue, and the other is the suit by the corporation, asserted by the stockholders in its behalf, against those liable to it. The former belongs to the complaining stockholders; the latter to the corporation. The complaining stockholders are allowed in derivative bills to bring forward these two causes of action in one suit. But any recovery granted by the decree necessarily is in favor of the corporation. The complaining stockholders secure nothing to themselves as individuals, beyond the mere right, which is inherent in the decree for relief to the corporation, of compelling their recalcitrant corporation to accept the relief which the decree affords.<sup>39</sup>

Traditional derivative suits involve a loss to the corporation resulting from the bad acts of its directors or managers.<sup>40</sup> Shareholders must use the derivative suit to force the corporation to recover these losses because the corporation's managers are the wrong-doers and therefore not eager to bring claims against themselves.<sup>41</sup> Any recovery the shareholders win, however, is a recovery of the

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<sup>36</sup> See *infra* notes 138–142 and accompanying text.

<sup>37</sup> The form is old and, some argue, obsolete. GEOFFREY MILLER, *THE LAW OF GOVERNANCE, RISK MANAGEMENT, AND COMPLIANCE* 365 (2014) (referring to the derivative suit as a “platypus”).

<sup>38</sup> *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984) (“The nature of the action is two-fold. First, it is the equivalent of a suit by the shareholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it.”).

<sup>39</sup> *Cantor v. Sachs*, 162 A. 73, 76 (Del. Ch. 1932).

<sup>40</sup> *Levine v. Smith*, 591 A.2d 194, 200 (Del. 1991) (“A shareholder derivative suit is a uniquely equitable remedy in which a shareholder asserts on behalf of a corporation a claim belonging not to the shareholder, but to the corporation.”).

<sup>41</sup> *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 95 (1991) (“[T]he purpose of the derivative action [is] to place in the hands of the individual shareholder a means to protect the interest of the corporation from the misfeasance and malfeasance of ‘faithless directors and managers’” (citations omitted) (quoting *Cohen v. Beneficial Loan Corp.*, 337 U.S. 541, 548 (1949))); *accord Taormina v. Taormina Corp.*, 78 A.2d 473, 475 (Del. Ch. 1951) (“[W]henver a corporation possesses a cause of action which it . . . refuses to assert . . . equity will permit a stockholder to sue in his own name for the

corporation, paid into the treasury, confirming the notion that the corporation is in fact the plaintiff.<sup>42</sup>

Although the rubric for determining whether a claim is derivative or direct is easy to state—asking simply who suffered the harm and who received the benefit<sup>43</sup>—it is not always easy to apply.<sup>44</sup> Moreover, the same set of facts may give rise to both types of claims.<sup>45</sup> Nevertheless, claims involving voting or undercompensation in the purchase or cancellation of a shareholder's shares are understood as paradigmatic *direct* claims, basic rights that shareholders possess individually.<sup>46</sup> Most claims involving mergers and acquisitions, therefore, are non-derivative in nature.<sup>47</sup> Claims alleging waste, meanwhile, are paradigmatic derivative suits.<sup>48</sup>

Studies of current patterns in derivative litigation reveal that derivative suits frequently are filed in federal court, often by repeat play law firms on behalf of shareholders with insignificant ownership stakes.<sup>49</sup> Derivative suits

benefit of the corporation solely for the purpose of preventing injustice when it is apparent that the corporation's rights would not be protected otherwise.”).

<sup>42</sup> Jessica Erickson, *Corporate Misconduct and the Perfect Storm of Shareholder Litigation*, 84 NOTRE DAME L. REV. 75, 81 (2008) (“In a derivative suit, the corporation is the functional plaintiff—the real party in interest . . . . Any recovery in a derivative suit is returned to the corporation. As a result, shareholders . . . do not receive any direct financial benefit.”).

<sup>43</sup> *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004) (stating that the standard “must turn *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)”).

<sup>44</sup> *See, e.g., Abelow v. Symonds*, 156 A.2d 416, 420 (Del. Ch. 1959) (“The line of distinction between derivative suits and those brought for the enforcement of personal rights asserted on behalf of a class of stockholders is often a narrow one. . . .”). Courts occasionally have struggled, for example, with claims involving the issuance of stock for inadequate compensation, which directly harms the corporation but also dilutes its shareholders. *See, e.g., In re J.P. Morgan Chase & Co. S’holders Litig.*, 906 A.2d 808, 818–19 (Del. Ch. 2005) (“[When a] board of directors authorizes the issuance of stock for no or grossly inadequate consideration, the corporation is directly injured and shareholders are injured derivatively. . . . [M]ere claims of dilution, without more, cannot convert a claim traditionally understood as derivative, into a direct one.” (citations and internal quotations omitted)).

<sup>45</sup> *See, e.g., Gentile v. Rossette*, 906 A.2d 91, 99–100 (Del. 2006) (describing “a species of corporate overpayment . . . that Delaware case law recognizes as being both derivative and direct in character.”); *Grimes v. Donald*, 673 A.2d 1207, 1212 (Del. 1996) (claim alleging excessive compensation derivative but board abdication direct).

<sup>46</sup> *Gatz v. Ponsoldt*, 925 A.2d 1265, 1277 (Del. 2007) (holding shareholders’ claim to be direct “because the Recapitalization constituted an expropriation of voting power and economic value from [the Company’s] public stockholders, and a transfer of that voting power and economic value to [the defendants]”).

<sup>47</sup> *See generally* Thompson & Thomas, *supra* note 4 (distinguishing between derivative suits and merger class actions and finding that merger class actions dominate derivative filings in Delaware for the period under study). For further discussion of merger litigation, see *infra* notes 59–104 and accompanying text.

<sup>48</sup> *See generally* R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, 2 DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 13.10 (2006) (“Claims of waste will always be derivative claims. . . .”).

<sup>49</sup> Erickson, *supra* note 6, at 1754–68.

follow fast upon corporate mishaps and often are filed in the wake of securities fraud class actions or enforcement actions by regulators or prosecutors and mimic allegations made in the prior action.<sup>50</sup> Claims of this type therefore have been labeled “tag-along” derivative suits.<sup>51</sup> The settlement of these claims typically focuses on non-pecuniary relief—changes to corporate governance provisions or corporate compliance programs to prevent the particular mishap from recurring, sometimes referred to as corporate “therapeutics.”<sup>52</sup> Substantial monetary recovery is uncommon.<sup>53</sup> The plaintiffs’ lawyers, nevertheless, are entitled to recover their fees from the defendant corporation on the basis of the settlement’s therapeutic benefit.

Derivative suits have, over their long history, developed an assortment of procedural obstacles to prevent abuse.<sup>54</sup> These include the continuous ownership requirement,<sup>55</sup> the posting of bonds,<sup>56</sup> the demand requirement,<sup>57</sup> and the formation of special litigation committees.<sup>58</sup> The shareholder class action, by contrast, need satisfy none of these legal hurdles.

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<sup>50</sup> Jessica M. Erickson, *Overlitigating Corporate Fraud: An Empirical Examination*, 97 IOWA L. REV. 49, 80 (2011).

<sup>51</sup> TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT 23 (2010) (noting the “tagalong derivative suit” that is likely to be filed in the wake of the 10b-5 claim”). For a current example of such a suit, see *In re Walmart Stores, Inc. Del. Derivative Litig.*, Consol. C.A. No. 7455-CS (Del. Ch. July 24, 2012) (alleging harm from failures of corporate governance and compliance that also led to a massive federal FCPA investigation). The same phenomenon is occasionally referred to as “coattail” litigation. See Howard M. Erichson, *Coattail Class Actions: Reflections on Microsoft, Tobacco, and the Mixing of Public and Private Lawyering in Mass Litigation*, 34 U.C. DAVIS L. REV. 1, 5 (2000).

<sup>52</sup> George D. Hornstein, *Legal Therapeutics: The “Salvage” Factor in Counsel Fee Awards*, 69 HARV. L. REV. 658, 663 (1956).

<sup>53</sup> Erickson, *supra* note 6, at 1802–03 (finding “meaningful financial benefit” in two out of every 101 “classic derivative suits” in her sample).

<sup>54</sup> See, e.g., George D. Hornstein, *Problems of Procedure in Stockholder’s Derivative Suits*, 42 COLUM. L. REV. 574, 574 (1942) (providing recommendations to the New York Law Revision Commission concerning procedural reforms in derivative suits in response to perceived abuses of the form).

<sup>55</sup> DEL. CODE ANN. tit. 8, § 327 (2014). For forceful criticism of the “comporaneous ownership” aspect of § 327, see generally J. Travis Laster, *Goodbye to the Contemporaneous Ownership Requirement*, 33 DEL. J. CORP. L. 673 (2008) (advocating that § 327 should require only that derivative plaintiffs hold stock at the time of lawsuit and that they not voluntarily divest during the lawsuit).

<sup>56</sup> See, e.g., George D. Hornstein, *The Death Knell of Stockholders’ Derivative Suits in New York*, 32 CAL. L. REV. 123, 123 (1944) (discussing the passage of the New York state bond posting requirement for derivative suits and questioning its constitutionality). There is no bond posting requirement in Delaware.

<sup>57</sup> DEL. CH. CT. R. 23.1(a) (requiring that the plaintiff “allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors . . . or the grounds for not making the effort”). The demand requirement can be seen as much as an outgrowth of the corporate form—the board directs the corporation, including in the decision to sue—as a means of mitigating abuse.

<sup>58</sup> See Minor Myers, *The Decisions of Corporate Special Litigation Committees: An Empirical Investigation*, 84 IND. L.J. 1309, 1320 (2009) (studying the current operation of special litigation

## B. Merger Class Actions

Shareholders dissatisfied with board conduct in the context of a merger transaction may bring their complaint in the form of a class action, rather than a derivative suit.<sup>59</sup> Recently, mergers have become a magnet for low-value shareholder suits.<sup>60</sup> Currently, in the United States, over ninety-seven percent of deals attract at least one shareholder claim, and many attract several such claims filed in multiple jurisdictions.<sup>61</sup> Whether these filings result in monetary relief for the plaintiff class depends strongly on the nature of the allegations. If the underlying transaction involves a deal with a controlling shareholder, the claim likely will result in monetary relief.<sup>62</sup> If, by contrast, the underlying transaction is a third party merger, it almost certainly will not.<sup>63</sup> As the following sections demonstrate, however, even when the claim results in monetary relief, it is far from clear that such relief is in fact a product of the plaintiffs' efforts.

### 1. Controlling Shareholder Deals

Controlling shareholder merger litigation raises traditional conflict of interest issues.<sup>64</sup> In these cases a shareholder exercising voting control over the

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committees and finding that committees pursue claims ten percent of the time, settle thirty percent of the time, and seek dismissal sixty percent of the time).

<sup>59</sup> See Thompson & Thomas, *supra* note 4, at 168 (reporting the results of a multiyear study of Delaware chancery court litigation finding that “[a]lmost all (94 percent: 772 of 824) class action suits arise in an acquisition setting whereas almost all (90 percent: 123 of 137) of the derivative suits arise in a non-acquisition setting”). The reference to “shareholders” here and throughout this Article is to shareholders of the *acquired* corporation. Shareholders of the *acquiring* company may be dissatisfied as well, but because their status as shareholders is fundamentally unchanged by the transaction, any claims they may possess against their board are likely to be insubstantial. Such claims will be derivative in nature—the fundamental injury, overcompensating the target, is derivative of the acquiring corporation’s—and will face the substantive hurdle of the business judgment rule, as opposed to the heightened substantive standards afforded to target shareholders.

<sup>60</sup> It has not always been so. For example, in 2007, only fifty-three percent of mergers attracted shareholder claims. *Recent Developments in Shareholder Litigation Involving Mergers and Acquisitions*, CORNERSTONE RESEARCH 2 (2012), [http://www.cornerstone.com/files/upload/Shareholder\\_MandA\\_Litigation-pdf.aspx](http://www.cornerstone.com/files/upload/Shareholder_MandA_Litigation-pdf.aspx), archived at <https://perma.cc/M4EA-F8VV?type=source>.

<sup>61</sup> Matthew D. Cain & Stephen M. Davidoff, *Takeover Litigation in 2013*, at 1 (Ohio State Pub. Law & Legal Theory, Working Paper Series No. 236, (2014), available at <http://ssrn.com/abstract=2377001>, archived at <https://perma.cc/U33H-VAA7?type=source> (finding an average of seven separate lawsuits filed in each case).

<sup>62</sup> Fisch et al., *supra* note 6 (manuscript at 5).

<sup>63</sup> *Id.*

<sup>64</sup> This can be understood as a conflict of interest on the part of the acquiring corporation’s board that has been appointed by the controller and is therefore likely to be conflicted between the controller’s interest (as buyer) to pay as little as possible for the corporation and the minority shareholders’ interest (as sellers) to maximize the price paid for their shares. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362 (Del. 1993) (“Classic examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally.” (citations omitted)).

corporation forces minority shareholders into a transaction resulting in the termination of their shareholding interest. Because control over the vote effectively allows the controlling shareholder to dictate terms to the minority, Delaware law applies the exacting “entire fairness” standard of review to scrutinize these transactions.<sup>65</sup>

In response to this heightened standard of judicial review, merging companies invariably appoint an independent committee of the board to negotiate with the controller.<sup>66</sup> Although the amount of deference courts are willing to give a special negotiating committee recently has evolved,<sup>67</sup> it remains extremely difficult for defendant corporations to prevail in controlling shareholder cases on the motion to dismiss or even summary judgment.<sup>68</sup> This combination of a difficult substantive standard and a procedural inability to avoid discovery creates a strong incentive for defendants to settle these cases.<sup>69</sup>

Settlement of controlling shareholder cases follows a formalistic, highly ritualized pattern referred to as a “minuet,” or alternatively, a “Kabuki dance.”<sup>70</sup> The process starts when the special committee begins to negotiate

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<sup>65</sup> *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711–15 (Del. 1983) (requiring fair dealing and fair price in non-arm’s length transactions).

<sup>66</sup> This is as much a function of the conflict facing the board, an obvious response to which is the formation of an independent committee, as it is an attempt to win judicial deference described below. *Cf. Weinberger*, 457 A.2d at 709–10 n.7.

<sup>67</sup> If the transaction is structured as a two-step tender offer followed by short form merger, the involvement of the special committee in negotiating the tender offer will be an important factor in shifting the standard of review from entire fairness to the business judgment rule. *See In re Siliconix, Inc. S’holders Litig.*, C.A. No. 18700, 2001 WL 716787, at \*2 (Del. Ch. June 19, 2001) (applying the business judgment rule rather than entire fairness to the Section 253 merger portion of a two-step transaction with other procedural protections, including a special committee and majority of minority condition). If the transaction is not structured as a two-step, the involvement of a special committee will at least function to shift the burden of proof of fairness from the board to the plaintiffs challenging the transaction. *See Kahn v. Lynch Comm’n Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994) (“[P]olicy . . . mandates careful judicial scrutiny of a special committee’s real bargaining power before shifting the burden of proof on the issue of entire fairness.”). The involvement of a special committee and a majority of minority vote may also shift the standard of review to the business judgment rule. *See Kahn v. M&F Worldwide Corp.*, 88 A.3d 635, 644 (Del. 2014).

<sup>68</sup> Even when the appropriate procedural protections are used, the question whether the special committee functioned properly is not one that can be easily answered at the motion to dismiss stage. The ability to shift the burden may thus fail to entitle defendants to an early dismissal. *M&F Worldwide Corp.*, 88 A.3d at 645 n.14. *But see Swomley v. Schlect*, CA No. 9355-VCL, 66–68 (Del. Ch. Aug. 27, 2014) (granting a motion to dismiss on the basis of procedural protections and noting that “the whole point of encouraging [the *M&F Worldwide*] structure was to create a situation where defendants could effectively structure a transaction so that they could obtain a pleading-stage dismissal against breach of fiduciary duty claims”).

<sup>69</sup> *In re Cox Commc’ns, Inc. S’holders Litig.*, 879 A.2d 604, 605 (Del. Ch. 2005) (“[E]ach *Lynch* case has settlement value, not necessarily because of its merits but because it cannot be dismissed.”).

<sup>70</sup> *In re Revlon, Inc. S’holders Litig.*, 990 A.2d 940, 945 (Del. Ch. 2010) (referring to “the opening steps in the *Cox Communications* Kabuki dance”); *In re Emerging Commc’ns, Inc. S’holders Litig.*, 2004 WL 1305745, at \*42 (Del. Ch. May 3, 2004) (referring to a “scripted minuet wherein [the

the terms of the transaction with the controller, a process that very often yields an increase in the merger price.<sup>71</sup> Roughly contemporaneously, the shareholder plaintiffs will have sued, alleging conflict and undercompensation, and settlement negotiations begin.<sup>72</sup> As the special committee's negotiation with the controller nears an end, and the ultimate merger price is finally on the table, defense counsel will offer to settle with plaintiffs' counsel at that price. Because this offer entitles them to recover fees, plaintiffs' counsel will happily agree.<sup>73</sup>

In this way, the problem with controlling shareholder cases is not that they fail to produce monetary relief. It is that the monetary relief they produce may in fact have no relationship to the litigation. The plaintiffs' lawyers' incentive is to "file early and free-ride" on the special committee's efforts, thus replicating the overcompensation and undercompensation problems already identified.<sup>74</sup> The free-riding lawyers are overpaid while the class interest is underserved by class counsel who sit back and wait to collect fees based upon the special committee's efforts. The actual impact of the litigation on the ultimate outcome is willingly obscured by both parties in order to protect the settlement.

## 2. Third-Party Mergers

Third-party merger cases do not involve the obvious conflict of interest created by the presence of a controlling shareholder on the other side of the transaction. Shareholders therefore are not entitled to the exacting "entire fairness" standard. Nevertheless, as long as the transaction invokes a fundamental

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Committee] would bargain for a negligible price increase . . . [creating] a credible record of 'arm's length' negotiations sufficient to survive entire fairness review.").

<sup>71</sup> This could be for either of two reasons: (1) the special negotiating committee has real negotiating power and uses it to extract price concessions from the buyer; or more cynically (2) both sides understand that in order to minimize liability risk, the special litigation committee must be seen to be "effective," for which the increase in price can be offered as evidence. If the latter explanation is correct, of course, the controller may merely hold back a portion of its ultimate price in the initial offer, such that the price concession extracted by the special committee is in fact illusory.

<sup>72</sup> The rough contemporaneity is possible because controlling shareholder transactions are often public before the merger agreement is signed. Because these transactions must be blessed by a special committee, they are typically announced as proposals when the special committee is formed, thus allowing shareholder plaintiffs to challenge the proposal and thereby become a part of the negotiation with the special committee. See *Cox Commc'ns*, 879 A.2d, at 620 ("Instead of suing once a controller actually signs up a merger agreement with a special committee of independent directors, plaintiffs sue as soon as there is a public announcement of the controller's intention to propose a merger.").

<sup>73</sup> See *id.* at 621 ("[T]he artistry of defense counsel is to bring [both] tracks to the same destination at the same time. . . . When [the final] price is known but before there is a definitive deal, defense counsel . . . makes its 'final and best offer' to plaintiffs' counsel. The plaintiffs' counsel then accepts . . .").

<sup>74</sup> See Elliott J. Weiss & Lawrence J. White, *File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions*, 57 VAND. L. REV. 1797, 1799 (2004) (documenting the phenomenon).

“change of control” of the target company,<sup>75</sup> shareholders benefit from the heightened standard of “enhanced scrutiny.”<sup>76</sup> The shareholders’ fundamental complaint, in the context of third-party mergers, is that the board breached its fiduciary duties by adopting a flawed merger process, often due to hidden conflicts of interest, the ultimate result of which is inadequate consideration in the merger.<sup>77</sup>

To their process claims, shareholder litigants in third-party merger cases typically append complaints concerning the quality and amount of disclosure received in connection with the merger transaction. Although the form and content of merger disclosure is driven in large part by federal securities law,<sup>78</sup> state courts have derived disclosure duties from the statutory requirement that the board put the merger to a shareholder vote.<sup>79</sup> State corporate law on merger disclosures now sits alongside and substantially overlaps federal proxy regulation.<sup>80</sup>

<sup>75</sup> Abbreviating somewhat, a change of control transaction is generally understood to involve either cash or other non-stock consideration or a transaction wherein a diffusely held corporation comes under the sway of a controlling shareholder. *See* *Paramount Commc’ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 37 (Del. 1993) (incorporating the diffuse-to-controlling shareholder aspect of the standard); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 185 (Del. 1986) (first announcing the doctrine).

