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The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions

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Shareholder litigation is the most frequently maligned legal check on managerial misconduct within corporations.¹ Derivative lawsuits and federal securities class actions are portrayed as slackers

1. Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part II: Empirical Studies of Corporate Law*, 4 AM. L. & ECON. REV. 380, 407 (2002) (“[W]ealth effects of derivative lawsuits are negligible.”); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 84 (1991) (“[S]hareholder litigation is a weak, if not ineffective, instrument of corporate governance.”); cf. Rafael LaPorta et al., *What Works in Securities Laws?* 8-10, 22 (July 16, 2003) (unpublished manuscript) (arguing that private enforcement of securities laws benefits stock markets), available at http://post.economics.harvard.edu/faculty/shleifer/papers/securities_fixed.pdf. For a historical critique of derivative litigation, see FRANKLIN S. WOOD, *SURVEY AND REPORT REGARDING STOCKHOLDERS’ DERIVATIVE SUITS* (1944) (commenting that derivative suits in the 1930s and early 1940s were largely frivolous).

in debates over how best to control the managerial agency costs created by the separation of ownership and control in the modern corporation.² In each instance, early hopes that these suits would effectively monitor managerial misconduct have been replaced with concerns about the size of the litigation agency costs of such representative litigation. Such litigation agency costs can arise when a self-selected plaintiff's attorney and her client are appointed to pursue the claims of an entire class of shareholders and have interests that may differ from those of the class.³

Now, however, a new form of shareholder litigation has emerged that is distinct from derivative or securities fraud claims: class action lawsuits filed under state law challenging director conduct in mergers and acquisitions. The empirical data reported in this article show that these acquisition-oriented suits are now the dominant form of corporate litigation and outnumber derivative suits by a wide margin.

Are these acquisition-oriented class actions just another deadbeat in the corporate governance debate? Should policymakers take action to cut back on the development of this new form of shareholder litigation? In this paper, we argue that, just as with derivative suits and securities fraud class actions, good policy must balance the positive managerial agency cost reducing effects of these acquisition-oriented shareholder suits against their litigation agency costs.

To frame our analysis of acquisition-oriented class actions, we begin with a look back at the history of this debate over representative litigation in corporate and securities law. For six decades, there have been efforts to limit shareholder derivative suits. These suits, in which one shareholder sues in the name of and on behalf of the corporation,

2. By this separation of function, managers are given control over other people's money even though the managers' individual interests may diverge from the interests of the group as a whole. In this Article, we will refer to the costs arising from this possible divergence as managerial agency costs. They have been the subject of vast literature beginning with Jensen and Meckling's famous article. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

3. Thus, representative shareholder litigation designed to constrain management agency costs may suffer from agency costs of its own, which we will call litigation agency costs. Shareholder lawsuits are not perfect mechanisms for controlling management agency costs because they are representative litigation, in that one self-appointed shareholder (and that litigant's attorneys) champions the claims of an entire class of investors. The plaintiff class's attorneys have much more to gain financially from a quick settlement of these suits than the named plaintiff, and these incentives can lead these lawyers to sell out the shareholders that they claim to represent. For a insightful critique of the problems of representative litigation, see Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 3, 5-6, 8 (1991).

are usually brought to enforce various fiduciary duties that officers and directors owe corporations and their shareholders. They thus can be contrasted to “normal” corporate litigation in which directors determine what actions to take for the corporation. Derivative suits were once said to have promise as a means to limit managerial agency costs.⁴

As early as 1944, however, states began to focus on the negative attributes of derivative suits, passing statutes requiring plaintiffs in derivative actions to post bonds to insure that they could pay defendants’ attorneys’ fees and expenses if the lawsuit was dismissed as frivolous.⁵ More recently, state legislatures and courts have added additional hurdles for plaintiffs to overcome, including requirements that plaintiffs make a demand on the board of directors before filing suit and permitting the use of special independent litigation committees of boards of directors to decide if derivative suits should be terminated.⁶ At the time of each of these cutbacks on the reach of derivative actions, policymakers stressed their desire to reduce litigation agency costs.⁷

With the decline of derivative litigation, the focus of the policy debate over the role of representative shareholder litigation shifted to securities fraud class actions. They, too, had great potential for reducing management agency costs.⁸ Yet, as the years passed, the courts and policymakers began to stress the abuses that can grow out of this form of representative litigation. By the early 1990s, plaintiffs’ law firms filing securities fraud class actions were accused of a whole host of dubious practices, including using professional plaintiffs in their cases, filing carbon copy complaints, and racing to the courthouse to be the first to file a case before the ink was dry on a company’s press release of unexpectedly weak earnings.⁹ In the Private Securities Litigation Reform Act (“PSLRA”) of 1995, Congress

4. *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949) (noting that derivative suits have long been “the chief regulator of corporate management”).

5. N.Y. BUS. CORP. LAW § 627 (McKinney 2003) (first enacted in 1944). This statute followed a critical report about derivative litigation by Franklin Wood, for a committee of the Chamber of Commerce of the State of New York. WOOD, *supra* note 1.

6. See, e.g., George W. Dent, Jr., *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U. L. REV. 96, 98-109 (1980).

7. See generally STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 404-05 (2002) (advocating the “radical solution” of an end to all derivative suits).

8. *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) (creating implied private right of action for shareholders for violations of Rule 14a-9, and holding that “[p]rivate enforcement of the proxy rules provides a necessary supplement to Commission action”).

9. Elliott Weiss & John Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2060-64 (1995).

focused on these “indicators” of litigation agency costs and legislated severe restrictions on securities fraud class actions,¹⁰ perhaps at the expense of permitting managerial agency costs to rise precipitously.¹¹

Our research into the role of the Delaware courts in modern corporate governance illustrates that derivative lawsuits and securities fraud class actions form only two pieces of the shareholder litigation puzzle. When we analyzed data that we had collected on all suits filed in 1999 and 2000 in the Delaware Chancery Court, the nation’s leading corporate trial court, we were surprised to find that approximately 80 percent of the breach of fiduciary duty claims, the vast bulk of state court representative litigation, are class actions against public companies challenging director action in an acquisition.¹²

These acquisition-oriented class actions dominate all other forms of state court shareholder litigation.¹³ Moreover, in 1999 and 2000, the number of these class actions filed in Delaware alone equaled about half of the total number of federal securities fraud class actions filed in *all* federal district courts during that same two-year period.¹⁴

10. Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered subsections of 15 U.S.C. §§ 77-78 (2000)). PSLRA is a multi-pronged effort by Congress to rein in litigation agency costs by, among other things, restricting the number of times that plaintiffs could file securities fraud lawsuits, encouraging institutional investors to become lead plaintiffs, and creating the potential for judicial sanctions against law firms found to be filing frivolous lawsuits. *Id.*

A few years later, Congress went on to wipe out states’ concurrent jurisdiction to hear securities fraud class action suits. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified in scattered subsections of 15 U.S.C. §§ 77-78). Proponents claimed that the state courts were being used to end run PSLRA’s restrictions, although the Uniform Standards Act did allow states to retain jurisdiction of acquisition-oriented class action suits. 15 U.S.C. § 77p(d)(1). The Uniform Standards Act’s provisions do not cover shareholder derivative actions. § 77p(f)(2)(B).

11. William S. Lerach, *The Private Securities Litigation Reform Act of 1995—27 Months Later: Securities Class Action Litigation Under the Private Securities Litigation Reform Act’s Brave New World*, 76 WASH. U. L.Q. 597 (1998).

12. By contrast, derivative suits, the traditional shareholder litigation that is the staple of corporate law casebooks, make up only about 14 percent of all fiduciary duty suits. The remaining suits are direct suits, intended to redress an individual shareholder’s grievances.

13. While there are no national numbers collected for state courts, Delaware has for many years been recognized as the national leader in the race to incorporate new and existing companies. ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 6-8 (1993). Coupled with its experienced judiciary and well-developed corporate law, this makes it the most attractive forum for shareholder litigation among any of the states.

14. We are comparing the number of consolidated cases in Delaware with the total number of consolidated securities fraud cases filed in all federal district courts. For further discussion of this point, see *infra* note 154 and accompanying text.

When we examine this new and dominant form of shareholder litigation more closely, we find several key differences from, and some similarities to, derivative suits and federal securities fraud class actions. First, as expected, we find that like the other types of representative litigation, these suits universally raise claims of high managerial agency costs, although concentrated in mergers and acquisition transactions in the market for corporate control. The suits typically make allegations of failure to maximize shareholder value in a sale of control under *Revlon*¹⁵ or challenges under *Weinberger*¹⁶ to the fairness of potential conflict-of-interest transactions, such as control shareholder acquisitions and management buyouts.

Second, our acquisition-oriented class action suits have many of the same characteristics identified in securities fraud and derivative cases as indicators of litigation agency costs. For example, in most cases multiple lawsuits with virtually identical complaints are quickly filed, usually within a few days of the announcement of the proposed acquisition. Over 75 percent of the time, the cases are filed by a small, well-defined group of plaintiff's law firms in the name of a professional cadre of plaintiff shareholders.¹⁷ Institutional investors have almost no monitoring role in this litigation.

Yet, this is not the same old story that spurred Congress to pass the PSLRA in 1995. There is no pattern of modest settlements for the shareholder group and most of that money going to the attorneys, as was sometimes found in earlier representative suits. Instead, we find that there were large monetary settlements paid to shareholders in many of these cases, that these settlements involved a substantially lower percentage level of attorneys' fees as compared to securities fraud class actions, and that these cases were pending for a relatively short period of time.

Furthermore, beneficial settlements are not equally spread among all acquisition complaints but are concentrated in cases where a majority shareholder is squeezing out minority public shareholders on disadvantageous terms, which we will call "control shareholder" suits. Even within this subset of self-dealing transactions, settlements producing a monetary return to shareholders do not occur across the entire class of control shareholder suits. Instead, such settlements are more likely to occur in cases where the initial offer price was substantially lower than what was offered to shareholders in the

15. See generally *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

16. See generally *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

17. See *infra* tbls.12-13.

remaining (non-settling) control shareholder transactions.¹⁸ We find only a few monetary settlements in cases challenging director conduct in management buyouts (MBOs) and third-party mergers, the other forms of “friendly deals.”¹⁹

Viewed from a broader perspective, shareholder acquisition litigation polices those management transactions with the highest potential for self-dealing. In other words, in settlements of acquisition litigation, more so than in derivative and securities fraud suits, the merits appear to matter.²⁰ All of these factors support a claim that the managerial agency cost reductions associated with acquisition suits are higher than with the other forms of shareholder litigation.

At the very least, these class actions should reduce the transaction costs associated with an acquisition if they provide a comprehensive resolution to shareholder complaints about those deals, even if the associated settlement does nothing more than raise the price of the deal to the level that would have been offered without the threat of litigation.²¹ A more optimistic perspective would be that these acquisition-driven suits serve an important effect a priori: corporate planners know the relative strength of the different legal doctrines associated with different forms of acquisitions, and try to minimize the costs of shareholder litigation by invoking procedural protections like the use of special committees and by offering shareholders a sufficiently high price for their shares that they do not file suit.²² If they ignore this information, and do not offer shareholders a sufficient premium for their stock, shareholder litigation forces them to do so in many instances.

In the hostile deals—that is, those involving a bid opposed by management, or deals where a second bidder shows up and tops a

18. When we add the amount of the settlement to the premium paid in the control shareholders' initial offer, we find that the combined premium exceeds the premium originally offered by control shareholders in the remaining transactions in our sample. This pattern is only partially repeated in the MBO and friendly third-party transactions. Just as with the controlling shareholder cases, the settlement pattern favors more payments being made in conflict-of-interest transactions where shareholders claims are stronger, and suggests that the increased consideration paid reflects the plaintiff's stronger likelihood of success. However, the settlements are not as concentrated in the low premium cases as in the controlling shareholder cases, suggesting that some other factor is driving them.

19. We categorize deals as friendly when they are initiated, or acquiesced in, by the management of the company involved in the transaction.

20. See, e.g., Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991) (claiming that the merits do not matter in securities fraud class action settlements).

21. Romano, *supra* note 1, at 62-63.

22. Neither perspective is inconsistent with the view that existing legal doctrine is too willing to permit recovery to plaintiffs in these cases, thus imposing tax on all acquisition transactions, even if the data shows positive recovery to shareholders.

friendly bid—we find that the bidders themselves also file suits in an effort to improve the chances of the company being sold to a hostile bidder or to a bidder not originally preferred by target management.²³ In these situations, we observe that representative suits appear to be filed after the bidder's suit so that the class action rides on the coattails of the bidder's case.

Monetary settlements are never achieved in the representative shareholder litigation in hostile deals. We believe there are two main reasons for this: first, these deals offer much higher premiums on average than the other change-of-control transactions in our sample, thereby undercutting any claim of unfairness to target company shareholders; and second, the bidders do not perceive that the shareholder plaintiffs have improved their chances of winning the takeover contest, and therefore if the bidder is victorious it does not offer the plaintiffs anything to settle the representative action. We further find that bidder lawsuits have some success in forcing target company directors to consider their bid to buy the company.

Placing our findings in the historical context of the debate over the value of representative shareholder litigation, we believe that acquisition-oriented class actions substantially reduce management agency costs, while the litigation agency costs they create do not appear excessive. For these suits, we therefore disagree with earlier studies that have claimed that all representative shareholder litigation has little, if any, effect in reducing management agency costs and should be evaluated solely in terms of its litigation agency costs.²⁴

Shareholder litigation should be seen as a complement to other corporate governance reform measures, such as the Sarbanes/Oxley Act,²⁵ the changes in New York Stock Exchange listing standards,²⁶ and recommendations of groups like the Conference Board,²⁷ which

23. "Hostile" deals are those that management is resisting as of the time that the complaint is filed.

There may be substantial other benefits for shareholders from bidder litigation. For example, the Delaware Chancery Court has limited the scope of deal protection provisions in a number of recent cases. See, e.g., *Chesapeake Corp. v. Shore*, 771 A.2d 293 (Del. Ch. 2000); *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95 (Del. Ch. 1999); *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, Nos. CIV.A. 17398, 17383, 17427, 1999 WL 1054255 (Del. Ch. Sept. 27, 1999). By narrowing the scope of these provisions, the court has increased the likelihood that subsequent bidders may choose to offer competing bids.

24. Bhagat & Romano, *supra* note 1, at 405-08; Romano, *supra* note 1, at 84-85.

25. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

26. See Exchange Act Release No. 34-48745, 68 Fed. Reg. 64,154 (Nov. 12, 2003) (approving NYSE and NASD rule changes), available at <http://www.sec.gov/rules/sro/34-48745.htm>.

27. COMM'N ON PUB. TRUST & PRIVATE ENTER., THE CONFERENCE BD., FINDINGS AND RECOMMENDATIONS, PART 2: CORPORATE GOVERNANCE, PART 3: AUDITING AND ACCOUNTING 2-28 (2003), http://fei.org/download/TCB_PublicTrust2-3.pdf.

have also focused on management agency cost reductions. These reforms and the debate in their wake emphasize improving corporate governance through changes in federal law and private ordering, without further limiting shareholder litigation's role as one of the menu of constraints on managers. Our findings support policymakers' decision to focus on broader corporate governance changes, and to leave shareholder litigation to continue to perform as it has in the past. State court litigation remains a valuable tool to check managerial agency costs. And, as two Delaware judges recently observed, "state corporate laws come with a full-service commitment to enforcement"²⁸

This article proceeds as follows. Part I begins with a discussion of corporate governance and the managerial agency cost reduction effects of derivative and securities fraud litigation. We then examine the theoretical and empirical evidence about the litigation agency costs created by derivative litigation and securities fraud class actions, and how policymakers have struggled to contain them. Part I concludes with an analysis of how acquisition litigation differs from the two more established types of shareholder litigation. In Part II, we present an overview of the core data from our study of shareholder litigation in Delaware. Part III presents our findings about class actions in acquisition settings, and we finish with our policy conclusions in Part IV.

I. SHAREHOLDER LITIGATION'S ROLE IN CORPORATE GOVERNANCE AND CORPORATE CONTROL

A. *Representative Litigation and Managerial Agency Costs*

Ownership and control are separated in most large public corporations in the United States, with dispersed shareholders delegating to professional managers the power to run these companies. This separation of ownership and control creates managerial agency costs because the interests of these managers do not always coincide with those of the investors in these firms.²⁹

28. William B. Chandler, III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 984 (2003).

29. Jensen & Meckling, *supra* note 2, at 309. Agency costs can be divided into three pieces: monitoring costs, bonding expenditures, and the residual losses that are too costly to prevent. *Id.* at 308.

Managerial agency costs can be minimized in many ways: through strong product, labor, and corporate control markets; by a variety of corporate governance mechanisms or norms; or through legal rules. Markets are an important mechanism for controlling managerial agency costs.³⁰ Competition in product markets can punish a firm's stock price directly if its managers shirk their duties or enrich themselves at their shareholders' expense. Product competition may also have indirect effects, as, for example, when external financing may be more difficult to obtain if lenders believe that the firm faces a risk of failure because it is not effectively competing in the product market.³¹ The market for corporate control will reinforce these effects if the company's stock price falls, and investors become more willing to use their collective power to sell the firm's stock.³² All of these markets will act as checks on managerial agency costs.

Corporate governance structures and norms are a second line of defense against managerial agency costs. For example, strong boards of directors, audits by independent accounting firms, and the listing requirements of self-regulatory organizations, such as the New York Stock Exchange, may all act to reduce managerial slack. Furthermore, norms of good corporate conduct, such as those promulgated by the Conference Board, the Business Roundtable, or the National Association of Corporate Directors have an important role to play in stopping managerial misconduct.

Law plays an important role, too, in reducing managerial agency costs. State corporate law provides the legal skeleton for the corporation and for the development of corporate governance systems. The directors of the corporation are given the power to manage and direct the business and affairs of the corporation.³³ Shareholders are given more limited powers, essentially the right to sell their shares, to vote their shares, and to sue to enforce their legal rights under state law.³⁴ While shareholder voting has proven to be a relatively weak

30. For the most comprehensive presentation of these arguments, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991). Product markets, labor markets, and the market for corporate control are examples of some of the more important markets. See, e.g., Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1083-84 (1998); Robert B. Thompson, *The Law's Limits on Contracts in a Corporation*, 15 J. CORP. L. 377, 380-82 (1990).

31. EASTERBROOK & FISCHEL, *supra* note 30, at 18-19.

32. HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 58-59 (1996).

33. See, e.g., DEL. CODE ANN. tit. 8, § 141 (2001).

34. Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell and Sue*, 62 LAW & CONTEMP. PROBS. 215, 216-18 (1999).

check on managerial actions,³⁵ derivative litigation in state courts and securities fraud class actions in federal courts have historically played key roles in checking potential, or remedying actual, managerial abuses.

1. Derivative Litigation's Effects on Managerial Agency Costs

Derivative actions are suits brought by a representative shareholder, in the name of the corporation, to enforce its rights against parties that injured it. These suits usually allege a breach of fiduciary duty, a concept that has developed under the "care" and "loyalty" headings, although "exculpation" clauses permitted by most state statutes have limited the development of suits to monitor care.³⁶ Fiduciary duty litigation through derivative suits has important direct and indirect effects on managerial agency costs. Suppose, for instance, that corporate executives have persuaded a company's compensation committee to award them millions of dollars in unwarranted stock option payments. A derivative lawsuit challenging these awards can have the beneficial effect of forcing the executives to return this unwarranted compensation, while also ensuring that the company's stock option plan is properly interpreted in the future.³⁷

A strong judicial opinion in such a case, upbraiding the directors for failing to comply with their fiduciary duties, can have the indirect benefit of deterring potential future wrongdoers at other companies.³⁸ Derivative litigation also makes boards of directors, officers, and employees more active watchdogs for corporate wrongdoing by others, and it can increase investor confidence that corporate insiders will perform their jobs ably and loyally.

35. The main exception has been when it is used in conjunction with the shareholders' right to sell their shares in the market for corporate control to facilitate a change of control transaction in a joint tender offer and proxy contest. *See, e.g.*, RANDALL S. THOMAS & CATHERINE T. DIXON, ARANOW & EINHORN ON PROXY CONTESTS FOR CORPORATE CONTROL 1-12 (3d ed. Supp. 2001).

36. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (authorizing provision in company's certificate of incorporation to exculpate directors for duty of care allegations).

37. *See, e.g.*, Sanders v. Wang, No. 16640, 1999 WL 1044880 (Del. Ch. Nov. 8, 1999).

38. Edward B. Rock, *Saints and Sinners: How Does Delaware Law Work?*, 44 UCLA L. REV. 1009, 1009-1105 (1997).

2. Federal Securities Fraud Class Actions and Managerial Agency Cost Reductions

Complementing state corporate law and derivative actions, federal law has played an increasingly important role in recent years, both by requiring public disclosures of a growing amount of information, and through class action lawsuits involving allegations of securities fraud. The federal courts handle almost all of this securities law litigation, especially after Congress enacted the Uniform Standards Act in 1998.³⁹ This legislation, which addressed what Congress perceived to be abuses of the class action securities fraud lawsuit, had the effect of preempting state courts from hearing most securities law claims, although the “Delaware carve-out” preserves state courts’ ability to hear class actions in acquisition cases and a limited number of other contexts.⁴⁰

Federal securities law class actions are brought in the name of those who purchased or sold securities at a price that was affected by misleading disclosures about the company. The defendants generally are the company itself and its senior officers. The plaintiff class often is large enough that it encompasses most of the company’s shareholders, with any claim producing a small amount for each individual shareholder.

These suits usually do not directly challenge actions by directors qua directors, but rather are primarily brought as claims that the corporation and/or individual officers made false and/or misleading disclosures to the company’s shareholders.⁴¹ Although couched in disclosure terms, these allegations frequently attack the very same corporate actions that are challenged in state court

39. For a discussion of the Uniform Standards Act of 1998, see *supra* note 10.

40. See *supra* note 10. The Delaware carve-out permits shareholder class action suits in state court in two kinds of cases: “(1) a purchase or sale transaction where one side is the issuer or an affiliate, and the other side is exclusively holders of the issuer’s equity securities, and (2) recommendations or other communications ‘with respect to the sale of securities of the issuer’ made to equity holders by or on behalf of the issuer or an affiliate concerning (a) voting, (b) acting in response to a tender or exchange offer, or (c) exercising dissenters’ or appraisal rights.” Thompson, *supra* note 34, at 231 (quoting 15 U.S.C. § 77p(d)(1)(B) (2000)).

41. These ideas are further developed in Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 897 (2003) (noting that federal law is directed more to officers’ conduct in contrast to state law’s focus on directors’ conduct). With the adoption of the New York Stock Exchange Listing Standards requiring a majority of independent directors, this separation between the federal and state function will become more noticeable. See *supra* note 26.

shareholder litigation. The claims thus directly go to corporate governance and the performance of management in running the company. Federal securities fraud class actions can thereby result, both directly and indirectly, in reductions of managerial agency costs.

3. State Acquisition Litigation and Managerial Agency Cost Reductions

Delaware has recognized the risk of greater managerial agency costs in acquisitions, as opposed to “ordinary” director decisions, and has imposed additional legal duties on corporate directors in this setting. In hostile takeovers, management entrenchment and refusal to sell the company when a sale is in the shareholders’ best interests are serious risks posed by the delegation of these decisions to the board of directors. In friendly sales to a third party, there is the constant fear that management may sell the firm too cheaply in order to obtain lucrative severance packages or employment contracts with the acquirer. Finally, if management itself, or a controlling shareholder, is the acquirer, managerial agency costs may be high because of the conflict of interest between the managers’ duty to get the best deal for shareholders and their own self-interest (or that of the controlling shareholder) in implementing terms that minimize what the insiders will have to pay to gain control of the remaining interests in the corporation.

The judicial response to higher managerial agency costs differs between friendly deals and hostile acquisitions. The aggrieved shareholders’ legal claims have different underlying strengths in these two settings, which we will discuss separately below.

a. The Legal Standards for Friendly Deals

Friendly transactions are often consummated through mergers of the two companies. Mergers can only be accomplished on a friendly basis, as both companies’ boards of directors must approve the transaction. In our sample, friendly mergers are usually either with an independent third party, a management buyout group, or a controlling shareholder entity. In the first two instances, shareholders are protected to some degree by the state law requirement that both companies solicit shareholders’ votes and obtain majority approval for the merger to be consummated.⁴² In control shareholder transactions, however, this legal rule provides no protection as the majority shareholder already has the votes it needs to approve the deal.

42. See, e.g., DEL. CODE ANN. tit. 8, § 251(c) (2001).

In order to reflect these different settings, the Delaware courts apply different standards of review to shareholder claims alleging director misconduct in a merger depending on the presence or absence of a conflict of interest. When the merger is negotiated on an arm's length basis, without any conflict of interest, the courts will normally apply the highly deferential business judgment standard of review to the allegations of the complaint.⁴³

In a merger with a controlling shareholder, the bidder already has a control block of the target company's stock, and it effectively picks the target's board of directors. This renders it highly unlikely that the target will resist being acquired by the control shareholder by deploying defensive tactics. Control shareholder transactions, however, such as a squeeze out of minority shareholders in a merger, raise a different set of issues. When a shareholder with more than 50 percent voting power forces through a merger in order to cash out the minority shareholders, these minority shareholders are powerless to stop the transaction. In other words, the minority shareholders' voting rights do not protect them against potentially abusive transactions. Nor does their power to sell their shares into the market provide protection, as the market price will already reflect the terms proposed by the majority shareholder in the merger, and no third-party bidder will be willing to bid in the face of the controlling shareholder's dominant position.

Claims in the context of control shareholder transactions are reviewed by the Delaware courts applying the standards first announced in the classic case of *Weinberger v. UOP*.⁴⁴ This decision and its subsequent interpretations⁴⁵ require such conflicted mergers to meet a judicial review based on entire fairness, as opposed to the more deferential review of the business judgment rule. This legal standard has teeth, as numerous court decisions favoring minority shareholders bringing representative litigation have proven.⁴⁶

43. The most notable exception to this statement is *Smith v. Van Gorkom*, 488 A.2d 858, 888-89 (Del. 1985). Recent Delaware opinions have explored whether a tender offer by a controlling shareholder is reviewed by a different standard than a merger. See *In re Pure Res., Inc. S'holders Litig.*, 808 A.2d 421, 433-47 (Del. Ch. 2002). This postdates the cases reported in our data set.