<sup>76</sup> Although there is general agreement on what situations currently give rise to enhanced scrutiny, there is debate over how broadly it ought to be applied. *Compare* J. Travis Laster, *Revlon Is a Standard of Review: Why It’s True and What It Means*, 19 *FORDHAM J. CORP. & FIN. L.* 5, 7 (2013) (criticizing the *Paramount* doctrine and seeking to articulate a broader basis for enhanced scrutiny), *with* Stephen M. Bainbridge, *The Geography of Revlon-Land*, 81 *FORDHAM L. REV.* 3277, 3337–38 (2013) (disputing the extension of enhanced scrutiny into non-traditional applications).

<sup>77</sup> The strongest cases identify some conflict of interest affecting board decision-making. *See, e.g.*, *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1264 (Del. 1988) (management team’s financial interest in winning auction and its domination of the nominally independent board contaminated sale process); *In re El Paso Corp. S’holder Litig.*, 41 A.3d 432, 442 (Del. Ch. 2012) (investment banker conflict of interest); *In re Del Monte S’holders Litig.*, C.A. No. 6027-VCL (Del. Ch., Dec. 1, 2011) (investment banker conflict of interest); *In re Topps Co. S’holders Litig.*, 926 A.2d 58, 91 (Del. Ch. 2007) (interest of founding family in remaining in management may have caused target to prefer private equity bidder).

<sup>78</sup> Federal requirements derive from the Proxy Rules. Securities Exchange Act of 1934 § 14(a), 15 U.S.C. § 78n(a)–(d) (2012).

<sup>79</sup> DEL. CODE ANN. tit. 8, § 251(c) (2014) (requiring a shareholder vote on mergers); *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992) (implying disclosure duties from the mandatory shareholder vote); *see also* Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director’s Fiduciary Disclosure Duty*, 49 *VAND. L. REV.* 1087, 1096 (1996) (describing the development of the duty of disclosure under Delaware corporation law).

<sup>80</sup> Elliot J. Weiss & Lawrence J. White, *Of Econometrics and Indeterminacy: A Study of Investors’ Reactions to “Changes” in Corporate Law*, 75 *CALIF. L. REV.* 551, 572 (1987) (criticizing Delaware decisions that “moved Delaware law from a posture of requiring less disclosure than federal law requires to a posture of requiring more . . .”). Innovations in Delaware disclosure duties have been driven by investment bankers and private equity firms. *See generally* Lloyd L. Drury III, *Private Equity and the Heightened Fiduciary Duty of Disclosure*, 6 *N.Y.U. J. LAW & BUS.* 33 (2010) (noting that state courts’ ability to alternate “between hard edged rules and fuzzy standards” enables them to “generate a more subtle and effective form of regulation than the federal pattern of enacting govern-

The typical pattern of third-party merger claims is for a filing to be made during the pendency of the transaction, often immediately upon public announcement of the transaction, and for the entire litigation effort to take place between the signing and closing of the transaction. The shareholder plaintiffs seek equitable relief—an injunction barring consummation of the transaction—and, in the meantime, expedited discovery. But Delaware courts rarely enjoin deals, even when plaintiffs identify a clear conflict of interest.<sup>81</sup> Instead, most such cases settle, often prior to the hearing on the motion for a preliminary injunction.<sup>82</sup> Moreover, most of these are “settlement class actions,” cases where the settlement is negotiated prior to certification of the class and where the approval of the settlement and certification of the class ultimately occur in the same hearing.<sup>83</sup>

In the vast majority of these settlements the only consideration received by plaintiffs is supplemental disclosure in the merger proxy.<sup>84</sup> The rest involve some amendment to the merger agreement, typically the deal protection terms, such as a reduction in the termination fee or the extension of a go-shop or window-shop period.<sup>85</sup> Pecuniary relief is vanishingly rare.<sup>86</sup> Nevertheless, the plaintiffs’ lawyers are entitled to have their fees paid by the defendant corporation in recognition of the benefit created by the supplemental disclosures. On

ance mandates”); Blake Rohrbacher & John Mark Zeberkiewicz, *Fair Summary: Delaware’s Framework for Disclosing Fairness Opinions*, 63 BUS. LAW. 881 (2008) (describing the role investment bankers play in disclosure duties between directors and shareholders).

<sup>81</sup> See, e.g., *In re El Paso Corp.*, 41 A.3d at 439 (Del. Ch. 2012) (“Although a reasonable mind might debate the tactical choices made by the El Paso Board, these choices would provide little basis for enjoining a third-party merger approved by a board overwhelmingly comprised of independent directors, many of whom have substantial industry experience.”). The most likely situation for injunctive relief involves the presence of an intervening bidder. See *infra* note 277 and accompanying text.

<sup>82</sup> See CORNERSTONE RESEARCH, *supra* note 60 (“Of the 190 unique settlements we identified, 180 were reached before the merger closed. Most of these were reached shortly before a hearing on the plaintiffs’ motion for preliminary injunction . . . or shortly before the shareholder vote. The median time between lawsuit filing and settlement in this sample was forty-four days.”); Fisch et al., *supra* note 6 (manuscript at 8) (citing studies that found “that nearly 70% of merger cases settle, while the rest are dismissed”).

<sup>83</sup> See Howard M. Erichson, *The Problem of Settlement Class Actions*, 82 GEO. WASH. L. REV. 951, 957–62 (2014) (arguing that these actions involve class counsel selling something they don’t own); Richard L. Marcus, *They Can’t Do That, Can They? Tort Reform via Rule 23*, 80 CORNELL L. REV. 858, 900 (1995) (distinguishing settlement class actions from ordinary settlements on the basis of “proxies” for negotiation and the substitution of “gross judicial fiat” for contractual agreement).

<sup>84</sup> Cain & Davidoff, *supra* note 61, at 16 (“Settlements which only require disclosure constitute 55.1% of the settlement types in the sample and are the most common type of settlement.”); Robert M. Daines & Olga Koumrian, *Shareholder Litigation Involving Mergers and Acquisitions*, CORNERSTONE RESEARCH 6 (Feb. 2013), <https://www.cornerstone.com/GetAttachment/9d8fd78f-7807-485a-a8fc-4ec4182dedd6/2012-Shareholder-Litigation-Involving-M-and-A.pdf>, archived at <https://perma.cc/9MZP-3496?type=pdf> (in 81% of merger cases filed in 2012, the only product of the settlement was additional disclosure).

<sup>85</sup> Fisch et al., *supra* note 6 (manuscript at 15–16).

<sup>86</sup> *Id.*



average, plaintiffs' attorneys are awarded fees in the range of \$350,000–\$700,000 for the settlement of such cases.<sup>87</sup> In exchange for paying the lawyers, defendants receive a broad litigation release, described in greater detail below.

### 3. Litigation Release and Claim Preclusion

The defense side to the settlement bargain is the release of claims. Defendants are willing to concede corporate benefit and pay attorneys' fees in exchange for a release from the plaintiffs' claims. It is important to emphasize, however, that the litigation release received by defendants in this context does not apply only to claims brought by plaintiffs in the present litigation. It also applies to any and all claims arising from the same underlying facts. This is so regardless of whether alternative legal theories arising from the same underlying facts actually were or even could have been raised by plaintiffs in the present action.<sup>88</sup> Moreover, once approved by a state court, settlements extinguish the ability of shareholders to litigate related claims in any U.S. court.<sup>89</sup> Preclusion of subsequent claims is a source of considerable value to defendants.<sup>90</sup> They therefore seek to maximize its scope by drafting the broadest possible litigation releases.

Defendants typically insist upon and receive releases extending to “all possible claims, known or unknown, asserted or unasserted, arising out of or relating to the events that were the subject of the litigation.”<sup>91</sup> To give the re-

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<sup>87</sup> *Id.* (“In disclosure-only settlements, the average fee award has declined over the past several years, from an average of \$730,000 in 2009 to an average of \$540,000 in 2012. Studies show that the average fee awarded in disclosure settlements in Delaware is approximately \$500,000.”).

<sup>88</sup> *Nottingham Partners v. Dana*, 564 A.2d 1089, 1106 (Del. 1989) (“[A] court may permit the release of a claim based on the identical factual predicate as that underlying the claims in the settled class action even though the claim was not presented and might not even [have] been presentable in the class action.”).

<sup>89</sup> U.S. CONST. art. IV, § 1 (“Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State.”); 28 U.S.C. § 1738 (2012) (further illuminating the Full Faith and Credit demand); *see also* *Matsushita Elec. Indus. Co. v. Epstein*, 516 U.S. 367, 399 (1996) (holding that a Delaware settlement was entitled to full faith and credit and precluded federal court plaintiffs from continuing their lawsuit unless they could show a due process violation in the suit that settled first). *See generally* *Pyott v. Louisiana Mun. Police Emps.’ Ret. Sys.*, No. 380, 2013 WL 1364695 (Del. Apr. 4, 2013) (dismissing suit filed in Delaware based on California court’s prior dismissal of derivative action with prejudice).

<sup>90</sup> Sean J. Griffith & Alexandra D. Lahav, *The Market for Preclusion in Merger Litigation*, 66 VAND. L. REV. 1053, 1058 (2013) (“The preclusive effect of settlement creates enormous value for the defendant. Without it, defendants’ planned transactions will be burdened by potentially large contingent liabilities and may even be enjoined. Upon reaching a preclusive settlement and resolving all shareholder claims, the transaction can move forward to closing.”).

<sup>91</sup> *Brinckerhoff v. Texas E. Prods. Pipeline Co.*, 986 A.2d 370, 385 (Del. Ch. 2010). For example, consider the following provision, taken at random from a recent stipulation of settlement in a merger class action:

[This Release grants] full and complete dismissal of the Action with prejudice, a permanent injunction barring, and . . . the settlement and release of: any claims, demands,

lease the greatest possible effect, class counsel separately agrees that the class members will waive any legal rights they may have that would limit the effect of the release.<sup>92</sup> Appraisal actions and claims to enforce the settlement are typically the sole claims excluded from releases in the deal context.<sup>93</sup>

The breadth of such releases and their ability to create lasting and far-reaching impairments of shareholder rights, however, raises a nest of serious policy considerations. Overbroad releases have been held to trigger substantive due process concerns.<sup>94</sup> Courts therefore may inquire into the fairness of the release at the time of settlement.<sup>95</sup> Generally, however, courts engage in this

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rights, actions, causes of action, . . . matters and issues known or unknown, contingent or absolute, suspected or unsuspected, disclosed or undisclosed, liquidated or unliquidated, matured or unmatured, accrued or unaccrued, apparent or unapparent, that have been or could have been asserted in any court, tribunal, or proceeding (including but not limited to any claims arising under federal, state, foreign, or common law, including the federal securities laws and any state disclosure law) . . . which the Releasing Persons ever had, now have, or may have had by reason of, arising out of, relating to, or in connection with the acts, events, facts, matters, transactions, occurrences, statements, or representations, set forth in or otherwise related, directly or indirectly, to the allegations in the Action, the Amended Complaint, financial or other advisory services in connection with the Merger, the Merger Agreement and any amendments thereto, and other transactions contemplated therein, or disclosures made in connection therewith (including the adequacy and completeness of such disclosures) (the “Settled Claims”) . . . .

Stipulation and Agreement of Compromise, Settlement and Release, at 8–9, *In re Amerigroup S’holders Litig.*, C.A. No. 7788-CS (Del. Ch. Oct. 26, 2012) [hereinafter *Amerigroup Stipulation*] (extending the Release to a wide array of actual and potential defendants, including the company as well as its employees, accountants, legal and financial advisors).

<sup>92</sup> The language of the example stipulation provides:

The Settlement is intended to extinguish all of the Settled Claims . . . . Consistent with such intention . . . the Releasing Persons . . . waive and relinquish, to the fullest extent permitted by law, the provisions, rights, and benefits of any state, federal, or foreign law or principle of common law, which may have the effect of limiting the respective Settled Claims and Released Defendant Claims.

*Amerigroup Stipulation*, *supra* note 91, at 13.

<sup>93</sup> *Brinckerhoff*, 986 A.2d at 385 (noting that defendants prefer a release with the broadest possible scope and that the “language of a release typically extends to all possible claims, known or unknown, asserted or unasserted, arising out of or relating to the events that were the subject of the litigation); *id.* (“A standard global release also encompasses claims that could not have been litigated in the settled action, such as federal securities claims.”).

<sup>94</sup> *Matsushita Elec. Indus. Co.*, 516 U.S. at 369; *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 812 (1985).

<sup>95</sup> In the words of former Chancellor Allen:

[I]n the context of a claim that is acknowledged to be moot and in which no consideration is to be paid to the class, it is not appropriate for the court to purport to release any claims of the class. The *res judicata* effect . . . is whatever it may be, but it would certainly offend fundamental notions of fairness to purport . . . to release claims that have never been advanced . . . in which there appears to be no serious discovery record . . . and most importantly, in exchange for no consideration.

inquiry only when the settlement is challenged by an objector,<sup>96</sup> and objections to settlement are exceedingly rare.<sup>97</sup>

In Delaware, the judicial rubric for evaluating the fairness of a release is whether the claims released were “based on the ‘same identical factual predicate’ or the ‘same set of operative facts’ as the underlying action.”<sup>98</sup> According to the Delaware Supreme Court:

A release is overly broad if it releases claims based on a set of operative facts that will occur in the future. If the facts have not yet occurred, then they cannot possibly be the basis for the underlying action . . . . Additionally, a release may be overbroad if it could be interpreted to encompass any claim that has some relationship—however remote or tangential—to any fact, act, or conduct referred to in the Action. In other words, a release is overly broad if it releases claims based on a common set of tangential facts, as opposed to operative or core facts.<sup>99</sup>

The question therefore is not whether the release may bar other important forms of litigation from being brought.<sup>100</sup> Rather, the question is merely whether the factual bases of released claims already in fact have occurred and whether released claims are related sufficiently to the settled litigation.<sup>101</sup> Although the question whether the underlying facts have or have not occurred is relatively straightforward, analysis of what is sufficiently related to the settled litigation requires judicial interpretation. Delaware courts applying this standard have held that state law disclosure-only settlements can validly release not

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*In re Advanced Mammography Servs., Inc. S’holders Litig.*, No. CIV.A. 14831, 1996 WL 633409, at \*1 (Del. Ch. 1996).

<sup>96</sup> The leading cases all involve shareholder objectors. See *In re Phila. Stock Exch., Inc.*, 945 A.2d 1123, 1129 (Del. 2008); *Nottingham Partners v. Dana*, 564 A.2d 1089, 1091 (Del. 1989); *UniSuper, Ltd. v. News Corp.*, 898 A.2d 344, 345 (Del. Ch. 2006).

<sup>97</sup> For example, in the ten year period between 2003 and 2013, the Delaware Court of Chancery entered 949 orders approving settlements. During that period, only 83 of such settlements were the subject of an objection. Moreover, many of these objections were one paragraph expressions of outrage and not the type of reasoned objection that courts are likely to take seriously. See, e.g., Transcript at 18–19, *In re True Religion Apparel, Inc. S’holder Litig.*, CA No. 8590-VCG (May 1, 2014) (quoting from a brief “*cri de coeur*” objection but ultimately finding a benefit and awarding fees).

<sup>98</sup> *UniSuper*, 898 A.2d at 347.

<sup>99</sup> *In re Phila. Stock Exch.*, 945 A.2d at 1146 (quoting *In re UniSuper*, 898 A.2d at 347).

<sup>100</sup> The res judicata effect of a settlement or judgment can only be determined when the subsequent claim is brought. *Matsushita Elec. Indus. Co.* 516 U.S. at 396 (“A court conducting an action cannot predetermine the res judicata effect of the judgment; that effect can be tested only in a subsequent action.”); *In re Phila. Stock Exch.*, 945 A.2d at 1147 (“[W]hether or not releasing the [related] claims will have preclusive effect in the related federal litigation is not an issue for this Court or the Court of Chancery to decide.”).

<sup>101</sup> *In re Phila. Stock Exch.*, 945 A.2d at 1146 (quoting *In re UniSuper*, 898 A.2d at 347).

only related fiduciary duty claims but also federal securities fraud claims because such claims arise from the same operative facts.<sup>102</sup>

Nevertheless, it is an odd standard that requires a court to evaluate the facts under which a claim arises when the claim itself may not yet have arisen. In other words, only plaintiffs presently seeking to press another claim will have an opportunity to make an argument under the current standard. In many cases, however, including proxy fraud, whether a worthwhile claim exists will only be known later, long after the merger litigation has been settled, when the truth or falsity of statements made in the proxy ultimately is discovered. Although it is true that plaintiffs can later argue that such cases should not be precluded, there is no way for them to challenge the settlement itself since, at the time of settlement, they do not know whether they possess valid claims.<sup>103</sup> An alternative standard, looking at the value plaintiffs receive in exchange for the defendant's release, was proposed by then-Chancellor Allen in the mid-1990s.<sup>104</sup> It has not been adopted, however. Instead, the courts have settled on a standard that provides for ineffective scrutiny of the breadth of the release, the ultimate result of which is that the litigation release may be worth considerably more to defendants than what they give the shareholder class to settle the case.

### C. The Judicial Role in the Settlement of Shareholder Litigation

Unlike purely private litigation, shareholder litigation cannot be settled without the involvement of a judge. Settlement agreements reached in shareholder litigation, as in other forms of representative litigation, become binding on absent members of the class only upon the entry of a judicial order.<sup>105</sup> Shareholder litigation therefore invariably concludes with a hearing at which a judge performs three essential tasks. First, the judge must decide whether the settlement is "fair and reasonable."<sup>106</sup> Second, the judge must determine

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<sup>102</sup> *Nottingham Partners*, 564 A.2d at 1107 (holding that a settlement of a Delaware fiduciary duty claim can release federal Rule 14a-9 claims because "although the two actions did not allege the identical nondisclosure claim, both actions arose under the same set of operative facts").

<sup>103</sup> On the subsequent determination of the preclusive effect of settlement, see *supra* note 105 and accompanying text.

<sup>104</sup> See *supra* note 95.

<sup>105</sup> Erichson, *supra* note 83, at 968–69 ("What binds the class is not the *agreement* between the defendant and the lead plaintiffs or class counsel, but rather the court's *judgment* approving that agreement. The binding effect of a class settlement, in other words, must be understood as a function of judicial power.").

<sup>106</sup> *Triarc Cos. Class & Derivative Litig.*, 791 A.2d 872, 876 (Del. Ch. 2001) (asking whether the settlement is "fair and reasonable in light of all relevant factors"). If the claim is a class, as opposed to derivative claim, the court will also be required to certify the class at the time of the settlement hearing. See *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 617–20 (1997) (noting that in certifying a class, the judge is charged with determining that the class meets the requirements of the class action rule, including adequacy of representation and of class counsel). Cases where classes are certified at

whether it is appropriate for the corporate defendant to pay plaintiffs' attorneys' fees. Third, if attorneys' fees are awarded, judges must determine the ultimate amount of the fee award. Each of these judicial determinations involves a distinct analytical framework, described below.<sup>107</sup>

Evaluation of the fairness and reasonableness of settlement requires the judge to weigh the relief received in settlement against the strength of the plaintiffs' claims.<sup>108</sup> Although this analysis might seem to imply an adjudication of the merits of the claim, the judge's role is in fact much more limited in scope, amounting to asking only whether the relief does rough justice to the claim.<sup>109</sup> Moreover, judges tempted to launch a thorough inquiry into the merits of a claim at the time of settlement face significant information asymmetries exacerbated by a non-adversarial process and an undeveloped factual record.

Judges know far less about the quality of a case than the litigants.<sup>110</sup> Judges know only what lawyers tell them, and in the context of shareholder settlements, the lawyers do not tell them much. Merger litigation, for example, typically settles prior to the motion to dismiss.<sup>111</sup> As a result, the judge will have received the initial complaint and answer but often no briefing of the merits or serious argument from either side concerning the quality of the case. Even more importantly, settlement hearings are non-adversarial, and both sides have a keen interest in winning judicial approval of the settlement agreement.<sup>112</sup> Defendants therefore do not oppose plaintiffs' assertions that they

the same time that settlements are approved, most merger cases, constitute "settlement class actions." See *supra* note 83 and accompanying text.

<sup>107</sup> Although the discussion below is slanted towards the court's role in approving class settlements, the court's role in approving derivative suits settlements is substantially similar. See DEL. CH. CT. R. 23.1 (requiring approval of the court for settlement); *In re MAXXAM, Inc.*, 659 A.2d 760, 768 (Del. Ch. 1995) (emphasizing that public policy in favor of settlement must be balanced against policy of ensuring fairness of the settlement).