44. *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

45. The most significant of these later decisions is *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (Del. 1994).

46. See, e.g., *Emerald Partners v. Berlin*, 787 A.2d 85, 97 (2001) ("The decision in *Weinberger* continues to be the seminal pronouncement by this Court regarding the entire fairness standard of judicial review."). The case results described in Table 18 of this Article reflect the continuing use of such claims in Delaware.

b. The Legal Standards for Hostile Deals

In the mid to late 1980s, hostile deal litigation was very hot, with bitter lawsuits leading to judicial decisions striking down takeover defenses and rich fee awards to class counsel that filed piggyback shareholder litigation. The success of these early cases created an entire new jurisprudence for takeover litigation.

Beginning in 1985, the Delaware courts developed an intermediate standard of review, more intrusive than the deferential business judgment rule, but short of the entire fairness of *Weinberger*. This enhanced scrutiny occurs in two settings that take their name from two leading cases from the 1980s—the golden age of takeover law in Delaware. In *Unocal v. Mesa Petroleum*,⁴⁷ the Delaware Supreme Court held that defensive tactics by an ostensibly independent board could still be subject to subjective bias; it therefore required that the company prove that a threat to the corporation existed and that the defensive tactic was a proportional response to that threat. The *Unocal* test, while appearing rigorous, has in fact been relatively benign in application, with few defensive tactics failing to pass its standards.⁴⁸

Defendants have had much more trouble under the standards set forth in *Revlon v. MacAndrews & Forbes*.⁴⁹ *Revlon* requires that in some, but by no means all, corporate control transactions, directors take steps to maximize shareholder value.⁵⁰ The promise of the *Revlon* decision itself was that in any sale of corporate control, the target company's board of directors had a duty to maximize shareholder value by taking the highest price for the company. Yet as students of corporate law learn, subsequent cases severely limit when corporate directors have *Revlon* duties. After the *Time/Warner* litigation,⁵¹ directors can negotiate a friendly stock-for-stock deal with a publicly held acquirer and not trigger *Revlon* duties. *Paramount v. QVC* reinstates *Revlon* in a friendly stock-for-stock deal if the acquirer has a controlling shareholder such that the shareholders of the target firm will effectively have lost their opportunity for a control premium.⁵²

47. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

48. Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: Sacred Space and Corporate Takeovers*, 80 TEX. L. REV. 261, 284 (2001) (survey of Delaware cases between 1985 and 2000 applying *Unocal* found no defensive tactic failed to pass proportionality test).

49. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985).

50. *See id.* at 184.

51. *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989).

52. *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994).

B. Representative Shareholder Lawsuits and Litigation Agency Costs

Plaintiffs' lawyers are the dominant players in representative shareholder litigation, whether derivative actions, securities fraud class actions, or state acquisition-oriented class actions. While in theory clients can and should control all litigation decisions, closely monitoring the actions of their attorneys,⁵³ the reality in representative litigation is that no individual shareholder has a sufficiently large stake in the outcome of the case to spend much time monitoring the attorneys.⁵⁴ The cost-benefit analysis for any single investor usually shows that the investor's potential gains from the litigation are miniscule compared to the expected costs from actively monitoring the pursuit of the case. Most investors respond to these incentives by remaining passive and may even be unaware that litigation is going on until after a settlement has been reached.⁵⁵ The end result is under-investment by shareholders in monitoring class counsel's efforts.⁵⁶

Poor monitoring creates the potential for agency costs, as the entrepreneurial attorney's interests can diverge from those of the clients.⁵⁷ If class counsel have tremendous discretion to run the litigation, they may do so in a manner that maximizes their benefit, even at the expense of the interests of their putative clients. For example, class counsel may choose to settle a strong case quickly for a small award of damages if they can obtain a large attorney fee award with little effort.

53. John Coffee, *Class Action Accountability: Reconciling Exit, Voice, and Loyalty in Representative Litigation*, 100 COLUM. L. REV. 370, 409 (2000) [hereinafter, Coffee, *Exit*]; John Coffee, *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877, 878 (1987) [hereinafter Coffee, *Balancing*].

54. Coffee, *Balancing*, *supra* note 53, at 884; Randall S. Thomas & Robert G. Hansen, *Auctioning Class Action and Derivative Lawsuits: A Critical Analysis*, 87 NW. U. L. REV. 423, 424 (1993).

55. Macey & Miller, *supra* note 3, at 20.

56. The effectiveness of monitoring depends on the observability of the agent's performance, whether that be direct observation by the principal or by examining the outcome. The legal system contains provisions designed to reduce monitoring costs such as admission to the bar, retention of membership, codes of ethics, and other rules of conduct. The legal system attempts to reduce bonding costs, those expenditures that are made by agents to assure their principals of the agent's trustworthiness, by the monopoly of the practice of law and reputational concerns.

57. Macey & Miller, *supra* note 3, at 3. There are substantial conflicts of interest between attorney and client in the context of entrepreneurial litigation, and these conflicts of interest are described as agency costs. All principal-agent relationships give rise to agency costs, which consist of the costs of monitoring the agent, the costs the agent incurs to guarantee fidelity or to bond him or herself to the principal, and the residual costs of opportunistic behavior that it is not cost-efficient to prevent. Coffee, *Balancing*, *supra* note 53, at 883.

Derivative suits were the first battleground over the appropriate balance between litigation agency costs and management agency costs. The United States Supreme Court addressed this tradeoff over fifty years ago in its opinion in *Cohen v. Beneficial Industrial Loan Corp.*⁵⁸

This [derivative] remedy, born of stockholder helplessness, was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests. It is argued, and not without reason, that without it there would be little practical check on such abuses.

Unfortunately, the remedy itself provided opportunity for abuse, which was not neglected. Suits sometimes were brought not to redress real wrongs, but to realize upon their nuisance value. They were bought off by secret settlements in which any wrongs to the general body of share owners were compounded by the suing stockholder, who was mollified by payments from corporate assets.⁵⁹

The Court, while noting the importance of the derivative action as a check on managerial agency costs, was more concerned about the potential for abusive "strike suits" that would generate high litigation agency costs. Striking the balance between the two in that case in favor of cutting litigation agency costs, the Court upheld New Jersey's statutory requirement that plaintiffs in derivative actions post a bond as security for payment of defendants' legal fees in the event that the action was dismissed as without merit.⁶⁰ Posting security for the defendants' expenses in defending the suit was one of the early efforts made by legislatures to reduce the litigation agency costs of derivative litigation.

Derivative litigation's costs were detailed in a report by Franklin Wood to the New York Chamber of Commerce in 1944.⁶¹ Wood and his team interviewed a large number of lawyers and collected data on all derivative suits filed in two counties of the State of New York and in the United States District Court for the Southern District of New York between 1932 and 1942.⁶² They published a scathing indictment of derivative suits, finding them to be filed by shareholders "having no real financial interest in the corporation," with it "being obvious that the only one likely to profit substantially in the event of success is the [plaintiff's] attorney."⁶³ They found that a small group of plaintiffs' attorneys filed most of these cases, that they

58. 337 U.S. 541 (1949).

59. *Id.* at 548.

60. *Id.* at 554-55.

61. WOOD, *supra* note 1.

62. *Id.* at 2. The two counties were New York County and Kings County. *Id.* at 3. For Kings County, Wood's team only collected data for 1938-42. *Id.* at 3.

63. *Id.* at 112.

earned very substantial fees when they were successful in court or by striking a settlement, and that they were frequently jockeying for position as “general” counsel; these factors led to the filing of many duplicative and substantially identical complaints.⁶⁴ In our terminology, Wood was claiming that derivative actions had high litigation agency costs.

Finally, Wood argued that these cases had little impact on managerial agency costs, despite the large settlements involved in many of them, because “[i]n substantially all instances the opinions approving the settlement have absolved the defendants from any charge of bad faith.”⁶⁵ Wood also pointed to the fact that on average these cases settled for less than 3 percent of the amounts demanded in the complaints, that the courts approved the settlements as adequate in almost every case, and that “derivative actions more than most others lend themselves to settlement as an insurance measure”⁶⁶ Based on Wood’s report, the New York legislature enacted a new provision of that state’s corporate code, requiring plaintiffs in derivative actions who held less than 5 percent, or \$50,000, of the defendant company’s stock to post bond for the company’s expenses in defending the action.⁶⁷

Courts and legislatures have also subjected derivative suits to additional limitations, including the contemporaneous ownership requirement⁶⁸ and, most importantly, the demand requirement, in an attempt to prevent litigation agency costs.⁶⁹ Unfortunately, these

64. *Id.* at 57, 75, 78, 82, 112. The term general counsel refers to what would now be called lead counsel.

65. *See id.* at 42.

66. *Id.*

67. N.Y. BUS. CORP. LAW § 627 (McKinney 2003) (first enacted in 1944). The 5 percent threshold appears to have been derived by examining the size of the stakes of shareholders filing derivative actions against close corporations. WOOD, *supra* note 1, at 30-31. The average shareholder plaintiff in these cases held more than 30 percent of the company’s stock, and in less than 7 percent of these cases did the plaintiff hold less than 5 percent of the company’s stock. *Id.* at 31. As of 2003, 16 states have these security for expenses statutes. DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS § 3:2, at 3-5 (2003).

68. The contemporaneous ownership requirement mandates that the named plaintiff in a derivative suit be a shareholder at the time of the transaction and at the time of filing of the suit. JAMES D. COX ET AL., CORPORATIONS 424 (1997). Alternatively, the named plaintiffs may have obtained their shares by operation of law from someone who was a shareholder at the time of the filing of the suit. *Id.*

69. The demand requirement forces a potential plaintiff to first make demand on the company’s board of directors to remedy the alleged misconduct, or to allege why such demand would be futile. Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 576 (2001).

requirements cannot perfectly differentiate between meritorious and non-meritorious suits, and therefore they deter both types of suit.⁷⁰

Federal securities fraud class actions are a second form of representative shareholder litigation in which strong concerns have been raised about litigation agency costs. Prior to 1995, courts and legislatures had developed some protections against high litigation agency costs in securities fraud class action litigation. For example, the Federal Rules of Civil Procedure regulated who could be the named plaintiff in these cases. In an effort to minimize litigation agency costs, two requirements were imposed on plaintiffs: the claim of the named plaintiff had to be typical of the claims of absent shareholders, and the named plaintiff had to be capable of providing adequate representation of the class.⁷¹

Typicality requires a close fit between the representative plaintiff's interests and the interest of absent parties, while adequacy of representation refers to the ability and willingness of the named plaintiff to act as a competent champion of the corporation. Unfortunately, these procedural safeguards were easily circumvented, as they were only likely to be enforced by defendants, who often had little interest in insuring that named plaintiffs satisfied either criterion.⁷²

Faced with allegations of serious abuses, Congress perceived a need to impose further restrictions on litigation agency costs in securities fraud cases and passed the PSLRA in 1995.⁷³ The Act imposed unique requirements and limitations on private class actions brought in federal courts and alleging securities fraud. These requirements and limitations were intended to realign agent and principal interests by altering the representation requirement,

70. Deborah A. DeMott, *Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 137, 140 (1985); see also Tim Brandi, *The Strike Suit: A Common Problem of the Derivative Suit and the Shareholder Class Action*, 98 DICK. L. REV. 355, 372 (1993). In some states, however, courts have discretion in how they apply these requirements. Thus, in California, for example, the court has discretion to require any plaintiff to post security for the defendant's expenses, irrespective of how much stock they hold. CAL. CORP. CODE § 800 (West 1990).

71. FED. R. CIV. P. 23; Macey & Miller, *supra* note 3, at 61-62; Elliot J. Weiss, *The Impact to Date of the Lead Plaintiff Provisions of the Private Securities Litigation Reform Act*, 39 ARIZ. L. REV. 561, 570 (1997).

72. The defendant is more likely to act strategically to serve his or her own interests by using the typicality and adequacy rules as a means for influencing the choice of plaintiff's counsel. Macey & Miller, *supra* note 3, at 64. The defendant may benefit if the plaintiff is not typical and has interests in the litigation not shared by the corporation because the defendant may find a way to settle the case cheaply in a way that favors the named plaintiff at the expense of the corporation or other shareholders. *Id.*

73. John W. Avery, *Securities Litigation Reform: The Genesis of the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335 (1996).

discovery, and the settlement process.⁷⁴ The adequacy of the representation requirement was modified to give greater control of the conduct of class actions to those investors, usually institutional investors, holding the largest stakes in the defendant companies.⁷⁵ Other changes included efforts to limit the class action lawyer's ability to generate litigation through the use of professional plaintiffs. These efforts proceeded by limiting the number of lawsuits in which an individual could serve as class representative, banning referral fees to brokers, and prohibiting class representatives from receiving special compensation.⁷⁶

While the lack of effective client monitoring is a problem with all representative litigation, special aspects to the problem have been identified in earlier public discussions and empirical research about derivative actions and federal securities fraud class actions. We turn first to identifying the common indicia of litigation agency costs and then to describing the prior evidence about the extent to which these indicia have been identified in derivative actions and securities class action. We then turn in the next part to how acquisition class actions differ.

1. Indicia of Litigation Agency Costs

Given existing research, and prior public discussions, what generalizations can we draw about the manifestations of litigation agency costs in representative litigation? We believe we can distill eight different indicia that have been identified as problematic through public discussions of derivative suits and securities fraud litigation. While each of these factors can be interpreted in different, and often conflicting, ways, in the earlier policy debates they were the most commonly maligned features of these suits. Without discounting

74. *Id.* at 373-76.