<sup>108</sup> *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 861 (Del. Ch. 1996) (explaining that judges must "assess the strengths and weakness of the claims asserted in light of the discovery record and to evaluate the fairness and adequacy of the consideration offered . . . in exchange for the release of all claims made or arising from the facts alleged").

<sup>109</sup> Erichson, *supra* note 83, at 966 ("The court [in approving settlement] does not adjudicate the merits of the dispute, instead ruling only on the rough fairness of a deal that the court presumes reflects market price.").

<sup>110</sup> See Griffith & Lahav, *supra* note 90, at 1083–84 (discussing the problem of information asymmetry); Geoffrey C. Hazard, Jr., *The Settlement Black Box*, 75 B.U. L. REV. 1257, 1272 (1995) (describing settlement process as a "black box" precluding serious judicial scrutiny); G. Donald Puckett, *Peering into a Black Box: Discovery and Adequate Attorney Representation for Class Action Settlements*, 77 TEX. L. REV. 1271, 1279–83 (1999) (describing serious judicial review of class settlements as "inherently futile").

<sup>111</sup> See *supra* note 82 and accompanying text.

<sup>112</sup> Griffith & Lahav, *supra* note 90, at 1093 ("The approval process that courts follow in determining fees awarded to class counsel is, in an important sense, nonadversarial."); accord *Alleghany Corp. v. Kirby*, 333 F.2d 327, 347 (2d Cir. 1964) (Friendly, J., dissenting) (quoted in *In re Sauer-Danfoss Inc. S'holders Litig.*, 65 A.3d 1116, 1137 (Del. Ch. 2011)) ("Once a settlement is agreed, the attorneys for the plaintiff stockholders link arms with their former adversaries to defend their joint

have wrested a hard fought and highly beneficial settlement from the company.<sup>113</sup> Worse, the parties may engage in “confirmatory discovery” to document the value of their settlement *after* agreeing to it, in which case coached witnesses will enter statements confirming the value of the settlement and the vital importance of the litigation in producing it.

Judges who nevertheless press on with a serious inquiry into the fairness and reasonableness of settlement soon may confront a paradox. If the judge, having determined that a settlement is of no real value, refuses to approve it, plaintiffs may not respond by dropping the complaint. Plaintiffs instead may force defendants to litigate, at least to the motion to dismiss and potentially beyond.<sup>114</sup> In such a situation, the judge’s finding that the settlement is of no merit may condemn the defendant to further rounds of non-meritorious litigation that may ultimately cost the defendant more than the settlement itself.<sup>115</sup> As noted in several recent Court of Chancery opinions, judges do not like to order litigants to incur waste.<sup>116</sup> Once the parties know this, however, a game of chicken ensues, where the lawyers on both sides, understanding the reluctance of judges to perpetuate the cycle of waste, are emboldened to conclude low-value settlements right up to the point where judges will reject them.

Apart from reviewing the fairness and reasonableness of the settlement as a whole, judges also must rule on whether it is appropriate for defendants to pay the plaintiffs’ attorneys’ fees. Theoretically, the court *orders* the defendant to pay attorneys’ fees. Given the non-adversarial nature of settlement hearings, however, the court in fact is in the posture of *approving* the defendant’s payment of attorneys’ fees. The award of attorneys’ fees typically is contested only in moot cases—that is, cases where there is no settlement agreement because

handiwork.”); *see also* Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs’ Attorney’s Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 46 (1991) (quoted in *In re Sauer-Danfoss*, 65 A.3d at 1137) (describing settlement hearings as “pep rallies jointly orchestrated by plaintiffs’ counsel and defense counsel”).

<sup>113</sup> There will be no argument, for example, over the actual contribution of plaintiffs in increasing the consideration in a controlling shareholder merger. *See supra* notes 70–74 and accompanying text. Nor will either side engage the question whether a package of corporate therapeutics actually reflects the plaintiffs’ efforts in litigating a derivative suit or whether it is more the product, for example, of a prosecutorial or regulatory action that may have preceded or coincided with the derivative suit. *See supra* notes 50–53 and accompanying text.

<sup>114</sup> Controlling shareholder merger litigation, for example, typically cannot be eliminated on the motion to dismiss. *See supra* note 68 and accompanying text.

<sup>115</sup> One source estimates defense costs involved in litigating a motion for preliminary injunction at \$1.5 million. *See* Griffith & Lahav, *supra* note 90, at 1081 n.122.

<sup>116</sup> *See, e.g.*, Transcript at 69, *In re Theragenics Corp. Stockholders Litig.*, C.A. No. 8790-VCL (Del. Ch. May 5, 2014) (“Because I can’t approve the settlement today, I’m not going to reach class certification, which is contingent on the settlement. I’m also not going to grapple with the fee question.”); Transcript at 24, *In re Medicis Pharm. Corp. S’holder Litig.*, CA No. 7857-CS, (Del. Ch. Feb. 26, 2014) (refusing to approve settlement of a merger claim on basis of a weak package of supplemental disclosures).

the relief sought in the shareholders' claim has been rendered moot by an action of the corporation.<sup>117</sup> The fundamental basis of the fee award is the benefit plaintiffs have conferred upon the corporation or its shareholders.

The doctrine under which courts award fees depends upon whether the benefit conferred is pecuniary or non-pecuniary in form. When fees are awarded for a monetary recovery or on the basis of a fund, the amount of which is either increased or protected by the settlement, then fees are awarded on the basis of the common fund doctrine.<sup>118</sup> When, by contrast, the only relief is non-pecuniary in nature, fees can be awarded only on the basis of the corporate benefit doctrine.<sup>119</sup> Although courts occasionally mix the terminology,<sup>120</sup> the doctrines are not interchangeable.<sup>121</sup> Qualifying for an award of fees under ei-

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<sup>117</sup> *In re First Interstate Bancorp Consol. S'holder Litig.*, 756 A.2d 353, 357 (Del. Ch. 1999) (“[U]ncertainty over the nature of the ‘benefit’ and its relation to the litigation may be expected to occur primarily in moot cases. Where a case has been litigated to a conclusion or settled, the nature of the ‘benefit’ and its causal connection to the litigation is ordinarily clear.”). Moot cases thus present an offshoot of the basic common fund/corporate benefit doctrine. As explained by the Delaware Supreme Court:

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

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

<sup>118</sup> See *Goodrich v. E.F. Hutton Grp., Inc.*, 681 A.2d 1039, 1045 (Del. 1996) (“If the settlement of a class action is approved and has provided for a monetary recovery, the common fund doctrine permits an attorney to independently request an award of fees from that same settlement fund.”); accord *In re Dunkin’ Donuts S’holders Litig.*, Civ. A. No. 10825, 1990 WL 189120, at \*3 (Del. Ch. July 23, 1990) (“Under the common fund doctrine, a litigant who confers a common monetary benefit upon an ascertainable class is entitled to an allowance for fees and expenses to be paid from the fund or property which his efforts have created.”).

<sup>119</sup> *Franklin Balance Sheet Investment Fund v. Crowley*, Civ. A. No. 888-VCP, 2007 WL 2495018, at \*6 (Del. Ch. 2007) (“Under the corporate benefit doctrine, a litigant who confers significant and substantial benefit to a class, albeit not a tangible monetary one, is entitled to an allowance of fees and expenses.”); accord *Dunkin’ Donuts*, 1990 WL 189120, at \*3 (“The corporate benefit doctrine comes into play when a tangible monetary benefit has not been conferred. It is enough, the doctrine holds, that the underlying litigation has ‘specifically and substantially’ benefited the class.” (citations omitted)).

<sup>120</sup> See, e.g., *United Vanguard Fund, Inc. v. TakeCare, Inc.*, 693 A.2d 1076, 1079 (Del. 1997) (“Delaware courts have long recognized the ‘common corporate benefit’ doctrine as a basis for the reimbursement of attorneys’ fees and expenses in corporate litigation. Under this doctrine, a litigant who confers a common monetary benefit upon an ascertainable stockholder class is entitled to an award of counsel fees and expenses for its efforts in creating the benefit.” (emphasis added) (citations omitted)).

<sup>121</sup> *In re Dunkin’ Donuts*, 1990 WL 189120, at \*4–5 (asserting the absence of “logical or legal support” for the “pick a doctrine” argument and emphasizing that courts do not “treat the doctrines as interchangeable”).

ther doctrine nevertheless requires the satisfaction of the same three conditions.<sup>122</sup> First, the claim must have been meritorious when filed.<sup>123</sup> Second, the litigation must have benefited the corporation or the class. And third, the benefit must be causally related to the lawsuit.

Judges have been liberal in their interpretation of these requirements. First, as in the case of the merit review discussed above, the judicial inquiry into whether the claim was meritorious when filed does not amount to adjudication or even serious analysis of the merits of the claim. Instead, the court asks only whether plaintiffs have “some reasonable hope” of ultimate success.<sup>124</sup> The second condition invites inquiry into the existence of a benefit. This is uncontroversial in common fund cases—the benefit is the monetary relief. Although the recognition of benefit in cases involving non-pecuniary relief may seem more contestable, courts in fact have been generous in recognizing non-pecuniary benefits, including disclosure-only settlements,<sup>125</sup> amendment settlements,<sup>126</sup> and therapeutic derivative suit settlements.<sup>127</sup> Although the existence of precedent recognizing the benefits of such settlements does not necessarily compel courts to recognize such benefits in a particular case,<sup>128</sup> judges have the same disincentive to deny corporate benefit that they

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<sup>122</sup> See *Tandycrafts, Inc. v. Initio Partners*, 562 A.2d 1162, 1167 (Del. 1989) (stating the elements as “(a) the claim was meritorious when filed; (b) the action was benefiting the corporation or a class was created prior to judicial resolution of the suit; and (c) the benefit was causally related to the lawsuit”); accord *In re Dunkin’ Donuts*, 1990 WL 189120, at \*5 (holding that “must show that (1) the action was meritorious at the time it was filed; (2) an ascertainable class received a substantial benefit; and (3) a causal connection existed between the action and the benefit”).

<sup>123</sup> See, e.g., *Allied Artists Picture Corp. v. Baron*, 413 A.2d 876, 879 (Del. 1980) (“The question of merit for the purposes of compensation is properly determined as of the commencement of the lawsuit and not by developments thereafter which could not have been known in the exercise of reasonable diligence at the time of filing.”).

<sup>124</sup> *Chrysler Corp. v. Dann*, 223 A.2d 384, 387 (Del. 1966) (rejecting an analogy to the summary judgment standard in favor of the motion to dismiss standard and further explaining that “[t]he plaintiff must have some factual basis at least for the making of the charges”).

<sup>125</sup> See, e.g., Transcript at 32, *In re Copano Energy, LLC S’holder Litig.*, C.A. No. 8284-VCN (Del. Ch., Sept. 9, 2013) (stating that under current precedent the appropriate question in recognizing the benefit of supplemental disclosure is not how many shareholders “cared” nor whether “the additional information affected anyone’s vote or allowed anyone to vote with greater confidence or conform” but whether “the additional disclosures materially enhanced the [shareholders’] knowledge about the merger”).

<sup>126</sup> See, e.g., *In re Compellent Techs., Inc. S’holders Litig.*, No 6084-VCL, 2011 WL 6382523, at \*28 (Del. Ch. Dec. 9, 2011) (awarding attorneys’ fees for benefit resulting from amendment of merger agreement’s deal protection terms).

<sup>127</sup> See, e.g., *In re Pfizer Inc. S’holder Derivative Litig.*, 722 F. Supp. 2d 453 (S.D.N.Y. 2010) (approving settlement focusing on governance and compliance reforms in lawsuit brought in wake of justice department settlement with the company for illegal marketing); see *In re Pfizer Inc. Shareholder Derivative Litigation*, BERNSTEIN, LITOWITZ, BERGER & GROSSMANN, LLP, <http://www.blbglaw.com/cases/00143>, archived at <http://perma.cc/K9KP-RQX6> (last visited Dec. 31, 2014) (describing the case and the settlement).

<sup>128</sup> Accordingly courts have occasionally used their discretion to reject settlements on the basis of an inadequate benefit to the corporation or shareholder class. Transcript at 9, *In re Amylin Pharm.*



do to set aside settlements generally.<sup>129</sup> Finally, with regard to causation, plaintiffs are presumed to have caused the benefit as long as it arose after litigation began.<sup>130</sup> This presumption can be rebutted, but only upon proof that the lawsuit *contributed in no way* to the creation of the benefit.<sup>131</sup> Moreover, the lawsuit need not be the sole or direct cause of the benefit.<sup>132</sup>

Judges who grudgingly approve settlements either because they are unable (under the applicable standards of review) or unwilling (due to their reluctance to trigger further rounds of wasteful litigation) to do otherwise have a final opportunity to express their dissatisfaction in the third major decision they must make at settlement—that is, the determination of the fee amount. The determination of *how much* to award in fees is distinct from the determination of *whether* to award fees and proceeds according to the so-called “*Sugarland* factors.”<sup>133</sup> In terms of process, once the parties agree upon a settlement, the plaintiffs will enter a fee request, which defendants typically will not oppose. The court will review the request in the same hearing at which it reviews fairness and adequacy and corporate benefit.

Although a thorough review of fee awards is beyond the scope of this Article, there is evidence that courts have been taking out their frustrations with the current system by knocking down fee awards, especially in the context of non-pecuniary relief. For example, in the 2011 Delaware Court of Chancery case *In re Sauer-Danfoss Shareholders Litigation*, Vice Chancellor Laster closely analyzed a set of eleven supplemental disclosures for whether they provided meaningful additional information to shareholders and, finding that only one did, re-

S’holders Litig., C.A. 7673-CS (Del. Ch. Feb. 5, 2013) (refusing to recognize corporate benefit and therefore refusing to award a fee on the basis of “additional meaningless disclosures that did not materially change the mix of information”).

<sup>129</sup> See *supra* note 116 and accompanying text.

<sup>130</sup> *Allied Artists Pictures Corp.*, 413 A.2d at 880 (noting that “[i]t is the defendant, and not the plaintiff, who is in a position to know the reasons, events and decisions leading up to the defendant’s action”).

<sup>131</sup> *Id.* (placing burden on corporate defendants to demonstrate “that the lawsuit did not in any way cause their action”); *United Vanguard Fund*, 693 A.2d at 1080 (requiring proof that the lawsuit “did not in any way contribute” to the benefit created in order to rebut the presumption of causation).

<sup>132</sup> *In re Dunkin’ Donuts*, 1990 WL 189120, at \*6 (“To establish the necessary causation . . . the benefit need not be directly and entirely attributable to the underlying litigation.”).

<sup>133</sup> *Sugarland Indus., Inc. v. Thomas*, 420 A.2d 142, 149–50 (Del. 1980). The *Sugarland* factors include:

- (i) the amount of time and effort applied to the case by counsel for the plaintiffs; (ii) the relative complexities of the litigation; (iii) the standing and ability of petitioning counsel; (iv) the contingent nature of the litigation; (v) the stage at which the litigation ended; (vi) whether the plaintiff can rightly receive all the credit for the benefit conferred or only a portion thereof; and (vii) the size of the benefit conferred.

*In re Plains Res. Inc. S’holders Litig.*, No. Civ. A. 071-N, 2005 WL 332811, at \*3 (Del. Ch. Feb. 4, 2005) (citing and applying the *Sugarland* factors).

duced the fee award from the requested \$750,000 to \$75,000.<sup>134</sup> Numerous recent Chancery Court decisions have applied similar logic, dramatically reducing requested fee awards in disclosure-only settlements, even in the absence of opposition from defendants or objectors.<sup>135</sup> The reduction of fee amounts thus may be taken as an expression of judicial dissatisfaction with the process generally.<sup>136</sup> Fee reductions, however, are not likely to solve the crisis in shareholder litigation because they are *ad hoc* and scattered, more the luck of the judicial draw than a comprehensive program of reform. Moreover, although fee reductions may reduce the overcompensation of plaintiffs' attorneys, they fail to address the undercompensation of the plaintiff class.<sup>137</sup>

#### D. The Crisis in Shareholder Litigation

The patterns outlined above reveal a crisis in shareholder litigation. Filings cluster around public events—the announcement of a merger or, in the context of derivative suits, a regulatory investigation or securities filing—and settlement patterns are dictated not by the plaintiffs' investigatory efforts but by timing considerations of the underlying transaction or the regulatory action. The result in each case is a proliferation of low value settlements that nevertheless entitle the plaintiffs' attorneys to recover fees from the corporation.

The overcompensation of attorneys on both sides of shareholder litigation is only the most visible sign of the crisis, however. The less visible but potentially more sinister aspect of the current system is the systematic undercompensation of the plaintiff class. This becomes clear upon consideration of the defense side to the settlement bargain. Defendants willingly pay plaintiffs' attorneys fees in exchange for extremely broad litigation releases. The ability of such broadly worded releases to extinguish meaningful claims is not merely potential. It is actual. For example, *In re Rural Metro Corp. Shareholders Litigation*, the bad banker case that recently resulted in liability and potentially significant damages, was nearly settled for supplemental disclosures. This re-

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<sup>134</sup> 65 A.3d at 1137.

<sup>135</sup> Transcript at 6, *In re Gen-Probe S'holders Litig.*, No. 7495-VCL (Del. Ch. Apr. 10, 2013); *In re PAETEC Holding Corp. S'holders Litig.*, No. 6761-VCG, 2013 WL 1110811, at \*5–6 (Del. Ch. Mar. 19, 2013).

<sup>136</sup> Transcript of Oral Arguments on Plaintiff's Motion for an Award of Attorney's Fees and Expenses at 58, *In re Del Monte Foods Co.*, C.A. No. 6027-VCL ("How do I price this stuff? . . . [Y]ou've just thrown in a number. And it may be a false sense of analytical clarity, but I am at least trying. . . . So, you know, I have a lot of trouble with the idea of 'Well, we got a lot of stuff. And so we get a lot of money.' . . . I'll be honest with you, Ceridian, Yahoo!, Alberto-Culver, I don't get how they get to the numbers there. I think the Court, as we regularly do, gave a lot of deference to the negotiations between counsel; but there isn't a lot of analysis as to how you get to a number." (quoting Vice Chancellor Laster)).

<sup>137</sup> Because fee reductions typically do not include a concomitant reduction in the breadth of the litigation release, they represent, essentially, a windfall gain to defendants.

sult was averted, narrowly, by a shareholder objection.<sup>138</sup> The dogs that don't bark may be worse. Recall that disclosure-only settlements release proxy fraud claims. What if the securities claims in the Bank of America/Merrill Lynch case, a \$2.43 billion proxy fraud settlement, had been released by a disclosure-only settlement?<sup>139</sup> There is no way of knowing how many such cases are silently extinguished by a release in a prior shareholder suit.

Furthermore, it is not merely a question of compensation. A basic public policy goal of shareholder litigation, arguably more fundamental than compensation, is the deterrence of potential corporate wrongdoers. Deterrence objectives, however, are not served by a system that thrives on a high volume of low value settlements.<sup>140</sup> Considering that standard deterrence theory sets sanctions at a level reflecting the net social cost of misconduct multiplied by the probability of detection, bad actors are not plausibly deterred by a litigation system that exposes the corporation to little more than payment of attorneys' fees.<sup>141</sup> Moreover, the common perception that such claims lack merit—a view fueled by the high volume of filings and the dearth of significant recoveries—itself diminishes the reputational impact of being made to defend such a suit.<sup>142</sup> It is hard to see how deterrence is served by suits with no meaningful financial or reputational consequence. This is a system in crisis. How the law ought to respond is the subject of the remainder of this Article.

## II. THE APPEARANCE OF FEE-SHIFTING BYLAWS

Fee-shifting bylaws emerged, in the wake of the Delaware Supreme Court's decision in *ATP Tour v. Deutscher Tennis Bund*, as a structural response to the crisis in shareholder litigation. Companies began adopting these provisions as soon as Delaware tabled its plan to ban them.<sup>143</sup> The following bylaw provision, adopted in the first week of July 2014, is typical:

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<sup>138</sup> 88 A.3d 54, 110 (Del. Ch. 2014) (allowing damages in claim involving investment banker conflict of interest). On the successful objection to the disclosure settlement, see generally Transcript, *In re Rural Metro Corp.*, No. 6350-VCL, (Del. Ch., Jan. 17, 2012) (settlement hearing where objectors are given control over subsequent litigation of case).

<sup>139</sup> See Peter J. Henning & Steven Davidoff Solomon, *For Bank of America, More Trouble from Merrill Lynch Merger*, N.Y. TIMES, Sept. 28, 2012, <http://dealbook.nytimes.com/2012/09/28/the-cost-of-putting-the-merrill-lynch-merger-behind-it/>, archived at <http://perma.cc/942H-GLB4>.