75. *Id.* at 373-75. PSLRA requires the first plaintiff to file a complaint and, within 20 days, to provide notice to members of the purported class in a widely circulated business publication. 15 U.S.C. § 78u-4(a)(3)(A)(i) (2000). The notice must identify the claims alleged and the purported class period and must inform potential class members that they may move to serve as the lead plaintiff. Within 90 days of the published notice, the court must consider the motions to appoint the lead plaintiff, and the Act introduces the concept of the most adequate plaintiff to help judges make the decision. § 78u-4(a)(3)(B)(i).

The Act creates a rebuttable presumption that the person or entity appointed should be the one most capable of adequately representing the interests of class members. *Id.* at 78u-4(a)(3)(B)(iii)(I). The most adequate plaintiff would be one that has responded to the notice, has the largest financial interest in the relief sought by the class, and fits all other Rule 23 requirements.

76. Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 536-37 (1997).

the possibility that some of these factors serve valuable functions, we label them as indicators of litigation agency costs because that is how they were treated during those earlier discussions.

First, are the representative suits settled out of court quickly for small amounts but with substantial attorney fee awards? This is the most frequently cited complaint about class action litigation: that entrepreneurial attorneys bring non-meritorious suits for their nuisance and settlement value.⁷⁷ The defendants' and plaintiffs' asymmetric stakes⁷⁸ and cost differentials⁷⁹ in these cases make it economically rational for defendants to settle even frivolous cases, while plaintiffs' attorneys can reduce their risks by having a portfolio of cases that they settle for too little money.⁸⁰

This leads to the second question about litigation agency costs: is the recovery small compared to the alleged damages in the case?⁸¹ If the plaintiffs' attorneys are settling cases quickly for small amounts, one possible implication of their actions is that the case is a nuisance claim brought only to collect an attorneys' fee award.⁸²

Third, is a large portion of the recovery going to the attorney for the class? This is an obvious area of concern because of the worry that attorneys will take more than their fair share of the recovery for

77. Brandi, *supra* note 70, at 369; D. Brian Hufford, *Deterring Fraud vs. Avoiding the Strike Suit: Reaching an Appropriate Balance*, 61 BROOK. L. REV. 593, 601 (1995).

78. Coffee, *Balancing*, *supra* note 53, at 889-91 (noting that defendants have much more at stake in this litigation than the plaintiffs' attorneys); John Coffee, *Rethinking the Class Action: A Policy Primer for Reform*, 62 IND. L.J. 625, 635 (1987).

79. Coffee, *Balancing*, *supra* note 53, at 891 (stating that defendants' costs of litigating these cases will be much higher because the burden of discovery falls heavily on their shoulders).

80. Every professor has a favorite example of what appears to be a bad settlement of a good corporate claim. Ours is *Sullivan v. Hammer*, No. CIV.A.10823, 1990 WL 114223 (Del. Ch. Aug. 7, 1990).

81. While this is a very important problem, it is also one of the most difficult to measure empirically because the size of potential damage awards is difficult to calculate in most representative litigation. This is particularly difficult in derivative litigation where it may be unclear what the appropriate damages are for a director's alleged breach of fiduciary duties. Even in federal securities litigation, where we can calculate with a higher degree of certainty the drop in the market value of a security during a fraud interval, there are still many disagreements about the appropriate method for doing so, and what constitutes a reasonable percentage recovery from the often enormous potential damages. *E.g.*, Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. REV. 883 (1990); Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 611-12 (1985); *see also* Mark L. Mitchell & Jeffry M. Netter, *The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission*, 49 BUS. LAW. 545 (1994). It is almost impossible to calculate the potential damages in these cases without detailed factual information about each case. This restricts us to a comparison of the size of the damage awards paid in the settlement, which is much less useful in determining whether the settlement was abusive.

82. Of course, there are other possible explanations for such actions, such as a lack of resources among the potential defendants.

themselves at the expense of the class. Such concerns are particularly strong when the class recovery is not in the form of cash, but rather in the form of apparently minor changes in corporate governance structures. If the recovery is structured so that class counsel receives all of the cash in the settlement, while the class members get only the uncertain potential for future corporate governance benefits, this raises the specter of high litigation agency costs.

Fourth, are the cases settling out of court with little activity? If cases are filed, sit idle for extended periods of time, and then settle or are dismissed without evidence of any action by the plaintiffs' attorneys, the claim could be made that these cases amount to little more than a sale of a release of all potential claims in litigation.⁸³ By contrast, when the defendant and plaintiff actively litigate the merits of the case, filing substantive motions and taking discovery, with the court actively involved in deciding various aspects of the case, it appears that both sides believe that the case is worth investing time and resources in litigating. There is no better evidence that the plaintiffs' law firm believes in its case than its willingness to invest its time and money in it.

Fifth, are these suits filed quickly after a public announcement of information about the company's activities? If so, this may indicate that the attorneys' interest in becoming lead counsel exceeds their interest in filing a meritorious lawsuit.⁸⁴ For example, in the debate about the merits of federal securities litigation prior to 1995, class action suits were often claimed to have been filed within days of the announcement of unexpected drops in corporate earnings. This was publicly portrayed as an example of the plaintiffs' attorneys' "race to the courthouse" in an attempt to be named the lead counsel in these cases.⁸⁵ Capturing the lead counsel position can be lucrative for these

83. Alternatively, the litigation could be playing a supporting role in a larger negotiation, such as may occur when the minority shareholders' interests are also being represented by a special committee of the board of directors in a control shareholder squeeze out transaction. In this situation, we would not necessarily want the litigation to be actively pursued unless negotiations between the acquirer and the special committee collapsed or went amiss.

84. Jill E. Fisch, *Aggregation, Auctions, and Other Developments in the Selection of Lead Counsel Under PSLRA*, 64 *LAW & CONTEMP. PROBS.* 53, 57 (2001) (noting also that rapid filing may lead lawyers to "seek out prospective plaintiffs rather than waiting to be approached," and that class counsel may be chosen "with little consideration given to qualifications").

85. Elliott J. Weiss & John S. Beckerman suggest that plaintiffs' attorneys will "share copies of their complaints with other plaintiffs' lawyers who will support their election as lead counsel." *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 *YALE L.J.* 2053, 2063 (1995). An alternative positive interpretation of quick filing of suits in an acquisition context is that the attorneys are attempting to obtain an injunction to stop the completion of the transaction until a court can determine the fairness of the consideration. While this is plausible, it is not supported by the

attorneys,⁸⁶ but hasty filing of frivolous suits may inflict needless costs on the shareholders, whom the attorney is supposed to be representing.

Sixth, are multiple lawsuits being filed against the company for the same alleged wrongdoing? Once a single representative action has been filed, the shareholders' interests in correcting any wrongs are presumably protected; filing more suits may simply raise the costs to shareholders of challenging the board's actions.⁸⁷ The plaintiffs' attorneys that were not the first to file their case still have an interest in participating in the litigation, however, as they might still be named lead counsel, or become a member of a syndicate of plaintiffs' attorneys that prosecutes the case. Thus, prior to 1995, it was common in federal securities litigation to find multiple class action complaints being filed against the same defendants alleging the same misconduct, often using identical language.⁸⁸

Seventh, does this type of litigation target a particular type of company? If these representative suits are filed based on their merits, then this type of litigation should name defendant companies from a broad spectrum of industries on a geographically dispersed basis for a wide variety of alleged wrongdoing. Should we find that these suits target only a particular type of company for a particular alleged form of wrongdoing, then it *may* be the case that the attorneys' incentives are what is driving the litigation rather than the merits of the case. Consider the high-technology industry, which was subjected to a disproportionate number of federal securities fraud lawsuits prior to

data in our sample. We found 53 lead cases (of a total of 348) where motions for a preliminary injunction or Temporary Restraining Order (TRO) were filed. Less than half of these (24) were in acquisition cases that would be relevant to this point. Of those 24, an order was granted in two cases, one transaction that involved a controlling shareholder and one in a third-party transaction. (There was also one non-acquisition in which a motion was granted.) For the remainder of the 53 cases in which a preliminary injunction or TRO motion was made, there was no indication on the docket sheet that the motion had been briefed or a hearing sought.

A third possibility is that the suits are filed quickly because in an acquisition, there is not much for the plaintiffs' counsel to find out: the premium has been announced, the identity of the parties (and possibility of a conflict of interest) is known, and the claim is that the price is too low. There is no need to engage in the same level of discovery that is needed in a securities fraud action, where it will be necessary to establish scienter.

86. Joseph A. Grundfest & Michael A. Perino, *The Pentium Papers: A Case Study of Collective Institutional Investor Activism in Litigation*, 38 ARIZ. L. REV. 559, 601 (1996) ("Currently, the lead counsel position is quite lucrative and the plaintiff's class action counsel have a significant interest in obtaining that spot.")

87. It is also possible that there will be beneficial effects of filing more suits, such as an increased likelihood of a favorable settlement or the appointment of better qualified lead counsel.

88. See *infra* notes 190, 193.

1995.⁸⁹ High stock price volatility and heavy share turnover are often claimed to have contributed to this industry's litigation risk.⁹⁰ In congressional hearings prior to the passage of the PSLRA, defendants claimed, and Congress appears to have accepted as true, that plaintiffs' lawyers were filing these cases against high-tech firms "whenever a stock price drops more than ten percent."⁹¹ Large stock price drops and high share turnover both inflate potential damage claims that can be made in Rule 10b-5 cases, making these firms more attractive targets to attorneys. However, these events do not increase the likelihood of fraud, which makes the higher number of fraud suits against high-tech firms suspect.

Finally, are there a small number of repeat law firms that file these actions, and a small number of professional plaintiffs that appear in them?⁹² There are obvious benefits from specialization by law firms in the sometimes arcane aspects of shareholder representative litigation and, at least in theory, benefits from having knowledgeable class representatives. Critics have claimed that, in practice, this inner "clique" acts to further its own interests at the expense of the shareholder class.⁹³ For example, the small number of repeat players in the industry may facilitate collusive divisions of the fees that are garnered in settlements with one firm agreeing to give up its claim to lead counsel position in the present action in order to gain other firms' support for its application to be lead counsel in the next action.⁹⁴ Obviously, competition to become lead counsel will suffer in this circumstance, and the class's interests in getting the best representation possible could be sacrificed as well.

89. Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience* 13-14 (Feb. 27, 1997) (unpublished working paper, on file with authors).

90. Christopher L. Jones & Seth E. Weingram, *Why 10b-5 Litigation Risk Is Higher for Technology and Financial Services Firms* (July 1996) (unpublished working paper, on file with authors).

91. Avery, *supra* note 73, at 339.

92. Even the earliest studies of shareholder litigation found that they were filed on behalf of a small group of named investors by a well-identified subset of law firms which specialized in bringing this form of litigation. WOOD, *supra* note 1; see also LAWRENCE E. MITCHELL, *GENTLEMAN'S AGREEMENT: THE ANTISEMITIC ORIGINS OF RESTRICTIONS ON STOCKHOLDER LITIGATION*, (George Wash. Univ. Law Sch., Pub. Law Research Paper No. 44, 2002) (criticizing the Wood Report), <http://ssrn.com/abstract=321680>.

93. Macey & Miller, *supra* note 3, at 1, 3, 5-6, 8.

94. The plaintiffs' law firms will commonly form a loose syndicate to represent the class. Lead counsel will get the lion's share of the work, but the other members of the group will each contribute something to the representation. If there is a positive settlement, the fee will be divided among the firms, with lead counsel getting the biggest portion and the other firms receiving payments that reflect their contributions to the case.

Similarly, professional plaintiffs almost always appear in cases represented by the same firm over and over again, creating the appearance that the plaintiffs are not independent from their counsel and are acting on the firm's behalf, rather than the other way around. If so, these plaintiffs' ability and willingness to actively monitor the actions of their counsel is called into question.

We turn next to a summary of the prior empirical evidence that has been compiled about these litigation agency cost indicia.

2. Litigation Agency Costs in Derivative Actions and Securities Fraud Class Actions: Prior Empirical Work

Prior studies of litigation agency costs in derivative suits and securities class actions provide us a foundation to analyze data as to the state court class actions in our study. This prior work tends to separate into two groups. The older vintage, including a study by Professor Thomas Jones analyzing shareholder litigation in the 1971-78 period⁹⁵ and one by Professor Roberta Romano analyzing shareholder litigation between the late 1960s and 1987,⁹⁶ present data on shareholder litigation that includes both derivative suits and class actions in state and federal courts.⁹⁷ The more recent studies have

95. Thomas M. Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits*, 60 B.U. L. REV. 542 (1980). Professor Jones includes settlement information on 55 disputes that spawned 228 lawsuits which he divides into 3 categories: those producing monetary relief; those producing monetary relief for which a value could not be calculated, and those without monetary relief. *Id.* at 547. He does not divide the cases between derivative suits and class actions or between state and federal court, but a majority of cases appear to be derivative and probably state claims. Among the 40 cases producing monetary relief, 21 report recovery to the shareholders (suggesting a class action) and 19 report recovery to the corporation (suggesting a derivative claim). *Id.* at 548-51 tbl.III. The other two categories appear from a limited description to be almost all derivative claims, although several of the cases reflect the post-Watergate improper contributions claims that mix federal and state claims. *Id.* at 556-62.