<sup>140</sup> See Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1736 (1994) (“[A] derivative suit increases corporate value in two circumstances: if the prospect of suit deters misconduct or, alternatively, if the suit itself yields a positive recovery net of all costs that the corporation must bear as a consequence of suit.”).

<sup>141</sup> STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 483 (2004).

<sup>142</sup> James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L.REV. 3, 11 (1999).

<sup>143</sup> Early adopters of bylaws shifting fees to shareholders included Hemispherx, Echo Therapeutics, LGL Group, all of whom adopted fee-shifting bylaws in early July 2014. See Hemispherx 8-K (“On July 3, 2014, the Board amended and restated the Company’s By-Laws to provide for fee-shifting to stockholders who engage in unsuccessful litigation and to require certain stockholders who

In the event that . . . any current or former security holder of the Company . . . initiates, asserts, maintains or continues against the Company any litigation . . . arising in whole or in part out of any Internal Matter . . . and . . . 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 Company . . . for all fees, costs, and expenses of every kind and description (including, but not limited to, all reasonable attorneys' fees and other litigation expenses) that the Company . . . incurred in connection with such Claim.<sup>144</sup>

Such provisions seek to respond to the perceived excesses in shareholder litigation by discouraging claims.<sup>145</sup> The response, however, is overbroad, aimed at deterring shareholder claims *per se*, rather than more precisely targeting the causes of *frivolous* litigation. Because such provisions chill the good claims along with the bad, they fail to advance the fundamental public policy interests underlying shareholder litigation.

Those wishing to challenge the current crop of fee-shifting provisions have two potential angles of attack: substance and form. The substantive challenge focuses on the fee-shifting rule itself, attacking its implications in law and policy. The formal challenge focuses on bylaws as the mode of adoption, arguing that regardless of the substantive validity of a fee-shifting rule, a by-law amendment is not the right means of enacting the rule. Because each of these challenges raises fundamentally different issues, the sections below review them separately, ultimately concluding that Delaware has strong reasons to reject the current generation of fee-shifting bylaws.

### A. The Substantive Proposal: Fee-Shifting

Fee-shifting, of course, was not invented for shareholder litigation. The rule that unsuccessful parties in litigation must pay their opponents' fees and

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engage in litigation to post security to cover the estimated expenses of litigation should the stockholder be unsuccessful.”); Liz Hoffman, *New ‘Loser Pays’ Option Attracts Two Companies*, WALL ST. J., July 7, 2014, at B6, available at [http://www.wsj.com/articles/proceedings-highlights-from-the-law-blog-1404687854?mod=\\_newsreel\\_2](http://www.wsj.com/articles/proceedings-highlights-from-the-law-blog-1404687854?mod=_newsreel_2), archived at <https://perma.cc/TW3L-PFN9?type=pdf>.

<sup>144</sup> HEMISPHERX BYLAWS § 5.7(a) (2014), available at <http://www.sec.gov/Archives/edgar/data/946644/000094664414000012/a31amendedandrestatedby-la.htm>, archived at <https://perma.cc/F2FZ-DAAT?type=pdf>. “Internal Matter” is defined in the bylaw to include derivative actions, claims alleging breach of fiduciary duty, claims arising under the Delaware General Corporate Law, claims arising under the federal securities laws, and claims governed by the internal affairs doctrine. *Id.*

<sup>145</sup> See, e.g., Hoffman, *supra* note 143 (quoting the statement of Echo Therapeutics upon adoption of its fee-shifting bylaw: “Echo’s Board and management team believe that it is in our shareholders’ best interests to focus our limited resources on our ongoing product-development efforts *rather than responding to frivolous litigation.*” (emphasis added)).

expenses is widely followed elsewhere in the world, not just in England.<sup>146</sup> Although the general rule in the United States is that litigants bear their own costs, fee-shifting often has been proposed to solve perceived excesses in the litigation system.<sup>147</sup> Moving to a fee-shifting rule, by changing the expected cost of litigation, changes the incentives of the parties to litigate. Although the general effect of fee-shifting on civil litigation often may be ambiguous and unpredictable, a movement to fee-shifting in the context of shareholder litigation likely will substantially eliminate claims activity.<sup>148</sup>

Legal scholars focusing on fee-shifting have evaluated its impact on three distinct incentives: (1) the incentive to file claims, (2) the incentive to invest in claims, and (3) the incentive to settle claims. First, with regard to the incentive to file, fee-shifting encourages the filing of suits with a high probability of success without regard to the cost of litigation, leading simultaneously to more low-value/high probability claims and fewer high-value/ low probability claims.<sup>149</sup> Second, fee-shifting often increases the costs of litigated cases since each side will discount the expected cost of further investment in the case by the probability that such costs will ultimately be borne by the opponent.<sup>150</sup> In particular, fee-shifting increases defendants' incentive to invest heavily in the

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<sup>146</sup> See generally John F. Vargo, *The American Rule on Attorney Fee Allocation: The Injured Person's Access to Justice*, 42 AM. U. L. REV. 1567, 1597–1601 (1993) (discussing other jurisdictions adopting fee-shifting regimes similar to the English Rule).

<sup>147</sup> For example, a widely supported provision of the Republican "Contract with America" in the mid-1990s would have adopted fee-shifting for federal cases brought under diversity jurisdiction. See generally Thomas D. Rowe, Jr., *Indemnity or Compensation? The Contract with America, Loser-Pays Attorney Fee-Shifting, and a One-Way Alternative*, 37 WASHBURN L.J. 317 (1998) (discussing fee-shifting through the lens of the "Contract with America"). Likewise, a loser-pays rule was proposed as a means to curb medical malpractice litigation in the more recent debate over health-care reform. Sheryl Gay Stolberg & Robert Pear, *Obama Open to Reining in Medical Suits*, N.Y. TIMES, June 15, 2009, at A1 (discussing medical malpractice reform in context of health-care reform).

<sup>148</sup> See Katz & Sanchirico, *supra* note 19, at 271–72 (summarizing "the main lesson of the economic literature on fee-shifting" as "the effects of cost shifting on the amount and intensity of litigation are substantially more complicated than a superficial consideration of the matter might suggest").

<sup>149</sup> Steven Shavell, *Suit, Settlement and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55, 73 (1982) (arguing that because the expected cost to the litigant is reduced by the potential that it will be paid by the other side, the litigant will have an incentive to pursue more claims whose value is low relative to the probability of success); see Bradford Cornell, *The Incentive to Sue: An Option-Pricing Approach*, 19 J. LEGAL STUD. 173, 174 (1990) (analogizing parties incentives in litigation to the pricing of an option, which increases with volatility).

<sup>150</sup> Ronald Braeutigam et al., *An Economic Analysis of Alternative Fee-Shifting Systems*, 47 L. & CONTEMP. PROB. 173, 180 (1984) ("[A] movement from the American system to one favoring successful defendants will indeed encourage defendants to spend more in their own defense . . . [T]he total expenditures by the two parties combined will increase."); Avery Katz, *Measuring the Demand for Litigation: Is the English Rule Really Cheaper?*, 3 J. L. ECON. & ORG. 143, 144 (1987) ("[T]he English rule provides a probabilistic subsidy to the purchase of legal services, since a party contemplating the expenditure of an additional unit of services knows that she will not bear its cost if she wins the lawsuit.").

defense of nuisance claims, using the potential infliction of substantial legal costs as a weapon to discourage claims.<sup>151</sup> Third, the impact of fee-shifting on settlement is ambiguous, but because it amplifies the parties' relative optimism and degree of information asymmetry, fee-shifting discourages settlement under most economic models.<sup>152</sup>

Whatever the effects of a move to fee-shifting may be in other contexts, it almost certainly will kill shareholder litigation because it would force *representative* litigants to bear *individual* responsibility for the full cost of an unsuccessful suit. Economically rational shareholders will thus be deterred from bringing claims unless their *proportional* share of the recovery exceeds the *full* cost of litigation, after both the recovery and the cost are adjusted for probability.<sup>153</sup> In such an environment, only large blockholders will likely find it worthwhile to sue and only in rare cases. The result is an entire class of meritorious cases that is never brought simply because the prospective defendants lack a sufficiently large blockholder. Ownership composition, obviously, has nothing to do with the merits of a claim, nor does it make sense to render firms without significant blockholders unaccountable to their shareholders.

Plaintiffs' law-firms might attempt to respond to this problem by offering to indemnify shareholders for the full cost of litigation, win or lose. But will they? There are likely to be meritorious cases that are simply too risky for plaintiffs' firms to take on, especially cases involving significant investigation

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<sup>151</sup> Amy Farmer & Paul Pecorino, *A Reputation for Being a Nuisance: Frivolous Lawsuits and Fee-Shifting in a Repeated Play Game*, 18 INT'L REV. L & ECON. 147, 156 (1998) (“[F]ee shifting is highly effective in reducing the number of lawyers engaged in nuisance suits.”); David Rosenberg & Steven Shavell, *A Model in Which Suits Are Brought for Their Nuisance Value*, 5 INT'L REV. OF L. & ECON. 3, 5 (1985) (“Under the British system, a plaintiff who would be unwilling to litigate would never file a claim; in particular, nuisance suits would never occur.”).

<sup>152</sup> First, fee-shifting may magnify the effects of optimism, making litigants less likely to settle. William M. Landes, *An Economic Analysis of the Courts*, in ESSAYS IN THE ECONOMICS OF CRIME AND PUNISHMENT 164, 172 (eds. Gary S. Becker & William M. Landes, 1974) (noting that the more likely a defendant believes that his legal fees will be eliminated or subsidized, the lower the cost differential between a trial and a settlement, and the more likely he will proceed to trial); John P. Gould, *The Economics of Legal Conflicts*, 2 J. LEGAL STUD. 279, 287 (1973) (“[T]he implied uncertainty that A has about B's case (and vice versa) may put off an out-of-court settlement until the case gets near to trial or until the evidence is actually presented in court.”); see also Shavell, *supra* note 149, at 57 (formally demonstrating this intuition). Second, fee-shifting may reduce the likelihood of settlement by increasing uncertainty, leading to a higher degree of asymmetric information. See Robert Cooter et al., *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEGAL STUD. 225, 226 (1982) (articulating this principle); see also Mitchell A. Polinsky & Daniel L. Rubinfeld, *Does the English Rule Discourage Low-probability-of-prevailing Plaintiffs?*, 27 J. LEGAL STUD. 519, 533–35 (1998) (pointing out that the increase in information asymmetry may lead to lower quality tried cases in a fee-shifting regime).

<sup>153</sup> The hurdle for bringing suit, in other words, is not just that probable gains exceed probable losses but that the shareholder plaintiff's proportional share of probable gains exceed the full amount of probable losses.

and, therefore, higher costs.<sup>154</sup> Moreover, many plaintiffs will rightly question the credit-worthiness of plaintiffs' law firms and their ability to meet their indemnification obligations in a major (or even minor) case.<sup>155</sup> Finally, it is important to recall that in the context of shareholder litigation, the starting point is not the American Rule, under which each side bears its own costs, but rather the Delaware Rule, under which the corporation always pays. Adopting fee-shifting therefore will not lead to more litigation since, under the Delaware Rule, every possible case is already brought.<sup>156</sup> Any movement from the extreme generosity of the current Delaware Rule on fees, in other words, will indeed deter litigation, as intended by those companies adopting fee-shifting bylaws.

The problem with current fee-shifting proposals is not that they deter shareholder litigation, but that they deter it indiscriminately. The extreme loser-pays position of current bylaw proposals takes no account of the merits of the underlying claim and, considering the amplified deterrent effect on representative actions, thus will discourage good and bad cases alike from ever being brought. There are examples of fee-shifting rules that force the losing party to pay only after a finding that the claim fundamentally lacked merit.<sup>157</sup> Conditioning fee-shifting not just on success but also on the weakness of the opponent's claim may do a better job than either the English or American Rules.<sup>158</sup>

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<sup>154</sup> Fee-shifting thus creates an incentive to bring low-risk, low-investigation cost claims rather than higher-risk claims that involve significant investigation and therefore greater defense costs. This flips the conventional assumption—that claims involving greater investigation are more meritorious—on its head and seems likely to lead to an underinvestment in meritorious claims. *See, e.g.*, Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PA. L. REV. 755, 769–71 (2009); Steven J. Choi et al., *The Screening Effect of the Private Securities Litigation Reform Act*, 6 J. EMPIRICAL LEGAL STUD. 35, 43 (2009).

<sup>155</sup> *See* John C. Coffee, Jr., *Fee-Shifting Bylaw and Charter Provisions: Can They Apply in Federal Court?—The Case for Preemption, Testimony Before the SEC Investor Advisory Committee*, 10 (Columbia Law Sch. Law and Econ. Working Paper Grp., Paper No. 498, 2014), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2508973](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2508973), archived at <http://perma.cc/V5FB-H2LM> (“[I]f a bold plaintiff’s law firm did sue, it would likely have to agree to indemnify the class representative from fee-shifting, and some class representatives might decline the position, fearing that the plaintiff’s firm could not fully protect them.”)

<sup>156</sup> At least in the context of merger litigation. *See supra* notes 75–137 and accompanying text.

<sup>157</sup> *See* Katz & Sanchirico, *supra* note 19, at 292 (listing examples including “the common-law torts of barratry, abuse of process, and malicious prosecution . . . sanctions for discovery abuse . . . and the . . . provisions of the Internal Revenue Code requiring the government to pay a taxpayer’s reasonable litigation costs upon a court finding that the government’s position in a tax dispute was substantially unjustified”); *see also* Brian T. Fitzpatrick, Twombly and Iqbal Reconsidered, 87 N.D. L. REV. 1621, 1646 (2012) (noting a Tennessee proposal that would shift some litigation costs to plaintiffs only if they lost on the motion to dismiss).

<sup>158</sup> Lucian Arye Bebchuk & Howard F. Chang, *An Analysis of Fee-Shifting Based on the Margin of Victory: On Frivolous Suits, Meritorious Suits, and the Role of Rule 11*, 25 J. LEGAL STUD. 371, 374 (1996) (demonstrating that conditioning fee-shifting on the margin of victory does a better job of conforming prospective litigants’ conduct to their *ex ante* estimate of the quality of their case).

Unfortunately, current fee-shifting proposals do none of this. As a result, they do indeed operate to deprive shareholders of valuable substantive rights.

Delaware cannot accept this outcome. Delaware law seeks to strike a careful balance between managers and shareholders.<sup>159</sup> By discouraging shareholder suits *per se*, Delaware law would adopt a pronounced anti-shareholder slant. This not only offends the corporate bar, a core constituency inside Delaware, it would also open the state to the risk of preemption by the federal government.<sup>160</sup> Delaware therefore needs a means of backing away from the substantive outcome of current fee-shifting proposals, both as a matter of principle and as a matter of politics.

A promising judicial route of retreat might be to focus on the distinction between individual versus representative litigation and the distinction between closely-held organizations versus diffusely-held public corporations. It might be more acceptable to shift fees to an individual suing merely for himself than to a class representative or derivative suit plaintiff. The extreme asymmetries provoked by fee-shifting in the context of representative litigation make it a strong candidate for judicial invalidation, unless perhaps the risk of unsuccessful litigation could be spread across the class as a whole.<sup>161</sup> In the context of closely-held organizations like ATP, it indeed may be possible to spread the cost of litigation across the plaintiff class as a whole, requiring merely that owners be sent a bill for their proportional share of litigation costs, the equivalent of an additional capital call. But in the context of diffusely-held public corporations, this is plainly impossible. Even if it were administrable for the corporation to send a bill to each shareholder, shareholders would not pay them, understanding (rightly) that their liability as shareholders is capped at the amount of their initial investment.<sup>162</sup> This logic suggests that the easiest way to achieve fee-shifting for representative actions in the context of widely held corporations is to have the corporation pay the bill, thereby reducing the

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<sup>159</sup> See, e.g., Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1095 (2000) (“[Delaware] courts have responded to takeover litigation with an attempt to balance deference to management decisionmaking with concern over shareholder treatment.”).

<sup>160</sup> See Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 8 (2005) (noting that the threat of federal preemption pressures the Delaware judiciary to continuously balance the interests of shareholders and corporate board); Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 BUS. LAW. 1, 22–23 (2006) (alarming to the undesirable effects of federal preemption of state law corporate governance); Mark J. Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588, 607–21 (2003) (summarizing the history of the federalization of corporate law, by way of federal legislative enactments in response to large-scale corporate failures, from the federal securities acts in the 1930s to Sarbanes-Oxley in 2002). Indeed, the SEC’s hearings on fee-shifting foreshadow the possibility of federal preemption on this point. See Coffee, *supra* note 155 (discussing testimony before the SEC).

<sup>161</sup> On the asymmetries of fee-shifting in the representative context, see *supra* note 153 and accompanying text.

<sup>162</sup> Indeed, this is the definition of limited liability.



wealth of each shareholder proportionally, the precise outcome that advocates of fee-shifting are seeking to escape.<sup>163</sup> This demonstration of circularity, starting from the premise that it is inappropriate to shift fees to an individual for bringing representative litigation, would allow courts to deny the applicability of fee-shifting to diffusely held public corporations without overruling the specific holding of *ATP Tour*.

This is not to suggest, however, that Delaware should invalidate fee-shifting *per se*. Rather, Delaware should leave room for fee-shifting to be applied more narrowly, in a way that distinguishes good cases from bad ones, a proposal for which is articulated in Part IV, below.<sup>164</sup> Judicial rather than legislative invalidation of the current generation of fee-shifting bylaws therefore might be preferable, since judicial invalidation likely would leave more room for corporate planners to design more narrowly tailored provisions.<sup>165</sup>

### B. The Procedural Form: Bylaw Arguments

Putting aside concerns over the substantive operation of fee-shifting, is it appropriate to adopt fee-shifting by means of a bylaw amendment? From the corporation's perspective, this route of adoption has much to commend it.<sup>166</sup> Unlike the corporate charter, the board typically has the power to amend bylaws without shareholder approval.<sup>167</sup> But should such a bylaw amendment be upheld?

Until recently, much of the developed caselaw concerning bylaw amendments focused on limits on the power of *shareholders* to amend bylaws. The adoption of anti-poison pill bylaws, for example, was stymied by the "recursive loop"<sup>168</sup> between shareholders' statutory authority to adopt bylaws "not inconsistent with law,"<sup>169</sup> and the board's statutory authority to manage the

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<sup>163</sup> This result is also rejected by this Article for both doctrinal and policy reasons in Parts III and IV, below. See *infra* notes 195–311 and accompanying text.

<sup>164</sup> See *infra* notes 253–311 and accompanying text.

<sup>165</sup> See *supra* notes 158 and accompanying text (suggesting another approach to fee-shifting).

<sup>166</sup> DEL. CODE ANN. tit. 8, § 109(b) (2014) ("The bylaws may contain any provision, *not inconsistent with law or with the certificate of incorporation*, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees." (emphasis added)).

<sup>167</sup> The statute expressly gives voting shareholders the power to amend shareholders but allows corporations to give directors co-equal power to amend the bylaws. § 109(a). Every well-counseled corporation confers this power on directors.

<sup>168</sup> Jeffrey N. Gordon, "Just Say Never?" *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511, 546 (1997).

<sup>169</sup> § 109(b). This limitation obviously applies to any provision of the Delaware General Corporate Law, not just § 141(a). See, e.g., *Crown EMAK Partners, LLC v. Kurz*, 992 A.2d 377, 402 (Del. 2010) (invalidating bylaw amendment conflicting with statutory procedure for removing and electing directors at annual meeting).

firm.<sup>170</sup> Efforts to use bylaws to pry open the nomination process were similarly stalemated until the Delaware Supreme Court sought to break the recursive loop by distinguishing procedure, a proper subject for bylaws, from substance, an improper subject for bylaws.<sup>171</sup> In the court's words, "a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made."<sup>172</sup>

The inapplicability of this caselaw to director-sponsored bylaws should be apparent. Does it make sense to limit board authority to adopt bylaws on the basis of the board's authority to manage the corporation? The substance-procedure distinction likewise makes little sense when applied to board-sponsored bylaws because any bylaw adopted by a board that had the effect of curbing its substantive authority would also be susceptible to subsequent repeal by the board in exercise of its substantive authority.<sup>173</sup> Perhaps in recognition of the apparent circularity of this reasoning, Delaware courts have tended to view board-sponsored bylaw amendments as a much more straight-forward application of contract doctrine.