96. Romano, *supra* note 1, at 60. Romano's article reports that her data set includes 5 groups of cases of roughly the same size: 1) acquisitions, including challenges to friendly mergers; 2) challenges to takeover defenses actions; 3) executive compensation and other self-interested transactions; 4) misstatements or omissions in financial statements; 5) residual claims. *Id.* In a letter to Professor Seligman, she reports that the data set of 128 settlements includes 38 class actions, 50 derivative actions, 31 both class and derivative actions and 9 actions by individual shareholders. Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 36 n.145 (1993) (reporting information from a letter to him from Professor Romano of Dec. 29, 1992). In the working paper that preceded the article, Professor Romano reports that about one-fifth of the lawsuits (25 of 122) had no state claim and that 40 percent of cases with settlement funds (16 of 40) arose under federal law. See ROBERTA ROMANO, *THE SHAREHOLDER SUIT: LITIGATION WITHOUT FOUNDATION* 74-75, tbls.11-12 (Yale Law Sch., Program in Civil Liab., Working Paper No. 130, 1990) (on file with authors).

97. Unfortunately, these studies do not always clearly distinguish between derivative and class action suits, and instead sometimes refer to a single category of shareholder litigation. See,

focused exclusively on federal securities class actions before and after the 1995 Act.⁹⁸ For the indicia of litigation agency costs discussed *supra* Part I.B.1, the two sets of studies make similar findings, suggesting that there is a core consistency in the two kinds of representative suits. Here, we summarize some of the main results of the most relevant studies.⁹⁹

Most shareholder suits settle and very few are litigated on the merits. The Jones and Romano studies, using data on all types of shareholder suits filed, found that most of these actions settled out of court. Using data from cases filed in the 1970s, Jones found that 74.7 percent of shareholder suits were resolved through out-of-court settlement.¹⁰⁰ Romano, using a broader data set from the 1970s and 1980s, similarly determined that 64.8 percent of shareholder suits settled out of court.¹⁰¹ This was considerably higher than what Wood found for public companies in the 1930s and early 1940s.¹⁰²

For federal securities suits, one study of cases filed prior to PSLRA found that “87.6 percent of the securities class actions filed from April 1988 through September 1996 ended in settlement, with the large majority of the remainder being resolved by dispositive motions or voluntary dismissal.”¹⁰³ A second study found that, in 1998, settlements comprised 85 percent of all dispositions of federal

e.g., WOOD, *supra* note 1, at 6-7; John E. Kennedy, *Securities Class and Derivative Actions in the United States District Court for the Northern District of Texas: An Empirical Study*, 14 HOUS. L. REV. 769, 769 (1977).

98. See *infra* notes 104, 118.

99. We do not include any discussion of those studies that have focused on stock market reaction to the filing or dismissal of shareholder litigation. See, *e.g.*, Mark L. Cross et al., *The Impact of Directors and Officers' Liability Suits on Firm Value*, 56 J. RISK & INS. 128, 131 (1989); Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 277-83 (1986); Kenneth E. Scott, *The Role of Preconceptions in Policy Analysis in Law: A Response to Fischel and Bradley*, 71 CORNELL L. REV. 299, 304-05 (1986).

100. Jones, *supra* note 95, at 545, 547.

101. Romano, *supra* note 1, at 60 & nn.7-8 (reporting 83 out of 128 resolved lawsuits settled; there were an additional 11 suits still pending in Romano's sample). Professor Romano adjusts Professor Jones's figures to reflect plaintiff suits voluntarily dropped, bringing the Jones and Romano figures closer together.

102. WOOD, *supra* note 1, at 32 (reporting 16 percent settlement rate). Professor Hornstein adjusted that data, but even as adjusted (29 percent) it remains much lower than the later studies. Romano, *supra* note 1, at 60 n.7 (citing George D. Hornstein, *The Death Knell of Stockholders' Derivative Suits in New York*, 32 CAL. L. REV. 123 (1944) (giving 31.5 percent as the percentage for recoveries in suits involving publicly held companies)). Professor Romano attributes the changes to court approval of settlements in representative actions and the availability of D&O (director and officer) insurance. *Id.*

103. JOSEPH A. GRUNDFEST & MICHAEL A. PERINO, STANFORD LAW SCH. SEC. CLASS ACTION CLEARINGHOUSE, SECURITIES LITIGATION REFORM: THE FIRST YEAR'S EXPERIENCE § IX (1997) (footnote omitted), http://securities.stanford.edu/research/studies/19970227firstyr_firstyr.html.

securities class action suits, although between January and June of 1999, that percentage dropped to 79 percent.¹⁰⁴

Because so many cases settle, few cases are litigated on the merits. Of the 32 cases that were adjudicated in the Romano study, only two, or about 6.25 percent, resulted in favorable outcomes for the plaintiffs.¹⁰⁵ The Jones study calculated the percentage of cases resulting in judgment for the plaintiffs, and found that of the 88 sample cases adjudicated by the courts, two resulted in plaintiff judgments.¹⁰⁶ These values could be explained by defendants vigorously defending strong cases, while settling weak ones.¹⁰⁷ Furthermore, even though a small number of shareholder lawsuits get resolved by trial, the courts may nonetheless play a monitoring function because they have to approve each settlement.¹⁰⁸

Most cases produce some relief for shareholders, although it is usually small when measured on a per share basis. Most plaintiffs obtain at least some form of relief, again, mostly through settlement.¹⁰⁹ This led Professor Jones to conclude, “the notion that shareholder plaintiffs rarely obtain relief is clearly a myth.”¹¹⁰ Professor Romano interprets the same pattern of settlements to reflect a less rosy picture, noting that average payouts in derivative settlements with monetary recovery are \$0.18/share, or about 2 percent of the stock’s price.¹¹¹ Her data show a median total recovery

104. TODD S. FOSTER ET AL., TRENDS IN SECURITIES LITIGATION AND THE IMPACT OF PSLRA 6 fig.10 (2000).

105. Romano, *supra* note 1, at 60 n.8. Both cases settled after favorable rulings for the plaintiffs. *Id.*

106. Jones, *supra* note 95, at 545. This study appears to have classified all settlements together even if they occurred after adjudications by the court.

107. *Id.* at 546-47.

108. Romano, *supra* note 1, at 57. However, courts may “rarely scrutinize settlements and, consequently, attorneys’ incentives are the key factor in shareholder litigation.” *Id.* (citing John Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 L. & CONTEMP. PROBS. 5 (1985)).

109. Jones, *supra* note 95, at 545 (noting that despite the high incidence in which shareholders obtain relief, 75.3 percent, it cannot be said that plaintiffs won in any absolute sense, asserting that “since an objectively fair recovery is often impossible to identify, shareholder success in derivative and class action litigation can best be measured in terms of the frequency with which they obtain some relief”).

110. *Id.*

111. Romano, *supra* note 1, at 62. Romano found that in only half of the settlements do shareholders obtain a financial recovery, and that “awards are paid to the attorneys far more frequently than to shareholders.” *Id.* Professors Romano and Jones also disagree on non-monetary settlements. Compare *id.* at 63, with Jones, *supra* note 95, at 545. Romano characterized such structural settlements as “inconsequential” and “cosmetic,” and most likely used to justify attorneys’ fees awards. Romano, *supra* note 1, at 63. Additionally, she claims that a review of such settlements does not provide evidence that shareholder litigation helps to deter

for all shareholders of \$2 million and an average recovery of \$9 million.¹¹² On this point, she breaks down her data between derivative and class claims and finds that derivative claims (e.g., executive compensation and self-dealing) are settled for much less than the class actions (e.g., financial disclosure and acquisitions claims).¹¹³ She also finds a difference between the types of suits as to frequency of cash payouts in settlements—only 21 percent of derivative actions result in cash settlements,¹¹⁴ but 67 percent of class action lawsuits result in defendants paying investors cash when the parties settle.¹¹⁵ Romano finds the difference of interest, “because the principal debate of the merits of shareholder litigation is focused on derivative, not class actions.”¹¹⁶

Similarly, Wood’s study of the 1930s and early 1940s finds small per share recoveries for shareholders from derivative actions in both state and federal court.¹¹⁷ For federal securities law cases in recent years, data available on recovery as a percentage of damages also depict a low percentage.¹¹⁸

Attorneys’ fees are significant even if the shareholder recovery is small. Plaintiffs’ attorneys’ fees are always paid in settlements, and are usually significant, even when the plaintiffs’ award is small or non-monetary.¹¹⁹ In Jones’ study, plaintiffs’ attorneys’ fees averaged 16.2 percent of the total plaintiff recovery, but ranged as high as 40.2

management misconduct, and corporations do not adjust management’s compensation “in response to lawsuits.” *Id.* at 84.

112. Romano, *supra* note 1, at 61. Romano notes that there are two possible explanations for this. The first is that most fiduciary breaches are minor and tend not to harm shareholders. *Id.* The other is that a large proportion of shareholder suits are “without merit.” *Id.*

113. *Id.* at 61 (finding average settlement amounts in class action suits to be \$11 million, while finding average settlement amounts in derivative suits to be \$6 million).

114. *Id.* The per share recovery in derivative suits is small, and only “approximately 2 percent of the stock price on the day prior to the lawsuit’s filing.” *Id.* at 62.

115. *Id.* at 61. Per share recoveries in class action claims, although difficult to ascertain, tend to be a little higher. *Id.* at 62 (“Computing per share recoveries in class actions is extremely difficult because information on class size, individual members’ losses, and hence their allotted recovery is, for the most part, unavailable.”).

116. *Id.* at 61.

117. WOOD, *supra* note 1, at 49-53.

118. DENISE N. MARTIN ET AL., NAT’L ECON. RESEARCH ASSOCS., RECENT TRENDS IV: WHAT EXPLAINS FILINGS AND SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS? 10 *tbl.7a* (1996) (noting the average settlement is 13.67 percent of plaintiffs’ claimed damages); MUKESH BAJAJ ET AL., SECURITIES CLASS ACTION SETTLEMENTS: AN EMPIRICAL ANALYSIS 26 *tbl.9* (2000) (presenting data showing low average ratios of different measures of loss to settlement value for 1991-1999), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=258027.

119. Jones, *supra* note 95, at 567. Attorney’s fees in derivative and class action lawsuits “can be quite substantial, both in absolute terms and as a percentage of the recovery.” *Id.* at 565.

percent.¹²⁰ Wood's study of derivative suits in the 1930s and early 1940s found that plaintiffs' attorneys' fees ranged from 20 percent to 45 percent of the gross recovery.¹²¹ Romano's study found that plaintiffs' and defendants' attorneys' fees are comparable.¹²²

In federal securities suits, plaintiffs' attorneys' fees in one study averaged 31.84 percent of the settlement amount.¹²³ That percentage is slightly higher for cases against high-technology companies, with attorneys receiving a fee 32.38 percent of the settlement amount.¹²⁴

Multiple lawsuits are often filed for the same alleged wrong. Multiple lawsuits arising out of the same fact pattern are regularly filed in shareholder representative litigation. Jones reports 2.6 lawsuits per disputed issue,¹²⁵ while Romano's study found a somewhat larger 3.6 ratio, with 506 lawsuits arising out of 139 disputed transactions.¹²⁶ Wood's early study found that "[i]t has become common for ten to twenty [derivative] actions to be brought, and stayed or consolidated, and the procession only ended by [an] injunction . . ." against further suits being filed.¹²⁷

Studies of federal securities claims reflect a similar pattern. For example, in the Northern District of California from 1983 to 1984, of the 111 securities class action filings, there were 35 different instances in which multiple cases were filed against the same issuer over the same alleged violations.¹²⁸ Similarly, in 1992, 265 securities fraud complaints were reported filed against only 113 different companies.¹²⁹ It was not uncommon, in some instances, to see as

120. *Id.* at 567. Jones noted that even where the plaintiff's recovery was trivial or non-monetary, the attorneys still received their customary fees. *Id.*

121. WOOD, *supra* note 1, at 78-81.

122. Romano, *supra* note 1, at 65 (noting that "in virtually all of these lawsuits, the amounts expended on legal fees by defendants were considerable, often in the same range as the costs"). Attorneys' fees are usually paid for by the corporation's D&O insurance, and not by the managers or directors who are sued. *Id.* at 56, 84.

123. MARTIN ET AL., *supra* note 118, at 15 tbl.12b.

124. *Id.* at 14 tbl.12a.

125. Thomas M. Jones, *An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Lawsuits, 1971-1978*, 60 B.U. L. REV. 306, 313 (1980).

126. Romano, *supra* note 1, at 59 n.4.

127. WOOD, *supra* note 1, at 68. Wood claims that these multiple suits were filed by attorneys trying to insure that they would get between 5 and 10 percent of the fees awarded to the lead counsel as a reward for their actions. *Id.* at 82.

128. Janet Cooper Alexander, *The Lawsuit Avoidance Theory of Why Initial Public Offerings Are Underpriced*, 41 UCLA L. REV. 17, 33 n.59 (1993).