Most notably, in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, then-Chancellor Strine upheld director-sponsored forum-selection bylaws from facial challenge on the basis of the corporate contract to which shareholders assent when they buy their shares.<sup>174</sup> Because the board's power to adopt bylaws is an express term of the contract when shareholders buy in, shareholders are bound under the terms of the contract when the board subsequently exercises that power.<sup>175</sup> The court's reasoning thus draws upon the "corporation-as-contract" metaphor that has long informed corporate law scholarship,<sup>176</sup> but

<sup>170</sup> DEL. CODE ANN., tit. 8, § 141(a). See D. Gordon Smith, et al., *Private Ordering with Shareholder Bylaws*, 80 FORDHAM L. REV. 125, 141 (2011) ("[A]ny purely textual examination of the DGCL reveals this unremitting circularity.").

<sup>171</sup> *CA, Inc. v. AFSCME Emp. Pension Plan*, 953 A.2d 227, 234 (Del. 2008).

<sup>172</sup> *Id.* at 234–35.

<sup>173</sup> This would be problematic only where the board had made a binding commitment to follow and not amend or repeal a bylaw they had adopted, a problem the court may have had in mind in its reference to "the prohibition, which our decisions have derived from Section 141(a), against contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders." *Id.* at 238.

<sup>174</sup> 73 A.3d 934, 955 (Del. Ch. 2013) ("In an unbroken line of decisions dating back several generations, our Supreme Court has made clear that the bylaws constitute a binding part of the contract between a Delaware corporation and its stockholders.").

<sup>175</sup> *Id.* at 956 ("[S]tockholders have assented to a contractual framework established by the DGCL and the certificates of incorporation that explicitly recognizes that stockholders will be bound by bylaws adopted unilaterally by their boards. Under that clear contractual framework, the stockholders assent to not having to assent to board-adopted bylaws.").

<sup>176</sup> See generally FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991) (arguing that the rules and practices of corporate law replicate the effects of the contracts into which interested parties in a corporate enterprise could have entered).

takes a further step in making it *literally* so, at least with regard to director-sponsored bylaws.<sup>177</sup>

This corporation-as-contract reasoning was then applied by the Delaware Supreme Court in *ATP Tour* to uphold the facial validity of fee-shifting bylaws.<sup>178</sup> Because bylaws are contracts and because contracts opting into a fee-shifting rule have been upheld in a variety of other contexts,<sup>179</sup> fee-shifting provisions may be legitimately adopted in bylaws.<sup>180</sup> Having found firm footing for the decision on contract principles, the *ATP Tour* court did not even consider the substance-procedure dichotomy.<sup>181</sup> *ATP Tour* thus amounts to a straightforward application of the contract logic of *Boilermakers*.

The contract reasoning in *Boilermakers*, however, is undergirded by the ability of shareholders who are displeased by a board-adopted bylaw to take action against it.<sup>182</sup> Dissatisfied shareholders can pass their own bylaw rescinding the action of the board.<sup>183</sup> Alternatively, in cases of extreme displeasure,

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<sup>177</sup> In case the lesson was unclear, the Chancellor summarized this aspect of his holding as follows:

In sum, stockholders contractually assent to be bound by bylaws that are valid under the DGCL—that is an essential part of the contract agreed to when an investor buys stock in a Delaware corporation. Where, as here, the certificate of incorporation has conferred on the board the power to adopt bylaws, and the board has adopted a bylaw consistent with 8 Del. C. § 109(b), the stockholders have assented to that new bylaw being contractually binding.

*Boilermakers*, 73 A.3d at 958; see also *Airgas, Inc. v. Air Prods. & Chems., Inc.*, 8 A.3d 1182, 1188 (Del. 2010) (“[C]harters and bylaws are contracts among a corporation’s shareholders.”).

<sup>178</sup> 91 A.3d 554, 558 (Del. 2013).

<sup>179</sup> See, e.g., *Sternberg v. Nanticoke Mem’l Hosp., Inc.*, 62 A.3d 1212, 1218 (Del. 2013) (“An exception to [the American R]ule is found in contract litigation that involves a fee-shifting provision.” (citations omitted)); see also John J. Donohue III, *Opting for the British Rule, or if Posner and Shavell Can’t Remember the Coase Theorem, Who Will?*, 104 HARV. L. REV. 1093, 1099–1102 (1991) (discussing contexts where fee-shifting provisions had been adopted by contract).

<sup>180</sup> *ATP Tour*, 91 A.3d at 558 (“Because corporate bylaws are ‘contracts among a corporation’s shareholders,’ a fee-shifting provision contained in a nonstock corporation’s validly-enacted bylaw would fall within the contractual exception to the American Rule. Therefore, a fee-shifting bylaw would not be prohibited under Delaware common law.”).

<sup>181</sup> There is an argument that because fee-shifting bylaws make shareholder suits economically irrational, they impact *whether*, not merely *how* shareholders can sue. See *supra* note 153. As such, they could be treated as substantive rather than procedural and therefore an inappropriate subject for bylaws. See *Boilermakers*, 73 A.3d at 951–52 (holding that forum-selection bylaws are “process-oriented” because they “regulate *where* stockholders may file suit, not *whether* the stockholder may file suit or the kind of remedy that the stockholder may obtain on behalf of herself or the corporation”).

<sup>182</sup> See *Boilermakers*, 73 A.3d at 955 n.93 (“For present purposes . . . the issue is not whether someone might deem it more legitimate in some sense to proceed by an amendment to the certificate of incorporation rather than by a bylaw. That decision was for the Chevron and FedEx boards in the first instance, and *the stockholders have multiple tools to hold the boards accountable if the stockholders disagree with it.*” (emphasis added)).

<sup>183</sup> *Id.* at 956 (“[T]he statutory regime provides protections for the stockholders, through the infeasible right of the stockholders to adopt and amend bylaws themselves. . . . Thus, even though a

shareholders can vote the offending directors out of office.<sup>184</sup> And, perhaps most importantly, shareholders can sue after the fact to demonstrate the inequity of the bylaw as applied in a subsequent dispute.<sup>185</sup>

In the context of fee-shifting, however, self-help is of much less avail to shareholders. First, although shareholders have the formal power to adopt their own bylaw rescinding a bylaw passed by the board, their ability to do so is in fact limited by the inability of the shareholder base to organize, especially in the context of a diffusely held public corporation on an issue that is actively opposed by management.<sup>186</sup> Shareholders may coalesce to amend the bylaws in the context of a takeover battle or a proxy fight.<sup>187</sup> The repeal of a fee-shifting bylaw, however, has no obvious inciting incident—it is unlikely to arise in connection with either takeovers or proxy fights—and therefore no likely champion to organize the repeal effort.<sup>188</sup>

Likewise, shareholders' ability to seek recourse by demonstrating the inequitable workings of fee-shifting as applied to their case devolves into a catch-22. In order for fee-shifting to be found inequitable, there must be a case in controversy. In order for there to be a case in controversy, a claim must be brought. However, fee-shifting bylaws operate to deter claims from ever being brought. Therefore fee-shifting bylaws, by eliminating the shareholders' claims in the first place, will preclude shareholders from ever attacking their operation as inequitable. The *ATP Tour* court appears to have missed this dynamic in their recitation of standard Delaware cases preserving the ability of shareholders to challenge facially valid governance terms on an as applied basis.<sup>189</sup> In the context of fee-shifting, there is likely to be no such opportunity. Instead, the shareholders' ability to protest will be stolen silently by a unilateral action of the board.

board may, as is the case here, be granted authority to adopt bylaws, stockholders can check that authority by repealing board-adopted bylaws.”)

<sup>184</sup> *Id.* at 956–57 (“And, of course, because [Delaware General Corporate Law] gives stockholders an annual opportunity to elect directors, stockholders have a potent tool to discipline boards who refuse to accede to a stockholder vote repealing a forum selection clause.”).

<sup>185</sup> *Id.* at 957 (“The forum selection bylaws . . . are considered presumptively, but not necessarily, situationally enforceable.”).

<sup>186</sup> *Cf.* Smith et al., *supra* note 170, at 129 (“The main impediment to private ordering in public corporations is the difficulty of conducting a negotiation involving widely dispersed shareholders.”) Diffuse ownership makes informal coordination impossible. Being a public company further inhibits shareholder communications by requiring compliance with the proxy rules. And managerial opposition means the only way to succeed is to wage and win a costly proxy fight.

<sup>187</sup> There are several examples of shareholders repealing bylaws in the context of takeover battles and proxy fights. *See, e.g., Airgas, Inc.*, 8 A.3d at 1184 (examining the broader proposition that amendments happen in takeover context); *Chesapeake Corp. v. Shore*, 771 A.2d 293, 354 (Del. Ch. 2000) (discussing the repeal of staggered board provision in the bylaws).

<sup>188</sup> Except, perhaps, proxy advisory firms, discussed below. *See infra* notes 190–193 and accompanying text.

<sup>189</sup> *ATP Tour*, 91 A.3d at 558–59.

The greatest constraint on boards' ability to adopt fee-shifting bylaws ultimately may be the second corrective measure referred to in *Boilermakers*—that is, the ability of shareholders to vote against directors who adopt fee-shifting bylaws. The typical inability of shareholders to act cohesively around corporate governance issues can be and often is overcome when proxy advisory firms take strong positions with regard to specific governance issues. A powerful recent example involves the board adoption of bylaws purporting to disqualify director nominees who received a portion of their compensation from outside sources, typically activist investors.<sup>190</sup> The majority of companies adopting this bylaw immediately repealed it when Institutional Shareholder Services (“ISS”), the most important proxy-advisory service, issued a strongly worded memo threatening to recommend a vote against any director nominee that had adopted the disqualification bylaw.<sup>191</sup> Fee-shifting bylaws would seem to present an even more significant opportunity for proxy advisors to organize shareholder opposition to director sponsored bylaws.<sup>192</sup> But for ISS, however, it would seem that shareholders have very little real power to constrain boards from adopting fee-shifting bylaws.<sup>193</sup>

The disconnect between *Boilermakers* and *ATP Tour* thus lies in the court's failure to perceive the distinction between shareholders' ability to engage in self-help in the forum-selection context and their inability to do so in the fee-shifting context.<sup>194</sup> Yet it is an important distinction, the clear implica-

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<sup>190</sup> The compensation arrangements were referred to as “golden leashes” in the financial press, reflecting the suspicion that directors receiving outside compensation would be tied more to the source of that consideration, often several orders of magnitude higher than customary director compensation, than to the corporation itself. See Matthew D. Cain et al., *The Case of the Golden Leash 3–5* (Dec. 20, 2014) (unpublished manuscript) (on file with author).

<sup>191</sup> Institutional Shareholder Services, *Wheeling Out the Procrustean Bed: Bylaw Restrictions on Dissident Nominee Compensation*, M&A EDGE NOTE: N. AM. 1, 3 (Nov. 26, 2013), [http://www.thedeal.com/first\\_word/Wheeling\\_Out\\_the\\_Procrustean\\_Bed\\_-\\_Bylaw\\_Restrictions\\_on\\_Dissident\\_Nominee\\_Compensation-1.pdf](http://www.thedeal.com/first_word/Wheeling_Out_the_Procrustean_Bed_-_Bylaw_Restrictions_on_Dissident_Nominee_Compensation-1.pdf), archived at <https://perma.cc/D4GZ-8LE8?type=pdf>.

<sup>192</sup> The most recent revision to the ISS Proxy Voting Guidelines foreshadows this opposition, citing unilateral charter or bylaw amendments that diminish shareholder rights as a basis for recommending votes against individual directors, committees, or entire boards, and likewise identifying fee-shifting provisions as key provisions impacting the ability of shareholders to bring suit against the company. *United States Proxy Voting Guidelines Updates: 2015 Benchmark Policy Recommendations*, INT'L S'HOLDER SERVS. 3, 6–7 (Nov. 6, 2014), <http://www.issgovernance.com/file/policy/2015USPolicyUpdates.pdf>, archived at <https://perma.cc/ND5E-ZSTW?type=pdf>.

<sup>193</sup> Whether fundamental matters of corporate policy should be delegated to a private for-profit firm is an important question outside the scope of the present Article. See generally Stephen Choi et al., *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869 (2010) (discussing the apparent influence of proxy advisors on shareholder voting and identifying various possible reasons for the relationship).

<sup>194</sup> Moreover, as alluded to above, Delaware has political economy reasons for looking favorably upon forum selection (i.e., retaining its place the national corporate law-maker) and disfavorably upon fee-shifting (i.e., risking horizontal pre-emption by offending core constituencies on both sides of the corporate bar and vertical pre-emption by demonstrating too great a pro-management bias). See *supra* notes 159–160 and accompanying text.

tion of which is that in the absence of significant ex post constraints on the ability of boards to abuse shareholders through the bylaw process, there should be greater ex ante scrutiny of board-adopted bylaws. In failing to recognize this underlying principle, the *ATP Tour* court claimed to apply *Boilermakers* but in fact adopted a much more rigid rule.

### III. THE TRANSFORMATION OF FEE-SHARING INTO FEE-SHIFTING

If current fee-shifting proposals overreach as a result of focusing on the effect of excessive litigation rather than its cause, the question of what has caused the current crisis in shareholder litigation remains, along with the question of how to fix it. This Part argues that the fundamental cause of the current crisis is the misinterpretation and resulting misapplication of the corporate benefit doctrine. This doctrinal error transformed a principle of fee-sharing into a rule of fee-shifting—that is, the Delaware Rule, under which the corporation always pays. The Delaware Rule, in turn, has given rise to the present crisis in shareholder litigation. Section A below probes the origins of the corporate benefit doctrine.<sup>195</sup> Section B shows precisely where and how judicial interpretation led the doctrine astray.<sup>196</sup> Section C then reviews and analyzes the implications of the transformation.<sup>197</sup> A concrete set of proposals for fixing the problem is offered in the Part that follows.

#### *A. Fee-Sharing: The Common Benefit and Common Fund Doctrines*

The doctrinal confusion surrounding fee-shifting has its origins in the ancient division between courts of law and courts of equity. In English courts of law, the cost of litigation, including attorneys' fees, was borne by the losing party—the so-called English Rule referred to above.<sup>198</sup> In English courts of equity, by contrast, the chancellor had jurisdiction over funds and estates in which multiple actual or potential claimants held a common interest and therefore regularly charged fees back to the estate when a claimant increased or protected the value of the estate for the benefit of all.<sup>199</sup> Courts of equity, in other words, applied a doctrine of fee-sharing, not fee-shifting.

In spite of famously declining to follow English doctrine on fee-shifting, American courts did adopt the practice of English courts of equity in ordering the sharing of fees among all beneficiaries of a fund recovered for the “com-

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<sup>195</sup> See *infra* notes 198–219 and accompanying text.

<sup>196</sup> See *infra* notes 220–238 and accompanying text.

<sup>197</sup> See *infra* notes 239–252 and accompanying text.

<sup>198</sup> Arthur L. Goodhart, *Costs*, 38 *YALE L.J.* 849, 851–54 (1929); Charles T. McCormick, *Counsel Fees and Other Expenses of Litigation as an Element of Damages*, 15 *MINN. L. REV.* 619, 619–20 (1931).

<sup>199</sup> Goodhart, *supra* note 198, at 854.

mon benefit.”<sup>200</sup> The leading American authority on the common benefit doctrine is a U.S. Supreme Court opinion from 1881, *Trustees v. Greenough*.<sup>201</sup> In that case, a bondholder successfully sued to rescind a fraudulent conveyance of railroad company assets. The trial court ordered the plaintiff’s attorneys’ fees to be paid out of the funds recovered, and the Supreme Court affirmed the award on appeal, treating the plaintiff as a quasi-trustee, the denial of whose expenses would unjustly enrich others benefited by his efforts.<sup>202</sup> In the Court’s words:

[Failure to award fees and expenses] would not only be unjust to him, but it would give to the other parties entitled to participate in the benefits of the fund an unfair advantage. He has worked for them as well as for himself; and if he cannot be reimbursed out of the fund itself, they ought to contribute their due proportion of the expenses which he has fairly incurred. To make them a charge upon the fund is the most equitable way of securing such contribution.<sup>203</sup>

The Court’s rationale thus firmly grounded what became known as the “*Greenough* rule” in equity, specifically trust, in which parties recovering funds for a trust estate are entitled to reimbursement either out of the funds recovered or “by a proportional contribution from those who accept the benefit of his efforts.”<sup>204</sup> The *Greenough* rule was widely accepted and applied by state as well as federal courts.<sup>205</sup>

Because the *Greenough* rule awarded fees only when the action increased or protected the value of funds common to all members of the class,<sup>206</sup> it came to be known alternatively as the “common fund” doctrine.<sup>207</sup> Monetary recovery was important because, as noted above, the rule permitted fee-sharing, not

<sup>200</sup> See generally John P. Dawson, *Lawyers and Involuntary Clients: Attorney Fees from Funds*, 87 HARV. L. REV. 1597 (1974) (analyzing the “uncertain and conflicting policies” behind the American approach to awarding attorneys’ fees); John Leubsdorf, *Toward a History of the American Rule on Attorney Fee Recovery*, 47 L. & CONTEMP. PROBS. 9 (1984) (analyzing the history of the American rule and shifts in attitude towards its application).

<sup>201</sup> 105 U.S. 527, 538 (1881).

<sup>202</sup> *Id.* at 531–33.

<sup>203</sup> *Id.* at 532.

<sup>204</sup> *Id.* at 533 (citing precedent, starting with English Courts of Equity).

<sup>205</sup> See generally *Allowance of Attorney’s Fee Against Property or Fund Increased or Protected by Attorney’s Services*, 49 ALR 1149 (1927), supplemented by 107 ALR 749 (1937) (providing historical context for the Rule and listing cases applying it).

<sup>206</sup> Plaintiffs, however, need not have been organized into a formal class action. Hornstein, *supra* note 52, at 665–75 (categorizing cases involving common fund recoveries as either “true,” “hybrid,” or “spurious” class actions).

<sup>207</sup> See e.g., Dawson, *supra* note 200, at 1601 (“The ‘common fund’ as a source of counsel fees has been created . . . by the United States Supreme Court [in *Greenough*].”). This Article therefore uses the terms “*Greenough* rule,” “common benefit doctrine,” and “common fund doctrine” interchangeably.

fee-shifting. Because funds recovered are an asset of the plaintiff class, fees paid from recovered funds are paid by plaintiffs, *not* the defendant.<sup>208</sup> When funds are not recovered (or the value of funds held in trust is not otherwise increased by the action), then the only means of recovering plaintiffs' fees under a doctrine of fee-sharing would be by means of a pro rata assessment on each member of the benefiting class.<sup>209</sup> Historically, parties did not press and courts did not award recoveries on this basis, but rather confined the reach of the *Greenough* rule to a share of funds recovered.

The *Greenough* rule was first applied to shareholder litigation in the context of derivative suits. The early cases treated the derivative suit as a straightforward application of the common fund principle, which indeed it was, as long as monetary relief was recovered.<sup>210</sup> Monetary relief was typical, and attorneys' fees were measured as a percentage of the recovery.<sup>211</sup>

The derivative suit, however, began to push at the limits of the *Greenough* rule when it resulted in non-pecuniary relief.<sup>212</sup> Some awards of non-pecuniary relief—such as, for example, the avoidance of a conflict-of-interest transaction or the cancellation of a harmful *ultra vires* act<sup>213</sup>—could be squared with the

<sup>208</sup> See George D. Hornstein, *The Counsel Fee in Stockholder's Derivative Suits*, 39 COLUM. L. REV. 784, 786 (1939) (“[In common fund cases,] the successful litigant’s lawyers are not being paid by the unsuccessful party, but by the class of which the successful litigant is a member, which would have had to pay these expenses had it brought the action itself.”); Robert A. Smith, *Recovery of Plaintiff's Attorney's Fees in Corporate Litigation*, 40 L.A. B. BULL. 15, 17 (1964) (“[U]nder the equitable fund doctrine, the award of attorney’s fees is against the *plaintiffs*. Plaintiffs do *not* obtain a personal judgment against the defendant or defendants for attorney’s fees.” (citations omitted)).

<sup>209</sup> Hornstein, *supra* note 208, at 789 (framing the claim to fees as “a claim by the attorney against the class”).

<sup>210</sup> *Id.* at 799 (reporting the results of a survey of fifty-four American cases from the late nineteenth and early twentieth centuries and finding that attorneys’ fees were awarded “if the suit is derivative and the corporation benefits, whether the suit results in (1) money damages; or (2) cancellation of an improper transaction, or the setting aside of a fraudulent conveyance”). The allegations in these suits overwhelmingly involved inadequate compensation in sales of corporate stock or assets, excessive executive compensation, and outright looting. *Id.* at 797. Underscoring the pecuniary nature of the relief involved in these suits, counsel fees were frequently measured against the percentage of the benefit returned to the corporation and were often in the range of twenty to thirty-five percent.

<sup>211</sup> *Id.* at 813–14 (compiling cases); see Hornstein, *supra* note 54, at 586–87 (updating prior study with fifteen additional observations showing consistent results); see also George D. Hornstein, *New Aspects of Stockholders' Derivative Suits*, 47 COLUM. L. REV. 1, 16–17 (1947) (further updating prior study with additional observations showing generally consistent results).

<sup>212</sup> See Hornstein, *supra* note 52, at 667–70 (citing cases where counsel fees were awarded in derivatives suits notwithstanding the lack of a common fund); Smith, *supra* note 208, at 17–18.

<sup>213</sup> See, e.g., *Greenough v. Coeur D'Alenes Lead Co.*, 18 P.2d 288, 289 (Idaho 1932) (awarding counsel fees in shareholder suit resulting in cancellation of an unauthorized sale of corporate shares to a member of the board of directors); *Abrams v. Textile Realty Corp.*, 97 N.Y.S.2d 492, 495–97 (Sup. Ct. 1949) (awarding counsel fees in shareholder suit to set aside an *ultra vires* act of the corporation); *Baker v. Seattle-Tacoma Power Co.*, 112 P. 647, 651 (Wash. 1911) (awarding counsel fees in shareholder suit resulting in a cancellation of sale and return of a valuable asset to the corporation). Although these cases do not result in the creation of a “common fund,” the benefit is pecuniary in nature and therefore easily measured by reference to the transaction cancelled or the funds protected. See,



common benefit doctrine in spite of not creating a separate fund because such awards had a clear monetary impact on the value of the firm.<sup>214</sup> Not all awards of non-pecuniary relief, however, were so easy to square with doctrine—for example, relief resulting in clarification of election procedures or the interpretation of bylaws. There was no clear authority under *Greenough* to award fees in derivative suits resulting in non-pecuniary relief with no clear monetary impact on the value of the firm.

Courts solved this problem with a doctrinal innovation that was grounded in the procedural peculiarities of the derivative suit. In derivative suits, although the corporation is listed as a nominal defendant, the corporation in fact serves as the *plaintiff*, bringing suit against those officers or directors that have harmed it.<sup>215</sup> That the shareholders have merely brought the claim on the corporation's behalf is reflected by the fact that any recovery ultimately won in the litigation is paid to the corporation, not the shareholders.<sup>216</sup> Because, in derivative suits, the plaintiff *is* the corporation, fees and expenses paid by the corporation are paid by the plaintiff. Hence, an award of attorneys' fees in a derivative suit, regardless of whether the relief is pecuniary or non-pecuniary in nature, is in fact paid by the plaintiff, consistent with the fee-sharing principle in *Greenough*. This was the reasoning followed in 1960 by the Minnesota Supreme Court in the leading case of *Bosch v. Meeker Co-Op Light & Power*, which held:

Since the corporation is the beneficiary of the recovery of funds or of the corrective benefit of the action, it should stand the expense of it. It should further be conceded that there may be stockholder's ac-

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*e.g.*, *Beyerbach v. Juno Oil Co.*, 265 P.2d 1, 12 (Cal. 1954) (measuring an award of attorneys' fees against the value of the fund protected). As a result, such cases fall within the original meaning and intent of *Greenough*, however, which allowed for relief not only for the recovery but also the *protection* of common funds. *See, e.g.*, *Dawson, supra* note 200, at 1614–25 (describing different means of creating funds consistent with *Greenough*).

<sup>214</sup> Such awards were consistent with the equitable origins of fee-sharing in increasing or protecting the value of a common fund. *See Tandycrafts, Inc. v. Initio Partners*, 562 A.2d 1162, 1164–65 (Del. 1989) (citing *CM & M Grp., Inc. v. Carroll*, 453 A.2d 788, 795 (Del. Super. 1982)) (“Typically, successful derivative or class action suits which result in the recovery of money or property wrongfully diverted from the corporation, or which result in the imposition of changes in internal operating procedures that are designed to produce such monetary savings in the future, are viewed as fund-creating actions.”). As a result of this reasoning, early commentators were generally untroubled by the award of fees in this context. *See, e.g.*, *Hornstein, supra* note 211, 13–16 (including several such cases in his survey of derivative suits).

<sup>215</sup> In a derivative suit, the corporation plays both roles, but at different times. In the first part of the derivative suit, where the stockholder sues the corporation to sue, the corporation is the nominal defendant. In the second part of the derivative suit, the suit for relief, the corporation is the plaintiff. Thus with regard to the ultimate relief paid in connection with the suit—relief that is paid as a result of claims asserted in the second part of the suit, not the first—the corporation is the plaintiff. *See supra* note 38 and accompanying text.

<sup>216</sup> *See supra* note 42 and accompanying text.

tions which do not result in the creation of cash funds or in the protection or conservation of corporate assets, but which nevertheless result in a correction or straightening out of corporate affairs, so as to provide a substantial benefit which will warrant recovery of costs and attorneys' fees.<sup>217</sup>

The *Bosch* court's innovation came to be known, of course, as the "corporate benefit" doctrine.<sup>218</sup> This doctrine was understood by courts adopting it as a corollary to the "common fund" doctrine, fully consistent with the *Greenough* rule.<sup>219</sup> Consistency with *Greenough*, however, depends upon the procedural peculiarities of the derivative suit in which the corporation against which attorneys' fees are ultimately assessed functions, in fact, as the plaintiff. It is in this context alone that corporate benefit remains true to its origins as a doctrine of fee-sharing, not fee-shifting.

### *B. Fee-Shifting: Corporate Benefit Outgrows the Confines of the Derivative Suit*

Now, fifty years after *Bosch*, the "corporate benefit" doctrine has been widely, if not uniformly, adopted by state and federal courts in the United States.<sup>220</sup> Unfortunately, these courts have not always attended to the origins of the doctrine and thus have often applied it beyond the traditional confines of the derivative suit. The doctrine has, for example, become an essential element in the settlement of shareholder class actions, driving the current boom in merger litigation.<sup>221</sup> The use of corporate benefit to award fees in this context is not justified by the origins of the doctrine. This is not a mere peccadillo. When a court applies corporate benefit outside of the derivative suit context, its order no longer effects a *sharing* of costs and fees among plaintiffs, but rather a

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<sup>217</sup> *Bosch v. Meeker Coop. Light & Power Ass'n*, 101 N.W.2d 423, 426 (Minn. 1960). Further clarifying the doctrine, the *Bosch* court stated:

In the face of unwise, arbitrary, or unreasonable ultra vires acts or conduct of corporate officers which would be harmful to the interests of the corporation, a stockholder should be permitted to prosecute a suit to redress a wrong or prevent a threatened wrong to his corporation even though such action might not result in "pecuniary benefit."

*Id.*

<sup>218</sup> See *supra* notes 119–132 and accompanying text (describing how this doctrine is currently applied in shareholder litigation).

<sup>219</sup> See, e.g., *Fletcher v. A.J. Indus., Inc.*, 72 Cal. Rptr. 146, 152 (Ct. App. 1968) ("the substantial-benefit doctrine is an extension of the common-fund doctrine").

<sup>220</sup> Forty states expressly recognize a plaintiffs' right to attorneys' fees in cases involving pecuniary relief. Fourteen states expressly recognize a right to fees under corporate benefit in the context of non-pecuniary relief. Seven have an express statement against it. The remainder are unclear.

<sup>221</sup> See *supra* notes 119–132 and accompanying text; see also Fisch et al., *supra* note 6 (manuscript at 8–9) ("The key to plaintiffs' counsel recovering fees [in merger litigation] is the portrayal of the settlement relief as a corporate benefit.").

*shifting* of costs and fees to the defendant, something courts typically are loathe to do in the absence of express statutory authorization.<sup>222</sup>

Delaware's use of the corporate benefit doctrine predates *Bosch*. For example, the 1958 Court of Chancery decision in *Saks v. Gamble* awarded fees in a derivative suit on the basis of a disclosure clarifying the ownership of a corporate asset, a benefit, the court said, that "cannot be directly measured in dollars and cents" but that nevertheless "was of sufficient value to justify the allowance of reasonable fees."<sup>223</sup> Although the courts in such cases clearly recognized that they were operating under an exception to the American Rule, the early decisions failed to delineate either the basis or the bounds of the exception. For example, the 1953 Delaware Supreme Court opinion in *Maurer v. International Re-Insurance Corp.*, widely cited for enumerating the recognized exceptions to the American Rule, did not include the corporate benefit theory on the list.<sup>224</sup> In this environment of doctrinal instability, judicial opinions combined claims and mixed theories so that a resulting award ultimately might derive from a more established theory, typically the common fund doctrine.<sup>225</sup> Those rare cases where corporate benefit was the only possible basis for a fee award usually were derivative suits.<sup>226</sup> But not always.

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<sup>222</sup> U.S. Supreme Court, for example, has held that:

[federal] courts are not free to fashion drastic new rules with respect to the allowance of attorneys' fees . . . or to pick and choose among plaintiffs and the statutes under which they sue and to award fees in some cases but not in others, depending upon the courts' assessment of the importance of the public policies involved in particular cases.

*Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240, 269 (1975); see *Dover Historical Soc'y, Inc. v. City of Dover Planning Comm'n*, 902 A.2d 1084, 1091 (Del. 2006) ("Historically, our courts have been cautious about creating and expanding judge-made exceptions to the American Rule absent express and clear legislative guidance. [The present case] clearly created a social benefit. But, that benefit is not of the kind that justifies creating a new judge-made exception to the American Rule.").

<sup>223</sup> 154 A.2d 767, 770 (Del. Ch. 1958).

<sup>224</sup> 95 A.2d 827, 830–31 (Del. 1953) (listing suits recovering a common fund, trustees seeking instructions concerning the administration of a trust or estate, interpleader suits, and court appointed counsel to advocate an issue no litigant will address); see *Mencher v. Sachs*, 164 A.2d 320, 322 (Del. 1960) (citing *Maurer* for the proposition that "[t]here can be no doubt of the 'jurisdiction' of equity to award counsel fees as costs in a proper case" while also asserting that the absence of a theory from the *Maurer* list does necessarily imply a proffered theory is improper); *Richman v. DeVal Aerodynamics, Inc.*, 185 A.2d 884, 885 (Del. Ch. 1962) (citing *Maurer* as authority to award fees in suit resulting in non-pecuniary relief, a situation not contemplated in *Maurer*).

<sup>225</sup> *Mencher*, 164 A.2d at 322 (combining a direct claim to compel a stockholders' meeting with a derivative claim to cancel illegally issued shares and awarding fees for an benefit that had "no dollar basis" in spite of the fact that the relief—the cancellation of illegally issued shares and the termination of a harmful contract—would have been cognizable under the common fund doctrine); *Lewis v. Great United W. Corp.*, No. 5397, 1978 WL 2490 at \*11 (Del. Ch. Mar. 28, 1978) (awarding fees in case mixing class and derivative claims on the basis of the common fund doctrine).

<sup>226</sup> See, e.g., *Chrysler Corp. v. Dann*, 223 A.2d 384, 386 (Del. Ch. 1966); *Saks*, 154 A.2d at 770.

In the 1962 Court of Chancery decision in *Richman v. DeVal*, an individual plaintiff petitioned the court for an award of attorneys' fees after successfully suing, in the midst of a battle for corporate control, to force the corporation to convene a special shareholder meeting.<sup>227</sup> The corporation contested the fee request, arguing that the plaintiff had acted in his individual capacity to further his own interest in seeking to "capture the control of DeVal."<sup>228</sup> Rejecting this as a basis to deny fees, the Court of Chancery asserted "where a basis in law for recovery of fees is established, the characterization of a suit as derivative or representative is immaterial, the assets of the corporation being a fund belonging to the stockholders in common."<sup>229</sup> The court declined to affirm the plaintiffs' broader contention that "wherever a legal suit is successful in permitting the whole body of stockholders to take some 'corporate action,' then the suit itself must be characterized as a class action and the corporation charged with the costs of the litigation," implying that this formulation likely overstated the rule.<sup>230</sup> Leaving the precise contours of the rule for another day, however, the court held merely that plaintiffs had created sufficient benefit in the present case to support an award of fees.<sup>231</sup> The *Richman* court thus ordered the corporate defendant to pay a non-derivative plaintiff's litigation fees on the basis of a non-pecuniary corporate benefit.

The modern source of the corporate benefit doctrine, the Delaware Supreme Court's 1989 decision in *Tandycrafts, Inc. v. Initio Partners*, arose in a similar context and came to a similar result.<sup>232</sup> After rebuffing a significant blockholder's unsolicited offer to acquire control, Tandycrafts began to campaign for a supermajority charter amendment to be voted upon at an upcoming shareholders' meeting. When the blockholder sued on the basis of misleading statements in the company's proxy concerning the supermajority voting requirement, Tandycrafts corrected its proxy but ultimately lost the vote.<sup>233</sup> After the meeting, the blockholder filed a request for attorneys' fees on the basis of the benefit created by the corrective disclosure in the proxy. The Chancery Court awarded fees, and Tandycrafts appealed.

On appeal, the Delaware Supreme Court rejected Tandycrafts' argument that fees could not be awarded because the blockholder had acted in an indi-

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<sup>227</sup> See 185 A.2d at 885.

<sup>228</sup> *Id.*

<sup>229</sup> *Id.* (citing *Mencher*, 164 A.2d 320).

<sup>230</sup> *Id.* at 886.

<sup>231</sup> *Id.* ("[T]his is not a case involving solely a demand for the calling of a stockholders' meeting. It also embraced an attack on proposed action by the directors which at least a majority in interest of the stockholders considered to be detrimental to the corporation generally.")

<sup>232</sup> 562 A.2d at 1167.

<sup>233</sup> Specifically, the proxy failed to disclose that the combined holdings of the company's employee benefits plan (10.9%) and shares held by management (7.5%) made a non-management sponsored takeover realistically impossible. *Id.* at 1163.

vidual capacity—that is, the suit was neither a derivative suit, nor a shareholder class action.<sup>234</sup> Instead, the court emphasized that the relevant inquiry in a fee award is “not the status of the plaintiff but the nature of the corporate or class benefit.”<sup>235</sup> Recognizing the benefit of the corrective disclosure in this case, the court again emphasized that “the form of the suit is not a deciding factor” and ultimately shifted fees to the corporate defendant.<sup>236</sup>

In so holding, of course, the court was making new law. Prior interpretations of the corporate benefit doctrine grounded it in derivative suits so that it could still be understood as an assessment of fees against plaintiffs, rather than defendants—that is, fee-sharing rather than fee-shifting. In cutting the strings tying the doctrine to its derivative suit origins, *Tandycrafts* essentially created a new exception to the American rule, allowing fee-shifting where previously there had only been fee-sharing.<sup>237</sup> The court did not offer a doctrinal foundation for the new exception, nor did it seriously consider the consequences, leaving it to the Court of Chancery to police abuse.<sup>238</sup>

### C. Implications of the Doctrinal Transformation

In spite of the unfortunate assertions of the Court of Chancery in *Richman*<sup>239</sup> and the Supreme Court in *Tandycrafts*,<sup>240</sup> there is a significant difference between whether an action is brought as a derivative suit, on the one hand, or as an individual or class action, on the other.<sup>241</sup> Most obviously, the derivative suit subjects the complaint to a panoply of procedural obstacles—the demand requirement, susceptibility to dismissal by a special litigation committee, and in some jurisdictions, a requirement that plaintiffs post a bond for defense costs—all of which are designed to deter excessive litigation.<sup>242</sup> By limiting fee awards

<sup>234</sup> *Id.* at 1165.

<sup>235</sup> *Id.* at 1166.

<sup>236</sup> *Id.* (quoting *Reiser v. Del Monte Prop. Co.*, 605 F.2d 1135, 1139 (9th Cir. 1979)).

<sup>237</sup> The *Tandycrafts* court used the phrase “fee-shifting” as have most courts since. *Tandycrafts*, 562 A.2d at 1164, 1166; *In re First Interstate Bancorp Consol. S’holder Litig.*, 756 A.2d 353, 360 (Del. Ch. 1999), *aff’d sub nom.* *First Interstate Bancorp v. Williamson*, 755 A.2d 388 (Del. 2000).

<sup>238</sup> *Tandycrafts*, 562 A.2d at 1166. The Court of Chancery has subsequently qualified the rights of bidders to seek attorneys’ fees in litigation connected to takeover fights but has not otherwise disturbed the breadth of the *Tandycrafts* holding. *In re Dunkin’ Donuts S’holders Litig.*, Civ. A. No. 10825, 1990 WL 189120, at \*9 (Del. Ch. July 23, 1990) (“[The bidder] has no obvious reason to try to ‘maximize shareholder value.’ Indeed, its interest, if successful, will minimize shareholder value. Stockholders, on the other hand, do not care if the bidder gets a ‘good deal,’ they want the most compensation available for their holding in the company.”).

<sup>239</sup> *Richman*, 185 A.2d at 885 (“[W]here a basis in law for recovery of fees is established, the characterization of a suit as derivative or representative is immaterial . . .” (emphasis added)).

<sup>240</sup> *Tandycrafts*, 562 A.2d at 1166 (stating that whether to award fees depends “not [on] the status of the plaintiff but [on] the nature of the corporate or class benefit” (emphasis added)).

<sup>241</sup> BALOTTI & FINKELSTEIN, *supra* note 48, § 13.10 (“Whether an action is characterized as individual, class, or derivative can have significant consequences.”).

<sup>242</sup> See *supra* notes 54–58 and accompanying text.

for non-pecuniary relief to the derivative suit context, the original corporate benefit doctrine thus contained built-in mechanisms to prevent abuse.<sup>243</sup> Further mechanisms also have been suggested to constrain the abuse of non-pecuniary relief in the derivative suit context.<sup>244</sup> Class actions are presently subject to none of these constraints.<sup>245</sup>

Nor, of course, are individual suits. Why then has the extension of the corporate benefit doctrine in *Tandycrafts* not led to a similar explosion of filings of *individual* as opposed to *class* actions? Although a partial answer to this question may be found in the subsequent denial of attorneys' fees for individual litigants in takeover cases, the context in which individual litigants are most likely to arise,<sup>246</sup> a fuller explanation is suggested by the dynamics of shareholder litigation explored above.<sup>247</sup> The litigation release is what makes defendants settle, and defendants seek the widest possible litigation release. However, litigation releases can bind absent parties only when entered as a judicial order in class or derivative litigation. Therefore, although *Tandycrafts* permits plaintiffs' lawyers to have their fees paid for individual actions, because defendants will settle on a class basis or not at all, plaintiffs' lawyers working under a contingency arrangement have no incentive to represent individual litigants.<sup>248</sup> Hence the absence of individual actions and the proliferation of shareholder class actions.

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<sup>243</sup> On the susceptibility of awarding fees for non-pecuniary relief to abuse, see Schechtman v. Wolfson, 244 F.2d 537, 540 (2d Cir. 1957) (“[T]here should be some check on derivative actions lest they be purely strike suits of great nuisance and no affirmative good, and hence it is ruled generally that the benefit to the corporation and the general body of shareholders must be substantial.”).

<sup>244</sup> See, e.g., AMERICAN LAW INST., 2 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.17 (1994) (requiring that “in no event should the attorney’s fee award exceed a reasonable proportion of the value of the relief (including nonpecuniary relief) obtained by the plaintiff for the corporation”). The Commentary to § 7.17 makes it clear that although intangible relief may be a basis for attorneys’ fees under this rule, the intangible relief must “be susceptible to sufficient valuation as to permit the courts to relate the fee award to it.” *Id.* § 7.17 cmt. (a). The commentary also urges judges reviewing settlements to be especially suspicious of any “settlement in which the defendants’ cash contribution just equals or exceeds the requested award of attorneys’ fees.” *Id.* § 7.17 cmt. (d).

<sup>245</sup> The class action is subject to its own procedural requirements, of course, including for example, numerosity, commonality, typicality, the fairness and adequacy of the class representative, and predominance of common questions of law or fact. See DEL. SUP. CT. R. 23(a)–(b). However, these essentially reflect the definition of a class action, not substantive rules designed to deter excessive class action litigation such as, in the federal context, the pleading requirements and discovery stay contained in the Private Securities Litigation Reform Act of 1995 (PSLRA). Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.). The PSLRA applies only to federal securities class actions, not shareholder class actions alleging breach of fiduciary duty under state law. *Id.*

<sup>246</sup> On the carve-out of fee awards in the takeover context, see *supra* note 238. On the likelihood of individual litigants arising in the takeover context, see *infra* notes 275–278 and accompanying text.