129. *Id.*

many as 15 complaints filed raising the same allegations, which would then be consolidated by the court into a single class action.¹³⁰

These suits tend to be filed by a small number of law firms and plaintiffs who own only a small amount of stock. Wood's study of the 1930s found that shareholder suits were brought by a small number of law firms and attorneys,¹³¹ and that plaintiff shareholders in derivative actions owned only a de minimis amount of stock in the defendant corporation.¹³² Prior to the passage of PSLRA, it was generally understood that Milberg Weiss Bershad Hynes, & Lerach ("Milberg Weiss") played a leading role as plaintiffs' class action counsel. During the period from April 1988 through September 1996, Milberg Weiss represented clients in approximately 31.4 percent of 842 class action securities fraud cases nationwide.¹³³ Since the passage of the Act, Milberg Weiss appears to have become even more dominant in securities class action. Between December 22, 1995 and December 31, 1996, out of the 109 securities class action proceedings in federal court, Milberg Weiss appeared in 51 of the suits, which equates to 43.8 percent.¹³⁴ Moreover, between the passage of the Reform Act and December 2001, Milberg Weiss was involved in 51.5 percent of all settled cases.¹³⁵

Suits are filed quickly. Prior to the passage of PSLRA, securities fraud suits were filed quickly after the announcement of adverse news about the targeted company.¹³⁶ Legislative history accompanying the 1995 Act describes "cookie-cutter complaints" filed "within hours or days" of substantial drops in the company's stock price.¹³⁷

Cases typically take years to resolve. This is a characteristic that has been shown for the federal securities class actions. Prior to the passage of PSLRA, an average of 2.67 percent of the federal

130. GRUNDFEST & PERINO, *supra* note 103, § II.

131. WOOD, *supra* note 1, at 57 (more than 60 percent of the "more substantial cases" were filed by a group of 14 attorneys or firms).

132. *Id.* at 50-53 (presenting data on cases in which there was a recovery showing that plaintiff shareholders in these derivative actions owned only a de minimis amount of stock in the defendant corporation.) However, another study that looked at shareholder suits in Dallas, Texas, found that the investment shareholder plaintiffs held in the defendant corporation ranged from \$2,000 to \$500,000. Kennedy, *supra* note 97, at 819-20 tbl.10.

133. GRUNDFEST & PERINO, *supra* note 103, § VII.

134. *Id.*

135. LAURA E. SIMMONS, CORNERSTONE RESEARCH, POST-REFORM ACT SECURITIES LAWSUITS: SETTLEMENTS REPORTED THROUGH DECEMBER 2001, at 10 fig.8 (2002), http://www.cornerstone.com/fram_res.html.

136. John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 375 (1996).

137. H.R. REP. No. 104-50, at 16 (1995).

securities fraud cases settled within one year.¹³⁸ If we expand this time frame outward to two years, we find 18.54 percent of these federal cases settling, with this number continuing to increase, so that after four years 57.59 percent of these federal class actions had settled.¹³⁹ After PSLRA, less than 1 percent of these cases settled within one year, and only 11.58 percent of these actions settled in less than two years.¹⁴⁰ Looking at settlement rates further out, only 26.06 percent of these cases were settled four years after filing.¹⁴¹

High-tech companies are sued most often. This focus on particular companies is evident in the more recent data relevant to federal securities class actions. High-tech companies make up the largest percentage of companies being sued in securities class actions. For example, in 1995, high-technology companies were targeted by about 21 percent of all federal securities class actions filings.¹⁴² Between 1996 and 1998, this percentage increased to 36 percent of all federal securities fraud class actions, then dipped slightly to .35 percent in 1999.¹⁴³ No other industry was hit with even half as many of these suits.

With these indicators developed in prior work in mind, we next ask what differences we might expect to find with acquisition-oriented class actions and their litigation agency costs.

3. State Law Acquisition Class Action and Litigation Agency Costs

Shareholder litigation against public companies in the acquisition setting is different in some respects than in the previously discussed derivative and federal securities fraud settings. For one thing, the time periods for state law acquisition-oriented cases may be more compressed than other forms of shareholder litigation because the suits are tied to the completion of an announced transaction. This means that the litigation may need to proceed very rapidly in tandem with the transaction if the shareholders are to obtain timely relief.

Furthermore, the litigation may be a barrier to the completion of the proposed transaction. This gives the acquirer stronger incentives to offer to settle the case by improving the terms of the consideration offered to the shareholders of the target company and thereby to insure that the transaction closes. Plaintiffs' counsel may

138. BAJAJ ET AL., *supra* note 118, at 17 tbl.2.

139. *Id.*

140. *Id.* (study of cases filed 1996-99).

141. *Id.*

142. MARTIN ET AL., *supra* note 118, at 13-14 tbl.10c.

143. FOSTER ET AL., *supra* note 104, at 5 fig.7.

also be able to convince an acquirer to make significant corporate governance changes in order to accelerate completion of the deal.

The potential for high litigation agency costs in these cases may also be different from that experienced in derivative and securities fraud litigation. While plaintiffs' counsel often claim full responsibility for any benefits to the class that arise after the filing of their complaints, it may be the case that events unrelated to the litigation are responsible for improvements in the terms offered in these transactions. For example, if a Special Committee of a target company's board of directors negotiates an increase in the offer price from an acquiring majority shareholder without any assistance from the plaintiffs' class counsel, the court may still award substantial, but unjustified, attorneys' fees to the attorneys that (indirectly) reduce the payments to the shareholders. Delaware, however, has not adopted any special safeguards against litigation agency costs in these class actions other than the typicality and adequacy requirements that exist for all class actions.¹⁴⁴

More directly, in a subset of acquisition class action suits, namely those brought in a hostile takeover setting or where a second bid has been made after the announcement of a friendly deal, there may also be a direct action brought by the frustrated bidder in a hostile takeover attempt or by a second bidder if there is already an existing friendly bid on the table. These suits can exist alongside of representative suits brought on behalf of the class of shareholders.¹⁴⁵ For the bidder suits alone, commentators have not raised concerns about litigation agency cost problems. Instead, the focus has been on the importance of the market for corporate control as a means of controlling managerial agency costs.

These bidder suits are different from other forms of shareholder litigation in that they can succeed even when there is no settlement or favorable court judgment. Instead, success is measured by whether the acquisition closes, not by the litigation outcome. For the representative litigation accompanying these bidder suits, though, the class counsel should not expect to obtain a favorable settlement unless the bidder's lawsuit is successful. Even then, a winning hostile bidder may refuse to offer the class anything more than what the bidder would pay anyway in the offer, and may pay no attorneys' fees to class counsel unless the bidder believes that these attorneys helped to change the outcome of the case. Thus, as we turn to our empirical

144. For a discussion of the typicality and adequacy requirements, see *supra* text accompanying note 72.

145. See, e.g., *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1141-42 (Del. 1990) (including claims made by a shareholder class and Paramount, the frustrated bidder).

analysis, one important question we must keep in mind is to what extent does representative litigation have a contribution to make when there is bidder litigation filed too?

II. SHAREHOLDER LITIGATION IN DELAWARE

The data in this article provide the most complete survey of state shareholder litigation. Our data set is comprised of all complaints filed in the Delaware Court of Chancery in 1999 and 2000. Delaware is the preeminent state of incorporation for public corporations in the United States and for decades has had the best-known corporate courts and corporation code. For generations, its courts have issued decisions in class actions, derivative lawsuits, and direct cases filed by investors against a multitude of public and private corporations seeking to remedy every imaginable violation of corporate law and norms. Corporate cases are heard exclusively by its Court of Chancery, whose Chancellor and four Vice-Chancellors, along with the five Delaware Supreme Court justices that hear appeals from Chancery Court decisions, give the state a bench that is nationally renowned for corporate expertise and has a reputation that is unmatched by any other state or federal court. Its docket is the center of shareholder litigation in this country.¹⁴⁶

A. Overview of the Data: Delaware Court of Chancery Cases 1999 and 2000

We begin with a census of the Delaware Court of Chancery's caseload for 1999 and 2000.¹⁴⁷ A brief glance at Table 1A reveals that

146. Academics split roughly into two camps about the role of Delaware and shareholder litigation in the Delaware Court of Chancery in controlling managerial agency costs. Those that subscribe to the view that Delaware corporate law is the leader in a "race to the bottom" believe that shareholder litigation is an important check on managerial abuses but that the Delaware law and its courts stifle shareholder complaints and facilitate managerial abuses of investors. See, e.g., William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 *YALE L.J.* 663 (1974). By contrast, those claiming that Delaware law is leading a "race to the top" hold out shareholder litigation as a product of entrepreneurial plaintiffs' attorneys whose cases are thrown out of court by Delaware judges, who thereby perform a valuable and needed service. See, e.g., Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. LEGAL STUD.* 251 (1977). The literature that this debate has generated is voluminous. For a summary of much of the early work, see ROMANO, *supra* note 13, . More recently, Professor Roe has suggested that Delaware competes with the federal government, not other states. Mark J. Roe, *Delaware's Competition*, 117 *HARV. L. REV.* 588, 600-34 (2003).

147. There are three branches of the Chancery Court: one in New Castle County, one in Kent County, and one in Sussex County. Each branch has its own clerk's office, the Registrar in Chancery. Our research found that the Chancery Court for New Castle County is where the overwhelming majority of corporate law complaints is filed. With the assistance of the Registrars

75 percent of the civil actions filed in the New Castle County Chancery Court are classified as corporate matters (1280 of 1716),¹⁴⁸ a number that will surprise no one who is familiar with that court. The remaining 25 percent of the civil actions reflect that court's less well-known jurisdiction over other matters of equity such as trusts and estates or complaints seeking injunctive relief in a variety of non-corporate matters for alleged harms.¹⁴⁹

If we look more closely at the corporate docket, we find in Table 1B that almost 80 percent of the complaints filed (1003 of 1280) raised questions of fiduciary duty that are the subject of this article, while the remaining cases address a variety of more discrete corporate issues (we will discuss these cases in more detail in section C below). Fiduciary duty litigation thus comprised approximately 60 percent of the New Castle County Chancery Court's entire caseload.¹⁵⁰

Table 1A: The Data Set—All Delaware Court of Chancery Cases 1999 & 2000

Total Complaints filed	1716
Corporate	1280 (75%)
Non Corporate	436 (25%)

in Chancery's offices in Kent and Sussex counties, we went through their files for all of 1999 and 2000, and examined all cases with corporate defendants. We found no complaints filed in Sussex County branch of the Court of Chancery that fell within the range of our search for fiduciary duty cases. We found three cases in Kent Court, two of which would come under the statutory categories and one that was a pro se petition including a breach of fiduciary duty allegation in a list of many other charges. That case is not included in the data presented here. Rather, we use only the data from the New Castle County Chancery Court for this study, which we believe to be the best indicator of corporate litigation in this country.

148. For this project, we read each of the 1325 complaints that were designated as corporate in the Chancery Court's filing system for New Castle County. We identified 45 that did not directly raise corporate law issues, such as insurance or agency disputes, etc., and these were added to the non-corporate count.

149. The Chancery Court is a court of equity in which all Delaware corporate cases originate. It was formed in 1792, and is the oldest of the Delaware courts. DEL. STATE BAR ASS'N, THE DELAWARE BAR IN THE TWENTIETH CENTURY 395 (Helen L. Winslow ed., 1994). As a court of equity, its judges decide cases without a jury. See generally COURT OF CHANCERY OF THE STATE OF DELAWARE—1792-1992 (1992) for essays about the distinctive characteristics of that court.

Although its subject matter jurisdiction is largely concentrated in the corporate area, the Chancery Court also hears cases involving will contests, estate disputes, and property fights. These cases do not involve shareholder litigation, and so we have not included them in our sample.

150. This figure is calculated by dividing the 1,003 fiduciary cases by a total of 1,716 complaints filed.

Table 1B: Breakdown of Corporate Cases

Total Corporate Cases	1280
Fiduciary Duty	1003 (78%)
Statutory & Other	277 (22%)

B. The Fiduciary Duty Claims

Fiduciary duty cases are the heart of shareholder litigation under corporate law. Fiduciary duty is designed as a legal rule to permit judges to apply core principles after the fact to a broad variety of situations in which managers may have misused the centralized power given them by the statutory structure. The core claims raised in these cases revolve around the familiar principles of the duty of loyalty, the duty of care, good faith, and the business judgment rule. Such claims have arisen over the years in an almost infinite variety of circumstances, ranging from the corporate opportunity doctrine to the duty to create internal corporate controls.

While fiduciary duty claims within their historical context suggest a wide-ranging coverage, Table 2 shows that today the overwhelmingly majority of fiduciary litigation in Delaware is in the form of challenges to director actions taken in the context of the sale of a company. That table shows the following:

Almost all shareholder litigation in Delaware is against public companies (91 percent: 952 of 1048). That conclusion will likely surprise few readers but it shows the strong public corporation focus of Delaware corporate law.

The vast majority of the fiduciary duty claims against public companies are class actions (85 percent: 808 of 952). Thus, for public companies, class actions outnumber derivative suits by a margin of almost 8-1. Derivative suits, the traditional receptacle for fiduciary duty litigation, make up a higher percentage of fiduciary duty suits versus private companies (28 percent, 26 of 93), but for private companies the bulk of fiduciary duty litigation occurs by way of direct suits (51 of 93 or 55 percent). Derivative suits against public corporations occur in less than 30 transactions each year. Derivative suits, in the aggregate, are focused on manager conflict-of-interest transactions, both in an acquisition setting and otherwise. About half of the derivative suits raise questions about improper benefits to managers. Another 18 percent, all in the context of close corporations,

allege oppression of minority investors by a majority. Less than 20 percent raise questions about improper financial records or other matters related to management's care in running the enterprise outside of an acquisition context.¹⁵¹

Almost 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. Thus, the data reveal the extent to which the different suits do different things. Derivative suits are addressed to self-dealing and similar settings and class actions are the remedy of choice for an acquisition claim even if, as shown below, many of them also raise a self-dealing issue.