<sup>247</sup> See *supra* notes 88–107 and accompanying text.

<sup>248</sup> Additionally, because fees are awarded in relation to the size of the benefit, a lawyer representing an individual litigant may be seen to create a smaller benefit (the benefit to the individual

Finally, it is simply not the case, as suggested in *Richman*, that assessing fees against the corporation in a class action is equivalent to assessing fees against the corporation in a derivative suit.<sup>249</sup> Fees are not assessed against corporations in the derivative suit context as a matter of administrative convenience but rather as a reflection of the fact that, in that context alone, the corporation is the plaintiff.<sup>250</sup> Furthermore, as a policy matter, the justification for awarding fees for therapeutic derivative suit settlements is that the therapeutics increase the long term value of the corporation.<sup>251</sup> This justification cannot apply to merger class actions because in that context there is no long term. Rather, the change of control transaction that is the basis of the plaintiffs' suit puts the corporation in a "last period" scenario, triggering duties to maximize the immediate short term value of the firm.<sup>252</sup> Non-pecuniary relief in this context does not increase firm value. It diminishes it by the amount paid in litigation costs and attorneys' fees, an amount often referred to as the "deal tax." Assessing attorneys' fees against the corporation for non-pecuniary relief in the context of merger class actions therefore destroys firm value whereas, in the derivative suit context, such relief enhances it.

Fee-sharing, the original position of the *Greenough* rule and the common fund doctrine, is not the same as fee-shifting. By failing to recognize this distinction, the *Tandycrafts* court inadvertently departed from both the American and English Rules on fees, creating instead the Delaware Rule, under which the corporation always pays. The Delaware Rule is the cause of the current crisis in shareholder litigation, fueling vast quantities of non-meritorious claims. The question, then, is what to do about it. That is the subject of the next Part.

#### IV. A PROGRAM OF REFORM

This Article has argued that the current generation of fee-shifting bylaws is not an acceptable means of responding to the crisis in shareholder litigation and ought therefore to be invalidated by the Delaware courts.<sup>253</sup> But what then? Returning to the *status quo* prior to *ATP Tour* leaves the fundamental public policy concerns unaddressed and the very problem that has led corpora-

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rather than the benefit to the class) and therefore be entitled to a smaller fee. See *supra* note 133 and accompanying text.

<sup>249</sup> 185 A.2d at 885 (justifying the fee award because "the assets of the corporation [are] a fund belonging to the stockholders in common").

<sup>250</sup> See *supra* note 38 and accompanying text.

<sup>251</sup> Hornstein, *supra* note 52, at 662–63.

<sup>252</sup> See generally Sean J. Griffith, *Deal Protection Provisions in the Last Period of Play*, 71 *FORDHAM L. REV.* 1899 (2003) (discussing the role of the last period problem in animating Delaware takeover jurisprudence); Laster, *supra* note 76 (employing the last period problem to critique the current doctrine of "enhanced scrutiny").

<sup>253</sup> See *supra* notes 157–165 and accompanying text.

tions to adopt fee-shifting bylaws unchanged. If Delaware is to take its role as the national corporate law leader seriously, it not only must invalidate fee-shifting bylaws, it also must offer a realistic solution to the problem of excessive shareholder litigation. This Article has identified the cause of the current crisis as the misapplication of the corporate benefit doctrine resulting in a system that shifts the full cost of intra-corporate litigation to corporate defendants. The right way to fix what is presently wrong with shareholder litigation therefore is to reform the doctrine of corporate benefit.

The remainder of this Article proposes three corrections to current theory and practice involving corporate benefit. First, corporate benefit should not be recognized as a basis for awarding attorneys' fees in class actions.<sup>254</sup> Second, in cases where corporate benefit is recognized, courts should conduct a more rigorous inquiry into how the benefit was created.<sup>255</sup> Third, courts should weigh the benefit received by the shareholder plaintiffs against the breadth of the litigation release received by the corporate defendant, tailoring the scope of the release to the benefit received to guard against the overbroad release of claims.<sup>256</sup> The sections that follow explore these policy proposals in greater detail. Finally, this Part closes by considering how best to enact this package of reforms.<sup>257</sup>

#### *A. No Corporate Benefit for Non-Pecuniary Relief in Shareholder Class Actions*

Corporate benefit should be returned to its doctrinal origins—the derivative suit—and no longer recognized as a justification for fee awards in the class action context.<sup>258</sup> Plaintiffs, of course, could continue to bring suits on a class basis and, if they recovered monetary relief, still could recover attorneys' fees on the basis of the common fund doctrine.<sup>259</sup> Outside of the derivative suit context, however, they could not recover attorneys' fees on the basis of non-pecuniary relief. As a result, plaintiffs would no longer pursue claims that could only result in non-monetary recoveries.

Unlike fee-shifting bylaws, this rule would install an effective filter to screen good claims from bad. The filter would operate on the basis of the plaintiffs' knowledge about the value of their claim, thereby circumventing the information asymmetries that make it difficult for courts to judge the underly-

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<sup>254</sup> See *infra* notes 258–282 and accompanying text.

<sup>255</sup> See *infra* notes 283–294 and accompanying text.

<sup>256</sup> See *infra* notes 295–302 and accompanying text.

<sup>257</sup> See *infra* notes 303–311 and accompanying text.

<sup>258</sup> Returning to doctrinal origins would also disallow the theory as a basis for recovery in individual actions. Individual actions, however, do not present the same problem as class actions. See *supra* note 248 and accompanying text.

<sup>259</sup> See *supra* note 118 and accompanying text.



ing merits of claims at settlement.<sup>260</sup> Claimants with high value claims—those that have some chance of resulting in monetary relief—will bring them. Claimants with low value claims—those that otherwise would result in disclosure-only settlements or other forms of non-pecuniary relief—either will not file them or will abandon them once they are revealed to lack a plausible basis for recovery.<sup>261</sup> The potential to recover fees (or not) thus will drive the advocates themselves—that is, those with the most knowledge concerning the expected value of the underlying claim—to sort good claims from bad ones.

The most obvious practical consequence of this sorting mechanism would be the elimination of disclosure-only settlements. This would present an immediate and substantial reduction in the amount of wasteful litigation without any meaningful loss of shareholder protection. Material misstatements in the proxy could, after all, still be litigated under federal securities law.<sup>262</sup> Indeed, keeping such claims alive by preventing the lawyers from trading a broad release for a meaningless disclosure settlement is a benefit of the rule.<sup>263</sup>

A potentially more controversial consequence of the rule, however, would be the termination of amendment settlements, currently the second most common outcome in merger litigation.<sup>264</sup> As described above, amendment settlements typically involve an adjustment to the merger agreement's deal protection provisions—often a reduction in the termination fee or an extension of the Go-Shop or Window-Shop period.<sup>265</sup> This may be a more objectionable consequence because reducing the stringency of deal protections does, in theory at least, produce a potential benefit for the shareholders—it increases the likelihood of a topping bid. This reasoning is reflected in the leading Delaware case on amendment settlements, the Delaware Court of Chancery's 2011 opinion in *In re Compellent Technologies, Inc. Shareholders' Litigation*, which not only recognized the benefit of such settlements but also suggested a formula for valuing them based upon the probability and magnitude of an overbid.<sup>266</sup> Be-

<sup>260</sup> See *supra* notes 110–113 and accompanying text.

<sup>261</sup> One problem is that claimants might not always know at the time of filing whether a claim is high or low value, a determination that may require some amount of litigation. The rule proposed by this Article would allow claimants to file and pursue investigative efforts, but should the investigation fail to uncover a significant basis for relief, it also creates an incentive for the claimants to drop the claim. Compare this outcome to fee-shifting bylaws, which discourage all claims from being brought in the first place. See *supra* note 153 and accompanying text.

<sup>262</sup> See Fisch et al., *supra* note 6 (manuscript at 31–32) (making this argument).

<sup>263</sup> See *supra* note 102 and accompanying text (discussing the ability of disclosure settlements to release federal securities law claims).

<sup>264</sup> Fisch et al., *supra* note 6 (manuscript at 20).

<sup>265</sup> See *supra* note 85 and accompanying text.

<sup>266</sup> No. 6084-VCL, 2011 WL 6382523, at \*21 (Del. Ch. Dec. 9, 2011). The formula applied to determine the attorneys' fees was first suggested by Vice Chancellor Laster, as dicta, in *Del Monte. See In re Del Monte Foods Co. S'holders Litig.*, No. 6027–VCL, 2011 WL 2535256, at \*16 (Del. Ch. June 27, 2011) (noting that “the value of the benefit [from a reduction in deal protections] does not

cause the rule advocated here would deny fee recoveries for such settlements, one might object that it will lead to overly protected deals and a concomitant decrease in topping bids.

This, however, is unlikely to be the case. First, as an empirical matter, overbids rarely occur in connection with amendment settlements,<sup>267</sup> and evidence suggests that shareholders do not place much value on such settlements.<sup>268</sup> Moreover, commentators have suggested that were disclosure-only settlements suddenly to go away, the problem of non-meritorious claims and low value settlements would simply migrate to the amendment context.<sup>269</sup> *Compellent*, although based on sensible first principles, will not solve this problem any more than *Sauer-Danfoss* solved it in the context of disclosure-only settlements.<sup>270</sup>

The rule advanced here would not award plaintiffs' attorneys' fees on a probability basis. It would demand actual benefit. Thus, if a reduction in deal protections caused by plaintiffs' efforts did in fact result in an overbid, plaintiffs' attorneys would stand to recover handsomely under the common fund doctrine.<sup>271</sup> Returning to the common fund theory in this context also provides a clear metric for valuing the relief obtained by plaintiffs,<sup>272</sup> sparing courts the mental gymnastics required to arrive at a value for non-pecuniary relief.<sup>273</sup>

depend on an actual topping bid. Pricing the benefit requires two inputs: (i) the overall likelihood of a topping bid and (ii) the incremental gain that the likely topping bid would have created").

<sup>267</sup> Cain & Davidoff, *supra* note 61, at 4; Daines & Koumrian, *supra* note 84, at 6–8.

<sup>268</sup> Fisch et al., *supra* note 6 (manuscript at 15–16) (finding that amendment settlements have minimal effect on shareholder voting).

<sup>269</sup> See, e.g., Edward B. Micheletti et al., *Valuing Therapeutic Benefits for an Award of Attorneys' Fees Post-In re Compellent Technologies Shareholder Litigation*, 17 M&A LAW. 1, 10 (2013) (arguing that the generous award of attorneys' fees for deal protection amendments "contains opportunities for mischief and unwholesome windfalls"); see also Fisch et al., *supra* note 6 (manuscript at 44–46) (discussing this possibility but also identifying countervailing factors).

<sup>270</sup> See *supra* notes 134–137 and accompanying text. Indeed, the reasoning in *Compellent* will likely make the problem worse since the averages used to determine the probability and magnitude of an overbid mask a number of complexities, including market-specific factors and firm-specific factors, that will leave such matters open to significant contestation. The susceptibility of this supposedly more stringent standard to manipulation and abuse recalls the problems of the securities class action and the cottage industry that has sprung up around it for financial economists, an industry the courts have been unwilling to tame despite several recent tries. See, e.g., *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S.Ct. 2398, 2417 (2014); *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 338 (2005).

<sup>271</sup> It may be sensible, in this context at least, to be considerably more generous in the amount of attorneys' fees awarded when a claim is successful. More generous fee awards not only recognize the fact that there is a significant contingency here that had not existed before—that is, the possibility that the attorneys' fees will not in fact be paid—it also accords with the standard economic account of damages multipliers, according to which large damage awards make sense both because they incentivize private law enforcement and because they increase deterrence. See generally Louis Kaplow, *Shifting Plaintiffs' Fees Versus Increasing Damage Awards*, 24 RAND. J. ECON. 625 (1993) (arguing that higher damage awards are more efficient than shifting plaintiffs' fees).

<sup>272</sup> See *Fletcher v. A.J. Indus., Inc.*, 72 Cal Rptr. 146, 151 (Ct. App. 1968) (citing *Beyerbach v. Juno Oil Co.*, 265 P.2d 1, 12 (Cal. 1954)) ("[A]n award of attorneys' fees to a successful plaintiff may

Furthermore, taking away amendment settlements will not cause deal protections to go unpoliced. Even if shareholder class actions challenging deal protections were to disappear altogether,<sup>274</sup> suits challenging excessive deal protections would still be brought by the intervening bidders themselves.<sup>275</sup> As described by the Court of Chancery: “Bidders, unlike the stockholders . . . are not organizationally disadvantaged. Indeed, the typical bidder is a well-organized and well-financed individual or small group of individual stockholders. They usually have vast resources that may be tapped to fund lawsuits necessary to advance their investment strategy.”<sup>276</sup> Intervening bidders often sue to challenge deal protections, and their suits are often successful.<sup>277</sup> These suits create significant positive externalities for all shareholders by forcing open defensive devices, thereby making an active bidding contest for the company more likely. As a result, under the rule proposed by this Article, although deal protections will not attract litigation in every case, leading to a plethora of low-

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properly be *measured by, and paid from*, a common fund where his derivative action . . . has recovered or protected a fund in fact. . . .” (emphasis added)).

<sup>273</sup> See Transcript at 92–93, *In re CapitalSource Inc. Stockholder Litig.*, Consol. C.A. No. 8765-CB (Del. Ch. Sept. 4, 2014) (“*Compellent* may give a false sense of mathematical certainty but fundamentally [it] relies on a great amount of judgment by the Court.”). Entering ungrounded, highly contestable rulings—on such matters as the value of corporate disclosures or other non-pecuniary relief—risks making courts appear results-oriented, which in turn can raise doubts concerning the independence of the judiciary. This is the reason Delaware courts have long sought to avoid being seen as “super directors.” See, e.g., *Brehm v. Eisner*, 746 A.2d 244, 266 (Del. 2000) (“To rule otherwise would invite courts to become super-directors, measuring matters of degree in business decision-making and executive compensation.”); *In re RJR Nabisco, Inc. S’holders Litig.*, Civ. A. No. 10389, 1989 WL 7036, at \*14 n.13 (Del. Ch. Jan. 31, 1989) (“To recognize in courts a residual power to review the substance of business decisions for ‘fairness’ or ‘reasonableness’ or ‘rationality’ where those decisions are made by truly disinterested directors in good faith and with appropriate care is to make of courts super-directors.”).

<sup>274</sup> This seems unlikely. It may still be worth the plaintiffs’ attorney’s investment to challenge deal protections in those cases where an intervening bidder seems especially likely, thereby preserving the opportunity to claim credit for the overbid should it arise. This set of incentives resembles the dynamic discussed above in the context of controlling shareholder cases. See *supra* notes 64–74 and accompanying text. The potential for such free-riding is addressed by the second reform, discussed below. See *infra* notes 283–294 and accompanying text.

<sup>275</sup> The ability of an intervening bidder *as such* to sue on the basis of fiduciary duty is unclear. See *Omnicare, Inc. v. NCS Healthcare, Inc.*, 809 A.2d 1163, 1174 (Del. Ch. 2002) (holding *Omnicare*’s status as a bidder did not confer standing to assert breach of fiduciary duty claims). But see J. Travis Laster, *The Line Item Veto and Unocal: Can a Bidder Qua Bidder Pursue Unocal Claims Against a Target Corporation’s Board of Directors?*, 53 BUS. LAW. 767, 797 (1998) (marshaling doctrinal support for a bidder-standing rule). However, intervening bidders are likely also to be shareholders with standing to sue on that basis.

<sup>276</sup> *In re Dunkin’ Donuts S’holders Litig.*, Civ. A. No. 10825, 1990 WL 189120, at \*10 (Del. Ch. July 23, 1990).

<sup>277</sup> See e.g., *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 939 (Del. 2003); *In re Topps Co. S’holders Litig.*, 926 A.2d 58, 91 (Del. Ch. 2007).

value settlements, they will be actively policed when they are most relevant—that is, in overbid situations.<sup>278</sup>

Are there other important shareholder rights, not relating to proxy disclosures or deal protections, that might go unenforced if plaintiffs' attorneys can no longer recover their fees in class action settlements? In considering this question, it is important to emphasize that the rule advocated here preserves the right of shareholder plaintiffs to recover attorneys' fees for therapeutic settlements of derivative suits.<sup>279</sup> Leaving this avenue open recognizes the derivative suit as the original means of righting corporate wrongs and the therapeutic settlement as the basic tool for protecting shareholders prospectively from such harms.<sup>280</sup> Any claim that can be pleaded as a derivative suit, as most actions

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<sup>278</sup> Because they can sue to challenge deal protections, bidders can be expected to look through facially strong deal protections, understanding that only moderate deal protections will be enforceable. On this point, a comment of Vice Chancellor Noble is revealing:

*Omnicare* may be read to say that there must be a fiduciary out in every merger agreement . . . . Thus, hostile bidders are on notice that Delaware courts may not enforce a merger agreement that lacks a fiduciary out if they present a board with a superior offer. If, however, a merger agreement lacks a fiduciary out, and no better offer has emerged why should the Court enjoin the merger? To require that a fiduciary out clause be put in the merger agreement when sophisticated hostile bidders are on notice that the merger agreement may be found unenforceable if they submit a superior offer? Enjoining a merger when no superior offer has emerged is a perilous endeavor because there is always the possibility that the existing deal will vanish, denying shareholders the opportunity to accept any transaction.

*In re Openlane, Inc. S'holders' Litig.*, No. CIV.A. 6849-VCN, 2011 WL 4599662, at \*10 n. 53. The most credible party to challenge a merger agreement is an intervening bidder. Should one fail to appear, however, it does not follow that they were deterred by the deal protections in the merger agreement. Would-be bidders will be well advised on which provisions of a merger agreement are likely to be enforceable and which are not. *See generally* Sean J. Griffith, *The Omnipresent Specter of Omnicare*, 38 J. CORP. L. 753, 767 (2012) (summarizing this line of reasoning by noting that “[n]o-out contracts . . . are indeed voidable, but only by frustrated bidders, not by ordinary shareholder plaintiffs”).

<sup>279</sup> In the transaction context, however, the continuous ownership rule will operate to extinguish derivative claims post-merger. *See Arkansas Teacher Ret. Sys. v. Countrywide Fin.*, 75 A.3d 888 (Del. 2013) (holding that plaintiffs who exchange shares in connection with a merger transaction lose standing to pursue derivative claims, absent fraud or mere reorganization, by application of the continuous ownership requirement). Prominent commentators have argued that this aspect of the continuous ownership requirement is bad policy generally. *See generally* Laster, *supra* note 55 (arguing that the contemporaneous ownership requirement for derivative actions is incoherent, unnecessary, and should be eliminated). At least this aspect of the requirement would have to be reconsidered if the derivative suit is to provide meaningful protection for shareholder rights in the transaction context.

<sup>280</sup> Moreover, there are several recent examples of meaningful monetary recoveries in derivative suit settlements. *See, e.g.*, Liz Hoffman, *Freeport-McMoRan Nears Settlement Over McMoRan, Plains Deals*, WALL ST. J., Nov. 30, 2014, available at <http://www.wsj.com/articles/freeport-mcmoran-nears-settlement-over-mcmoran-plains-deals-1417379391>, archived at <https://perma.cc/8JYM-RGZK?type=pdf> (reporting on \$100 million settlement of shareholder derivative suit relating to the purchase of two affiliate companies); Alison Frankel, *Uglyduckling Shareholder Derivative Suits Are Poised for Swandom*, REUTERS, Jan. 2, 2015, available at <http://blogs.reuters.com/alison-frankel/2015/01/02/ugly-duckling-shareholder-derivative-suits-are-poised-for-swandom/>, archived at <http://perma.cc/L5CX-7JND> (noting positive recoveries in recent shareholder derivative suits, notably in-

targeting corporate governance reforms can be, thus still could be settled for non-pecuniary relief.<sup>281</sup> Those cases that cannot be pleaded as derivative suits—voting rights cases, for example—still may be brought by individual investors, especially activist investors pressing for board reforms or insurgents running a proxy fight. Here again, as in the context of bidder suits brought to invalidate excessive deal protections, dispersed shareholders enjoy a positive externality from such suits without suffering the cost of excessive litigation brought to create highly questionable shareholder value. The underlying intuition here is that shareholders are likely better served by litigation brought by a real shareholder with a substantial economic stake in the outcome than by litigation brought by contingency fee lawyers unaccountable to a genuine client.

Finally, it bears noting that notwithstanding Delaware's central importance in the making of American corporate law, another state has already adopted the approach urged here. In 2013, in *Kazman v. Frontier Oil Corp.*, the Texas Court of Appeals applied to shareholder suits a state statute barring fee recoveries for "coupon" settlements of class actions.<sup>282</sup> As a result of *Kazman*, Texas no longer awards attorneys' fees for non-pecuniary relief in shareholder class actions. Delaware should do the same.

### *B. Rigorous Inquiry into the Cause of the Benefit*

In cases where some corporate benefit is recognized—derivative suit settlements and common fund settlements of shareholder class actions—courts should conduct a more rigorous inquiry into the cause of the benefit.<sup>283</sup> Courts

volving Activision and News Corp.). Mechanisms designed to ensure that these claims are not abused are articulated in Part IV B. and C. See *supra* notes 283–302 and accompanying text.

<sup>281</sup> See Erickson, *supra* note 6, at 1754 (regarding the ability of governance cases to be brought as derivative suits). Even the recent bad banker cases, although pleaded as merger class actions, are more appropriately understood as derivative suits focusing on the board's breach of fiduciary duty in agreeing to investment banking arrangements rife with conflict of interest. See, e.g., *In re Rural Metro Corp. S'holders' Litig.*, 88 A.3d 54, 110 (Del. Ch. 2014); *In re El Paso Corp. S'holder Litig.*, 41 A.3d 432, 442 (Del. Ch. 2012) (investment banker conflict of interest); *In re Del Monte*, 2011 WL 2535256, at \*1 (investment banker conflict of interest). Under current interpretations of the continuous ownership requirement, the ability of shareholders to press these claims successfully as derivative suits is doubtful since the plaintiffs would surrender shares in the transaction and post-merger standing would pass to the acquirer. See *infra* note 279 and accompanying text.

<sup>282</sup> 398 S.W.3d 377, 379 (Ct. App. Tex. 2013). The relevant statute is Texas Rule of Civil Procedure 42(i)(2), which states: "If any portion of the benefits recovered for the class are in the form of coupons or other noncash common benefits," attorneys' fees must be awarded "in cash and noncash amounts in the same proportion as the recovery for the class." *Id.* (citing TEX. R. CIV. P. 42(i)(2)); see Christopher R. Leslie, *A Market-Based Approach to Coupon Settlements in Antitrust and Consumer Class Action Litigation*, 49 UCLA L. REV. 991, 1070–98 (2001) (discussing the problem of collusive coupon-based settlements and suggesting reforms).

<sup>283</sup> For an example of a court taking this responsibility seriously, see *In re Citigroup S'holder Derivative Litig.*, 12-cv-03114-JPO (S.D.N.Y. Aug. 19, 2013) (denying \$6 million fee request based on role of derivative suit in leading to ouster of Citigroup CEO Vikram Pandit because "[s]hareholder

currently fail in their examinations of causation not for want of will, but as a result of jurisprudential standards that discourage real scrutiny.<sup>284</sup> As a result, the only way to ensure genuine judicial scrutiny of causation is to adjust the relevant legal standard.

Current law places the burden, in both corporate benefit and common fund settlements, on the party seeking to disprove the causal role of the litigation in the relief ultimately obtained by plaintiffs, effectively requiring defendants or objectors to prove a negative—that the lawsuit “did not in any way contribute” to the ultimate relief.<sup>285</sup> This rule is behind the proliferation of “tag-along” derivative suits settling for therapeutic changes that may in fact reflect the prior enforcement efforts of prosecutors or regulators.<sup>286</sup> It also explains the ability of plaintiffs in controlling shareholder cases to receive credit for an increase in consideration actually produced by the efforts of the special negotiation committee.<sup>287</sup> Likewise, it creates an opportunity for plaintiffs in merger litigation to claim credit for the appearance of a topping bid more plausibly attributed to economic conditions or industry dynamics.<sup>288</sup> Defendants are often complicit, if not downright collusive, in plaintiffs’ assertions, understanding that unless they allow plaintiffs’ attorneys’ to collect their fees, there will be no settlement and, therefore, no release of claims.<sup>289</sup> Courts wishing to challenge causation are therefore on their own, facing a difficult standard, typically without an adversarial proceeding to develop the facts.<sup>290</sup>

How then should the standard be changed? A starting point might be to distinguish cases in which plaintiffs win relief, whether in the form of therapeutic changes or additional merger consideration, on a “clear day” when there is no obviously related antecedent event, such as a regulatory action or a topping bid. The current rule’s presumption in favor of plaintiffs’ causal role is appropriate in such cases because it operates to correct an information asymmetry that otherwise would favor defendants. The defendants, after all, possess

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pressure, not the lawsuits at issue in this action, was the cause of Citigroup’s policy changes”), *aff’d sub nom.* Moskal v. Pandit, 13-3577 (2d Cir., Aug. 20, 2014).

<sup>284</sup> See *supra* notes 130–132 and accompanying text.

<sup>285</sup> Alaska Elec. Pension Fund v. Brown, 988 A.2d 412, 414 (Del. 2010); see United Vanguard Fund, Inc. v. TakeCare, Inc., 693 A.2d 1076, 1080 (Del. 1997) (requiring defendant to demonstrate that the lawsuit “did not in any way cause [its] action”).

<sup>286</sup> See *supra* notes 50–51 and accompanying text.

<sup>287</sup> See *supra* notes 79–88 and accompanying text.

<sup>288</sup> See *supra* notes 70–74 and accompanying text.

<sup>289</sup> See *supra* notes 88–93 and accompanying text.

<sup>290</sup> See *e.g.*, Transcript of Hearing at 19, 49, *In re* TPC Grp. S’holders Litig., CA No. 7865-VCN, (Del. Ch. June 11, 2014) (mootness proceeding expressing unease with “a standard which defendants have no hope of ever meeting” and wondering further how defendants could ever “rebut every possible indirect effect the litigation can have”). In a subsequent letter opinion in the case, Vice Chancellor Noble summarized the standard for overcoming the presumption of causation as “defendants must prove that the nonexistence of the presumed fact is more probable than its existence.” *In re* TCP Grp., C.A. No. 7865-VCN, letter op., at 6 (Del. Ch. Oct. 29, 2014) (internal quotations omitted).

all relevant information about what, in fact, triggered the relief. The plaintiffs do not. Placing the burden on the defendants therefore triggers the production of information in their exclusive possession.

In cases involving clearly related antecedent events, such as a regulatory enforcement action or a topping bid, *plaintiffs* should be made to rebut the presumption that they did *not* cause the relevant change.<sup>291</sup> This shift of the burden and the standard in the context of antecedent events is appropriate because it is especially in this context that the lawyers on both sides are likely to be complicit, seeking to settle the case for reasons other than its underlying merits—to close a deal or eliminate contingent liabilities in preparation for other corporate action. In such cases, the fundamental information asymmetry is not against plaintiffs in favor of defendants. Rather, it is against the court in favor of the litigants. Once the litigants have joined hands in settlement, they have every reason to obscure its origins and its effect—hence the “Kabuki dance” involved in controlling shareholder settlements.<sup>292</sup> In such cases, unless the parties are forced to meet a standard requiring them to demonstrate that the relief is in fact a product of their efforts, courts cannot seriously examine the causal role of the litigation.

Furthermore, shifting the burden and the standard in this context not only prevents plaintiffs’ counsel from receiving credit for something they most likely did not cause, it also prevents duplicative litigation.<sup>293</sup> For example, in cases where regulators or prosecutors extract corporate governance relief in the wake of a failure of corporate compliance, as indeed they often do, shareholder litigation over the same events is fundamentally duplicative.<sup>294</sup> The rule advocated here would discourage such “tag along” suits, making it much harder for attorneys to recover fees for bringing them. But it would not discourage suits where there had in fact been no related antecedent event, recognizing that in such cases the litigation is more likely to have produced the benefit. The policy result thus would not discourage shareholders from suing to enforce important

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<sup>291</sup> As with the current rule, this presumption would be rebuttable. See DEL. R. EVID. 301(a) (stating that a rebuttable presumption “imposes on the party against whom it is directed the burden of proving that the nonexistence of the presumed fact is more probable than its existence”).

<sup>292</sup> See *supra* note 70 and accompanying text.

<sup>293</sup> See Erickson, *supra* note 50, at 80–81 (“[M]any shareholder derivative suits may simply serve as tagalong suits to other types of corporate litigation . . . [R]eforms that allow corporations, rather than individuals, to bear the bulk of the settlement burden would encourage shareholder derivative suits that are simply tagalong suits to securities class actions and other private litigation.”).

<sup>294</sup> See, e.g., *In re Walmart Stores, Inc. Del. Derivative Litig.*, Consol. C.A. No. 7455-CS (Del. Ch. July 24, 2012) (derivative suit following in wake of FCPA investigation of Wal-Mart that has already resulted in substantial reform of Wal-Mart’s corporate compliance program). See generally Amy Deen Westbrook, *Double Trouble: Collateral Shareholder Litigation Following Foreign Corrupt Practices Act Investigations*, 73 OHIO ST. L.J. 1217 (2012) (examining consequences of the rise in shareholder litigation based on violations of the Foreign Corrupt Practices Act).

rights, it merely would discourage them from free-riding on the efforts of others already doing so.

### *C. Proportionality of the Litigation Release to the Benefit Received*

Third and finally, in order to combat the undercompensation problem inherent in providing defendants with extremely broad litigation releases in exchange for minimal compensation to plaintiffs, courts reviewing settlements should insist upon a relationship between the scope of the release and the magnitude of the benefit. Current judicial practice in evaluating the fairness and adequacy of settlement only weighs the relief received against a rough assessment of the merits of the underlying claim, not the value of the relief against the scope of the release.<sup>295</sup> Moreover, judicial scrutiny of the release itself investigates only the relationship between the released claims and the factual basis of the settled case.<sup>296</sup> Neither of these analytic rubrics sufficiently scrutinizes the settlement bargain. The best way to do that would be to require an express weighing of what actually is exchanged at settlement. Courts should balance the benefit received by plaintiffs against the scope of the release received by the defendant.

Several opinions of the Court of Chancery reveal receptivity to this analytic framework. Chancellor Allen, for example, suggested that it would be inappropriate to release claims that had never been asserted in a settlement that resulted in no consideration for the plaintiff class.<sup>297</sup> More recently, in 2014 in the Delaware Court of Chancery case of *In re Medicis Pharmaceutical Corp. Shareholder Litigation*, then-Chancellor Strine refused to approve a broad release given in a disclosure-only settlement, noting that “giving out releases lightly is something we’ve got to be careful about.”<sup>298</sup> Vice Chancellor Laster did likewise in 2014 in the Delaware Court of Chancery case of *Rubin v. Obagi Medical Products, Inc.*, a decision in which he expressly acknowledged the issues at stake:

Delaware courts have often been quite deferential in recognizing that when parties bring significantly weak claims . . . they can be settled for weak consideration. The problem with that approach . . .

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<sup>295</sup> See *supra* note 109 and accompanying text.

<sup>296</sup> See *supra* note 99 and accompanying text.

<sup>297</sup> *In re Advanced Mammography Servs., Inc. S’holders Litig.*, No. CIV.A. 14831, 1996 WL 633409, at \*1 (“The *res judicata* effect of a dismissal based upon stipulation of mootness . . . would certainly offend fundamental notions of fairness to purport . . . to release claims that have never been advanced, that in some instances may belong to other entities that comprise the class (derivative claims), in which there appears to be no serious discovery record in any event, and most importantly, in exchange for no consideration.”).

<sup>298</sup> Transcript at 24, CA No. 7857-CS (Del. Ch. Feb. 26, 2014) (concluding that the disclosures are not “enough to justify a release”).



is that there are unknown unknowns in the world, and the type of global release the plaintiffs' counsel gives in this case and routinely gives in return for disclosure settlements provides expansive protection for the defendants against a broad range of claims, virtually all of which have been completely unexplored by plaintiffs.<sup>299</sup>

The Vice Chancellor went on to suggest that he would consider approving the settlement (and fees) if the release were made proportional to the relief achieved: "if people wanted to restructure the settlement so that it extended only to the claims actually brought in this litigation . . . then I think the scope of the release would be proportional to the relief that the plaintiffs actually obtained."<sup>300</sup> Soon after *Obagi*, Vice Chancellor Laster revisited the same set of issues in *In re Theragenics Corp. Stockholders Litigation* and again refused to approve a settlement offering a broad release when a number of potentially significant issues had not been explored by plaintiffs.<sup>301</sup>

The principle suggested by these opinions is a rule of proportionality, balancing the relief received by plaintiffs against the release received by defendants. In cases where plaintiffs receive insubstantial relief, the litigation release received by defendants should be correspondingly narrow. Thus, for example, disclosure-only relief should justify release only of state law disclosure claims, not federal securities claims and perhaps not even other fiduciary duty claims should a latent breach subsequently appear. Cases settling for significant pecuniary relief accordingly merit broader litigation releases. The Delaware Supreme Court's 2008 decision in *In re Philadelphia Stock Exchange, Inc.*, for example, permitted a release seeking "complete peace" and releasing claims "to the broadest extent possible under law," but only in the context of a settlement that provided monetary relief of \$99 million to the shareholder class.<sup>302</sup>

A rule requiring proportionality between the relief and the release thus would prevent latent high value claims from being precluded by prior low value settlements, but still allowing litigants to receive significant releases for significant relief. Although this rule is designed to address the undercompensation problem inherent in the present system, it may have a broader effect. Recall that it is the prospect of receiving a release of any and all claims arising from the same underlying facts that brings defendants to the settlement table. Hence, if defendants can no longer receive such a broad release in exchange for a settlement that offers little value for the shareholder class, defendants may no longer settle nuisance claims. If defendants are no longer willing to

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<sup>299</sup> Transcript at 8, C.A. No. 8433-VCL (Del. Ch. Apr. 30, 2014).

<sup>300</sup> *Id.* at 9.

<sup>301</sup> Transcript at 69, C.A. No. 8790-VCL (Del. Ch. May 5, 2014) (noting that "when a fiduciary action settles, I have to have some confidence that the issues in the case were adequately explored, particularly when there is going to be a global, expansive, all-encompassing release given").

<sup>302</sup> 945 A.2d 1123, 1137–38 (Del. 2008).

settle, plaintiffs will be forced to fight, and plaintiffs forced to fight are much less likely to press claims that can only result in little or no relief. Instead, they will drop such cases or never file them in the first place. Excessive litigation, in other words, will substantially decline.

No one defendant can have this effect on its own. Even if one defendant refuses to settle, the temptation to buy a broad release on the cheap will be too much for others to resist. Therefore, the availability of the broad, cheap release must be taken away from defendants as a class. Once the temptation is gone, defendants can credibly commit not to settle low value claims. And a credible commitment not to settle can go far towards discouraging such claims from being brought in the first place.

#### D. How to Enact the Reforms

Having articulated this package of reforms, it may be worth pausing a moment to reflect on how they might be implemented. In particular, could corporations adopt the reforms themselves, through charter or bylaw amendments? Or is legislative or judicial action required?

With regard to the first question, there is clearly ample room in the prevailing contract theory of bylaws to permit corporations to adopt a bylaw opting-out of corporate benefit.<sup>303</sup> Indeed, if broad fee-shifting bylaws are valid under that theory, then clearly the more carefully aimed rule under consideration here ought also to be valid. Moreover, should the courts eventually strike down fee-shifting bylaws, corporations still ought to be able to opt-out of corporate benefit. Opting out of corporate benefit, unlike fee-shifting, does not deter shareholder claims by punishing class representatives or class counsel for bringing suit.<sup>304</sup> Furthermore, shareholders would still have the full panoply of responses noted in the Delaware Court of Chancery 2013 case of *Boilermakers Local 154 Retirement Fund v. Chevron Corp*—they can vote and, more importantly, they can sue, a remedy the current generation of fee-shifting bylaws denies them.<sup>305</sup> Finally, a corporate benefit opt-out is more plausibly procedural, regulating *how* shareholders may sue, not *whether* they can, than the current generation of fee-shifting bylaws.<sup>306</sup>

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<sup>303</sup> This is the first reform proposal, described above in Part IV. A. See *supra* notes 258–282 and accompanying text. Here it would take the form of a bylaw commitment precluding the corporation from agreeing to a class settlement where it pays attorneys’ fees for non-pecuniary relief. For brevity, this reform is here referred to here as “opting out of corporate benefit.” For discussion of the contract theory of bylaws, see *supra* notes 174–181 and accompanying text.

<sup>304</sup> For discussion of how fee-shifting bylaws punish shareholder claims, see *supra* note 153 and accompanying text.

<sup>305</sup> 73 A.3d at 955 n.93.

<sup>306</sup> See *supra* note 181 and accompanying text.

Assuming then that corporations *could* thus opt-out of corporate benefit by means of a board-sponsored bylaw, *would* they? Here, unfortunately, the analysis becomes more problematic. Even if it is in every corporation's *ex ante* interest to fight frivolous shareholder suits, all corporations have a strong *ex post* incentive to buy the broad, cheap releases that such suits provide.<sup>307</sup> It is, in other words, a collective action problem.<sup>308</sup> Although corporations would on the whole prefer the rule advanced here, few may adopt it, anticipating the *ex post* incentive to defect. Hence, action on the part of the legislature or the judiciary is likely necessary to enact the needed reforms to corporate benefit. Moreover, the second and third reforms, involving changes to the substantive legal standards employed by judges in reviewing the settlement of shareholder suits, are beyond the power of corporations themselves and therefore require legislative or judicial action.

The optimal form of implementation thus would be an amendment to the Delaware General Corporation Law following the approach of the Texas legislature in *Kazman*, but tailored to the corporate law context.<sup>309</sup> The resulting change effectively would return Delaware to the American Rule on fees, a middle point between the harsh anti-shareholder consequences of the English Rule, on the one hand, and excessive generosity of the current Delaware Rule, on the other. Likewise, statutory amendments could be crafted to enact the second and third reforms advocated here—rules encouraging a more rigorous inquiry into the cause of the benefit and requiring strict proportionality between the relief and the release.

It is worth noting, however, that the latter two rules, focusing on the subject and scope of judicial action at settlement, could also be implemented directly by courts. Indeed, the Court of Chancery has demonstrated a willingness to experiment on these points that ought to be encouraged.<sup>310</sup> Judicial action could also bring Delaware back to the American Rule on fees. This, however, would require the Supreme Court to confront the Delaware Supreme Court 1989 decision in *Tandycrafts Inc. v. Initio Partners* and overrule, or at least qualify, longstanding judicial practice arising from that opinion.

Still, there is no time like the present. Delaware is in the midst of an historic re-evaluation of the current system of shareholder litigation and every-

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<sup>307</sup> See *supra* notes 88–93 and accompanying text.

<sup>308</sup> See generally MANCUR OLSON, JR., *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* (1965) (examining the extent to which individuals choose to bear the costs of organizational effort for their individual interest).

<sup>309</sup> For example, adapting from the Texas statute: “if any portion of the benefits recovered for the shareholder class are in the form of non-pecuniary relief or other noncash common benefits, attorneys’ fees may not be awarded for that proportion of the settlement and must, in any event, be awarded in cash and noncash amounts in the same proportion as the recovery for the class.” See *supra* note 282 (discussing *Kazman* and the Texas approach).

<sup>310</sup> See *supra* notes 290, 297–301 and accompanying text.

thing ought therefore to be on the table.<sup>311</sup> With regard to the package of reforms offered here, it does not matter whether the legislature or the judiciary takes the lead. Moreover, although most effective as a package, each of the reforms articulated in this Article is fully severable and could be implemented separately from the others.

#### CONCLUSION

This Article has urged policy-makers to take advantage of the controversy surrounding fee-shifting bylaws to solve the deeper problems giving rise to the current crisis in shareholder litigation. The present system of shareholder litigation results in overcompensation of attorneys, undercompensation of the plaintiff class, and ineffective deterrence. Reform is therefore needed, but not in the form of fee-shifting bylaws, which overreach and penalize good and bad claims alike.

The way to attack a crisis is by going after its cause, not merely its effects. Having reviewed patterns and practices in shareholder litigation, this Article has identified the cause of the crisis as misinterpretation and misapplication of the corporate benefit doctrine. It has therefore articulated three narrowly tailored reforms to correct corporate benefit and, in doing so, fix shareholder litigation. These include: no longer awarding attorneys' fees for recoveries of non-pecuniary relief in shareholder class actions, shifting the burden for establishing causation in certain settlement contexts, and insisting that the scope of the defendant's litigation release be proportional to the relief received by the plaintiffs' class. Delaware's ongoing review and examination into shareholder litigation provides an ideal opportunity to enact these reforms.

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<sup>311</sup> See *supra* note 19 and accompanying text.