While there is more to be said on derivative claims, our focus in this paper is on class actions, which are by far the largest segment of the data set.¹⁵² Put a different way, class actions make up almost all of the suits brought against public corporations, and class actions themselves are almost always brought against public corporations. Class actions virtually all arise in an acquisition setting and make up an even higher percentage of cases stemming from acquisitions.

Before going further, we should note that it is not unusual in representative litigation to see multiple complaints filed concerning the same transaction, as law firms jockey for a piece of the action. While we discuss this phenomenon more fully later in the paper,¹⁵³ we provide in the right hand columns of Table 2 the breakdown for just the lead complaints in our data. These data reflect the fact that the Chancery Court will order consolidation of all cases attacking the same transaction, thereby combining any instances where multiple complaints are filed into one action.

The main result of looking at lead complaints is to moderate some of the trends just discussed. Over the two-year period that we studied, there were 348 lead complaints in the Chancery Court, roughly 61 percent (213) of which were acquisition-oriented class actions against public companies. By comparison, if we look at the

151. Of 83 lead cases that are derivative suits, 45 allege benefit to managers and 15 allege oppression to minority shareholders. Ten challenge acquisition transactions, many of which also raise a conflict question as to the directors and one challenges the actions of a manager in a charter amendment. Less than 20 percent (16 of 83) raise questions of improper financial records or duty to supervise and an additional three cases raised questions of misleading statements. Four cases fell into "other." For public companies only, the number of lead cases drop to 56, the number raising claims about benefit to managers is 27 (48 percent), the number raising financial records or misleading statements is 19 (34 percent) and the number raising acquisition claims drops to 8 (14.2 percent).

152. See Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Litigation*, 57 VAND. L. REV. (forthcoming 2004).

153. See *infra* tbl.10 and accompanying discussion.

number of lead complaints filed in federal securities fraud actions, we find that in 1999 a total of 219 such actions were brought, while in 2000 there were 202 federal securities fraud complaints filed.¹⁵⁴

Table 2: Types of Fiduciary Duty Actions¹⁵⁵

All Complaints				Lead Complaints		
Type of Case	Total	Acquisition	Non-Acquisition	Total	Acquisition	Non-Acquisition
FIDUCIARY DUTY CASES	1048	813	235	348	213	135
CLASS ACTIONS	824	772	52	223	196	27
Public Entity	808	765	43	213	194	19
Private Entity	16	7	9	10	2	8
DERIVATIVE	137	14	123	83	9	74
Public Entity	108	12	96	56	7	49
Private Entity	26	2	24	25	2	23
Not Available	3	0	3	2	0	2
DIRECT	87	27	60	74	18	56
Public Entity	36	19	17	25	10	15
Private Entity	51	8	43	49	8	41

C. A Brief Overview of the Remaining Corporate Caseload

Before moving on to discuss more fully the fiduciary duty cases in our sample, we want to briefly describe the remaining corporate cases, which comprise just over one-fifth of our sample. These complaints raise a variety of statutory and contractual claims.¹⁵⁶ Expedited statutory proceedings under sections 211, 220, and 225 of the Delaware Corporate Code are the most important category of these cases, with the most frequent (66 cases) being shareholders

154. Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 930 tbl.1 (2003).

155. The three types of suits total 1048, which is 45 more than the total number of complaints because a few suits have both class and derivative counts (22); or derivative and direct counts in their complaints (15); or class and direct counts (2); or class, derivative, and direct counts in the same complaint (3).

156. We recognize that in the course of resolving some of these disputes, the Chancery Court will undoubtedly need to resolve many issues that involve determinations about fiduciary duties. This is especially true for proceedings under section 225 and section 211. However, these cases are sufficiently different from the suits that we are addressing in this paper that we do not include them in our analysis here.

seeking to inspect books and records under section 220 of the code.¹⁵⁷ The other two expedited proceedings shown are designed to resolve important corporate governance questions, with section 211 claims filed by shareholders seeking to compel an annual meeting (21 cases) and section 225 proceedings instituted to determine contests over who the directors are within the corporation (39 cases).¹⁵⁸

There are three other types of statutory cases worth mentioning briefly. Appraisal proceedings make up a very small portion of the Chancery Court docket (about 1 percent or 22 cases out of the two year total of 1716 cases filed), which is consistent with earlier research finding that appraisal is a little-used remedy in Delaware.¹⁵⁹ Indemnification litigation under section 145 of the Delaware Corporate Code constitutes an even smaller percentage of the cases in the sample, only 12 cases total. Finally, actions involving the various code provisions relating to winding up the corporation's business (including dissolution, appointment of a receiver, and appointment of a custodian) occupy a larger piece of the statutory caseload, with 45 cases (or about 2.5 percent of the total docket of the court). The other two categories of cases shown on Table 3 are contract cases (33 cases)¹⁶⁰ and claims to determine stock ownership (26).¹⁶¹

The cases shown in Table 3 typically are not representative cases, but rather direct suits brought by an individual shareholder. Some of these kinds of statutory cases have been written about elsewhere.¹⁶² In this paper, we focus our attention on fiduciary duty suits and the problems of representative litigation.

157. See DEL. CODE ANN. tit. 8, § 220 (2001). This category includes parallel claims to access brought under the Limited Partnership statutes.

158. This category includes parallel cases about determining managers in LLCs.

159. Randall S. Thomas, *Revising the Delaware Appraisal Statute*, 3 DEL. L. REV. 1, 22 (2000) (finding that from 1977 to 1997 a total of 266 appraisal cases were filed in the Delaware Chancery Court, or an average of fewer than 14 cases per year).

160. These cases represent a small but potentially very important aspect of the Chancery Court's caseload. In recent years, the Court has permitted parties to a contract that has otherwise no connection to Delaware to select the Chancery Court as the forum to decide all disputes arising under the terms of their agreement. These choice of forum clauses are popular because the Chancery Court provides fast, expert decisions in resolving these matters.

161. The contractual claims, for example, grow out of shareholders' agreements. Thus, the contract category and the stock ownership category overlap somewhat and include pre-emptive rights cases and valuation of shares where there is a contract to purchase.

162. See, e.g., Thomas, *supra* note 159 (appraisal); Randall S. Thomas, *Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information*, 38 ARIZ. L. REV. 331 (1996) (books & records); Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1 (1995) (appraisal).

Table 3: Non-Fiduciary Claims in Delaware

Type of Suit	Number
Books & Records (§ 220)	66
Dissolution, Receiver & Custodian (§ 279 et seq.)	45
Determining Directors (§ 225)	39
Contract	33
Stock Ownership	26
Appraisal (§ 262)	22
Compelling Shareholder Meeting (§ 211)	21
Indemnification (§ 145)	12
Other	16
Total Non-Fiduciary	279

D. Who Gets Sued in Fiduciary Duty Litigation?

As we saw above, fiduciary duty lawsuits largely target public companies. If we break out the types of defendants in these cases, though, some interesting patterns emerge. Table 4 shows the breakdown of these statistics both for the number of complaints filed and, in the right columns, the number of lead cases filed. First, we can see that most shareholder litigation targets the largest companies. Of the cases in our data set, over 56 percent of the complaints filed, and over 35 percent of the complaints in lead cases, name New York Stock Exchange (NYSE) companies as defendants. NASDAQ companies are named in about 25 percent of the cases, or about 28 percent of the lead cases.¹⁶³ Together, NYSE and NASDAQ companies make up over 81 percent of the companies named as defendants in our complaints, and roughly 64 percent of the defendants named in lead cases.

163. The differences in the percentages of NYSE and NASDAQ companies in our sample could potentially reflect a different percentage of NYSE companies than NASDAQ companies being incorporated in Delaware, or it could reflect differences in the level of acquisitions that the two groups engage in.

Table 4: Type of Entity Sued¹⁶⁴

All Complaints					Lead Complaints			
Type of Entity	Total	Class Action	Derivative	Direct	Total	Class Action	Derivative	Direct
NYSE	567	513	52	13	124	98	26	6
NASDAQ	249	218	32	10	99	81	16	8
Small Public ¹⁶⁵	107	77	24	13	55	34	14	13
Non-Public	77	16	26	51	68	10	25	50
Unspecified	3	0	3	0	3	0	3	0
Total	1003	824	137	87	348	213	83	77

Once we disaggregate these figures and look separately at class actions, derivative suits, and direct suits, we see some important differences in who gets sued in these actions. The class actions target the largest companies in our sample. This is not surprising given who is involved in acquisitions.

While the class actions are almost always brought against publicly held companies, derivative suits are more evenly distributed, with about 70 percent against publicly held corporations and 30 percent naming closely held companies.¹⁶⁶ If we look at direct suits, about 65 percent of these complaints list private entities as defendants. There are many reasons to think that suits by minority investors in private companies are different from those filed by small investors in public companies.¹⁶⁷

If we focus solely on the public company cases for a moment, we find that derivative lawsuits are generally filed against larger public companies. The median market cap for public companies that are subject to derivative suits is \$1.138 billion, with the 25th percentile at \$219.5 million and the 75th percentile at \$6.15 billion.¹⁶⁸ This cap is substantially larger than for class actions, where the

164. Some complaints included class, derivative, and direct counts and have been counted in each category so the sum in the three categories exceeds the total number of cases. See *supra* note 155.

165. This category includes companies listed on the Amex, the NASDAQ small cap, or over-the-counter listings, and a few corporations that we identified as public, but for which we could not ascertain where the shares were traded.

166. See *supra* tbl.2.

167. Thomas & Martin, *supra* note 69, at 600-02 (listing examples of differences between closely held and publicly owned corporations).

168. This is influenced upward by the derivative suits for improper financial records, failure to supervise, and misleading statements, which are usually filed against very large companies.

median sized defendant has a market capitalization of \$389 million, a 25th percentile at \$118 million and a 75th percentile at \$1.39 billion.

Derivative cases are brought more often against NYSE companies than NASDAQ companies. Derivative cases differ from the class action cases in that the derivative cases contain a substantial subset that are brought against closely held companies, illustrating that derivative litigation has a distinctive role in privately held companies.

There are some other interesting distinguishing characteristics of derivative litigation. The companies that are sued in derivative suits are less likely to be headquartered in California than the companies in class action suits, with the Golden State companies making up only 10 percent of the derivative cases (vs. 16 percent of the class actions).¹⁶⁹ Internet and computer companies make up about 19 percent of the derivative sample, in the same range as with class actions but lower than what has been observed for securities fraud cases.¹⁷⁰ There is, however, little reason to expect the same pattern among the defendants in our cases as in the federal cases, since our class actions are challenging the terms of acquisitions, while the federal class actions are alleging securities fraud, frequently in the IPO context.

E. Acquisition Cases: Friendly, Hostile, Arm's Length and Control Shareholder Transactions.

Our sample contains a wide variety of complaints challenging director action in a sale of corporate control. These cases typically allege that directors have failed to get enough money in a friendly merger or other fundamental corporate transaction that management has proposed, or have failed to respond adequately to a proposed hostile bid. Focusing first on the data for all complaints filed, Table 5 shows that the most common acquisition cases (about 31 percent of the acquisition complaints) involve claims that a controlling shareholder violated its fiduciary duties to minority shareholders when the controlling shareholder initiated a merger or other

169. The number of derivative suits filed against companies headquartered in particular states is as follows: New York – 9; California and Massachusetts – 8; Delaware – 7; Illinois – 5; nine states with 2; and another nine states with 1. There were 83 companies in this set. The headquarters of the remaining defendants were unknown.

170. Grundfest and Perino estimate that 34 percent of securities fraud complaints post-PLRA name high-technology companies as defendants. Grundfest & Perino, *supra* note 89, at tbl. 8. In our sample of derivative suits, the numbers are: internet & computers—15; banking & finance—11; health care—8; retail—7; real estate & manufacturing—6 each; entertainment & telecom—3 each; and various others with 1 or 2 for a total of 83.

fundamental corporate change, such as a tender offer or various two-step transitions. These cases raise obvious conflict-of-interest issues. In these cases, the allegations are that a greater than 50 percent shareholder is using majority power to cash out the minority at an unfair price, or through unfair dealings.

Two other types of friendly deals, management buyout proposals (MBOs) and sales to a friendly third party, each generate about 23 percent of the complaints shown on Table 5. The MBO cases raise conflict-of-interest claims because of the potential for the target company's board of directors to give its managers special preferences in a sale of control. The third-party transactions raise less obvious conflict-of-interest concerns, such as the possibility that managers received better treatment than other shareholders by receiving side payments from the bidder.

Hostile transactions, or multiple bidder situations, generate much less litigation. Only 80 complaints, or about 10 percent of the acquisitions cases, arise out of a hostile offer.¹⁷¹ Second bidder cases, which involve situations where a second bidder emerged after management announced a friendly deal to be acquired, account for another 13 percent of the cases. The relative scarcity of these cases may reflect a variety of factors, including the reduced likelihood of a sweetheart deal at a low price in a hostile or competitive bidding situation.

There are relatively few derivative and direct complaints filed in the acquisition context. Ten of the 27 direct acquisition lead actions are complaints filed by bidders either in hostile transactions or in second bidder situations. Of the remaining direct acquisition complaints, the largest number challenge director action in control shareholder transactions.

Narrowing the focus to lead complaints shifts the pattern of distribution slightly. Third-party transactions now outnumber control shareholder acquisitions among lead cases. Hostile bidder lead cases now outnumber second bidder filings, reflecting the extraordinarily large number of multiple complaints that are filed in second bidder situations (averaging almost 10 complaints for each transaction!).¹⁷²

171. There are 23 lead cases involving hostile acquisitions, which also represents about 10 percent of the total number of lead cases.

172. While a large number of complaints filed in second bidder cases might be hypothesized to reflect either a strong legal claim or a high expected return to the plaintiffs' attorneys, in fact, we find neither to be the case. For further discussion of this point, see *infra* Part III.B.3.

Table 5: Contexts for Acquisition Cases¹⁷³

All Complaints					Lead Complaints			
Type of Transaction	Total	Class Action	Derivative	Direct	Total	Class Action	Derivative	Direct
Control Shareholder Acquisition	248	238	2	10	65	56	2	9
MBO type transaction	177	177	0	1	42	42	0	1
Third-Party Acquisition	187	182	4	5	72	67	3	5
Second Bidder Deals	107	101	1	5	11	10	0	1
Hostile Transactions	80	74	7	6	23	21	4	2
Total Acquisition	799	772	14	27	223	196	9	18

F. Frequency of Relief

How frequently does shareholder litigation result in benefits to shareholders? In Table 6, we provide data on the disposition of the lead cases in our sample. There are 348 lead cases involving breach of fiduciary duty claims that were litigated in the Chancery Court in 1999 and 2000, with about two-thirds of them being acquisition cases and the remainder non-acquisition cases.

There are statistically significant differences in the dispositions of acquisition cases (largely class actions) and non-acquisition cases (mostly derivative actions). For example, class actions are resolved much more quickly, on average, than derivative suits. While about 20 percent of the sample cases were still pending at the time this table was prepared, if we compare the two groups of cases, we see almost two-thirds of these pending cases are non-acquisition cases. In other words, the non-acquisition cases that make up just 38 percent of all lead cases account for 64 percent of the cases remaining open. These differences are statistically significant (with a P-value of less than .01)

Similarly large significant differences exist between the frequency with which acquisition and non-acquisition lead cases are

173. The total number is less than the sum of the three types of complaints because some complaints included class, derivative, and/or direct counts in their complaints.

dismissed without prejudice and with no relief: acquisition cases are dismissed without prejudice over 53 percent of the time, while non-acquisition cases fall in this category in roughly 22 percent of the lead cases. This difference is statistically significant (with a P-value of less than .01). In the same vein, if we look at the frequency of dismissal with prejudice and no relief, we see the opposite pattern: non-acquisition cases are much more likely to be dismissed with prejudice (about 27 percent of the lead cases) than acquisition cases, which show up in this group only about 5 percent of the time. Again, these differences are statistically significant (with a P-value of less than .01). Finally, acquisition lead cases are statistically significantly more likely to result in settlements with relief than non-acquisition cases (with a P-value of less than .05).

The explanation for these very different patterns may be found in the differences in the intensity of actual litigation in the two types of cases. One unusual aspect of the acquisition-oriented class action lawsuits is the lack of much actual litigation activity in them. Most of these suits are filed and then sit without activity until they are either settled or dismissed.¹⁷⁴ One measure of this inactivity is the infrequency with which substantive motions, such as a motion to dismiss for failure to make demand, a motion to dismiss for failure to state a claim, or a motion for summary judgment, are filed.

There are more substantive motions filed in derivative actions than in class action litigation. Thus we see that in 53 of 83 (63.8 percent) of the lead derivative cases we find substantive motions being filed, whereas such motions are made in class actions in only 96 of 223 lead cases (43.0 percent). Overall, derivative litigation looks more like real litigation than the class actions.¹⁷⁵

This suggests that the difference in the dismissal patterns for the two types of suits may be the result of very different underlying litigation strategies by plaintiffs' counsel. Since dismissals without prejudice are normally voluntary, it could be that class actions are much more likely to be dropped by plaintiffs' counsel if they fail to produce prompt relief. Derivative cases are more likely to be hard

174. This is consistent with civil litigation generally. See Charles Silver, *Does Civil Justice Cost Too Much?*, 80 TEX. L. REV. 2073, 2095 (2002) (reporting studies finding no discovery in 38 percent, 42 percent, or half of cases of various studies.).

175. These differences should not be hastily interpreted as evidence that class actions are frivolous though. If the point of filing a complaint is to raise the price that is paid in the transaction, and filing a strong claim is sufficient to engage the bidder in negotiations to accomplish that objective successfully, then there would be little point in filing a lot of motions for the parties to brief.

fought, and, therefore, an unfavorable outcome will lead to an involuntary dismissal.

Table 6: Disposition Status of Lead Cases

	All Lead Cases	Acquisition Lead Cases	Non-Acquisition Lead Cases
Total Number of Lead Cases	348 (100%)	213 (100%)	135 (100%)
Still Pending	68 (19.54%)	24 (11.26%)	44 (32.59%)
Dismissed Without Prejudice and With No Relief	143 (41.09%)	113 (53.05%)	30 (22.22%)
Dismissed With Prejudice and With No Relief	49 (14.08%)	13 (6.10%)	36 (26.67%)
Settlement With Relief	85 (24.42%)	60 (28.17%)	25 (18.51%)
Dismissal (No Information)	3 (0.86%)	3 (1.4%)	0 (0%)

In Table 7, we look at the frequency with which settlements (or other relief) occur in these lead cases. Once again, there appear to be differences in how acquisition cases and non-acquisition cases are settled. Here, we must use caution in interpreting these values due to the relatively large number of cases that have yet to be resolved. To be precise, we have 85 cases that have settled with some relief, but 67 cases that are still pending after at least twenty months. Since we believe it is likely that a number of these longer lasting cases will settle, the values reported in Table 7 are likely to shift.

Looking at the preliminary figures, though, some interesting results appear. First, if we look at the total number of settlements, we see that fiduciary duty cases have produced some form of relief in 85 lead cases, or about 24 percent of the total number of fiduciary duty lead cases filed. There are sizeable differences between the percentages of settlements in acquisition and non-acquisition lead cases: about 28 percent of the acquisition cases are settled with relief, while only roughly 18 percent of the non-acquisition cases resulted in relief for the plaintiff shareholders. As noted above, this difference is statistically significant (with a P-value of less than .05). The difference is likely to shrink as only about 10 percent of the acquisition cases

remain open while more than 30 percent of the non-acquisition cases are still pending.

In Romano's 1991 study of shareholder litigation filed between the late 1960s and 1987 (including both state and federal actions), she found that 83 out of 128 resolved suits settled, with another 11 suits pending.¹⁷⁶ If we assume that none of the other 11 suits resulted in relief, then the *lowest* settlement rate possible in her data is about 59.7 percent. By comparison, if all 67 pending cases in our sample settled with relief for shareholders, the *highest* possible settlement rate for our database would be 43.7 percent. So there is *at least* an 16 percentage point decline in settlement rates between the two samples, and probably higher. This seems to indicate a decline in the likelihood of settlement of shareholder litigation from the earlier time period (1967 to 1987) of Romano's data to the 1999-2000 time period in our database.

What explains this apparent change? While there are many potential explanations, one possibility is that more acquisition-oriented representative class actions are filed today than were filed during Romano's sample period. We speculate that there may have been more merger and acquisition transactions in recent years, and that information concerning them may be more widely available. Also, for at least some portion of the earlier years in Romano's sample, hostile acquisitions were rarely attempted. If more cases are filed, but only the same number of good cases exist, then the average settlement rate could fall.

A second possible explanation may be a shift in litigation patterns from state court to federal court. The Delaware courts are limited by federal law to accepting class actions in the acquisition context and a few other well-defined areas.¹⁷⁷ This change in the law may have resulted in many higher value cases moving out of state court into federal court, thereby reducing the likelihood of settlement in state court on average.

The underlying settlement patterns become clearer if we break out cases according to whether the defendant is a public or private entity: cases with public company defendants are much more likely to result in settlements than those against private entities. If we look at all lead cases, public company cases settle about 28.1 percent of the time (78 out of 278), while private entity cases are settled in about 10.3 percent of the cases (7 out of 68). These differences are statistically significant (with a P-value of less than .01). All of these

176. Romano, *supra* note 1, at 60.

177. See *supra* note 10.

results must be viewed with caution, though, as a large number of cases are still pending.

Table 7: Settlements or Other Relief in Lead Cases

Settlement with Relief in Lead Cases	All Lead Cases or Settlements	Acquisition Cases	Non-Acquisition Cases
Total Number of Lead Cases	348	213	135
Total Number of Settlements	85	60	25
Settlements: Publicly-held defendant	78	58	20
Settlements: Privately-held defendant	7	2	5

Why would public company cases settle more frequently? Again, there are a variety of possible explanations for this pattern. Public firms may be more likely to have directors' and officers' insurance coverage to pay for a settlement, or private entity litigation may be more intensely personal and therefore affected by spite and personal animosity.¹⁷⁸ There may also be institutional features of the public company class action lawsuits, like the frequency with which they are filed by the same set of law firms, which make them different from the other cases in our database. We will return to this issue in Part III below.

When we look more closely at the settlements entered into, we see substantial variations in the cases that have been resolved.¹⁷⁹ Table 8 reports these data. First, the most common form of relief is a cash award, which occurs in about half of these situations. These settlements most commonly involve the payment of additional consideration in an acquisition transaction. We discuss the features of these settlements in more detail in Part III.B.

If we look at the size of these settlements, we find that the median settlement in the 42 cases with monetary settlements is \$15.0

178. See Thomas & Martin, *supra* note 69, at 586-87 (finding that in shareholder challenges to executive pay practices, plaintiffs are more successful in private company litigation than public company litigation).

179. As noted above, 67 cases are still pending.

million. Acquisition cases have a higher median settlement (\$15.4 million) than non-acquisition cases, in which the median is \$11 million.

If we compare the size of these settlements with those obtained in recent federal securities fraud cases, we see that the median settlement in a federal securities fraud case during the period from 1996 to 2000 was \$5 million.¹⁸⁰ In 2001, this value rose to \$5.4 million. Clearly, the Delaware cases settle for more than the federal cases, probably because the relief is usually additional consideration for public shareholders in a current acquisition.¹⁸¹

Substantive relief other than cash is the second most common form of relief. These non-monetary settlements include rescission of contracts, corporate governance changes, and other relief. They make up a greater share of the relief in the non-acquisition cases than in the acquisition actions.¹⁸² Additional disclosure is the only relief provided in seven cases,¹⁸³ while no identified relief other than attorneys' fees is found in eight cases. The attorneys'-fees-only category mostly reflects situations where the case was dismissed as moot after the bidder raised the offer price (and in the absence of a binding contract to settle the then-pending shareholder litigation).¹⁸⁴ In that situation, courts have refused to approve a settlement but have permitted the acquirer, as a matter of business judgment, to pay money to resolve a threatened or pending fee petition.¹⁸⁵

180. PRICEWATERHOUSECOOPERS, LLP, 2002 SECURITIES LITIGATION STUDY 2-3 (2002), <http://www.pwcglobal.com/us/eng/about/svcs/fas/2002%20securities%20litigation%20study.pdf>.

For the period from 1996-2000, securities fraud cases alleging accounting fraud have substantially larger median settlements in them (\$7.15 million) than non-accounting cases (\$3.5 million). *Id.* at 3.

181. *See infra* Part III.A.2 (noting that fewer of the Delaware cases settle than the federal securities fraud cases).

182. Twenty-eight of the total 85 cases granted substantive relief other than additional consideration. Of those 28 cases, 16 were acquisition and 12 were non-acquisition. Of the 85 total cases, 60 were acquisition cases and 25 were non-acquisition cases. Therefore, these non-monetary settlements were the type of relief obtained in 16 of 60 (21 percent) of the acquisition cases, and 12 of 25 (48 percent) of the non-acquisition cases.

183. Cases where additional disclosure was ordered along with other substantive relief are recorded in the previous category.

184. We note that in these cases the company did what the plaintiffs had asked them to do, and it could be the case that it did so at least in part because of the lawsuit. Thus, the suit probably advanced meritorious claims and may well have yielded benefits.

185. *In re* Advanced Mammography Sys., Inc. S'holder Litig., No. CIV.A.14831, 1996 WL 633409, at *1 (Del. Ch. Oct. 30, 1996); *see also* United Vanguard Fund, Inc. v. Takecare, Inc., 693 A.2d 1076 (Del. 1997) (recognizing the propriety of a fee award to plaintiff counsel in action rendered moot by acts of the defendant that benefit the class and are causally related to the litigation). For an example of such a case in this data set, see *In re* Cellular Communications Int'l, Inc. S'holders Litig., 752 A.2d 1185 (Del. Ch. 2000).

Table 8: Type of Relief Obtained in Settlements

Type of Relief	Number of Settlements	Acquisition	Non-Acquisition
Additional Consideration (Median \$)	42 (\$15.0 million)	31 (\$15.4 million)	11 (\$11 million)
Substantive Relief Other than Additional Consideration	28	16	12
Additional Disclosure, but No \$	7	6	1
Attorneys' Fees Only	8	7	1
Total	85	60	25

With our overview of the data fresh in mind, we turn next to our reexamination of the balance between managerial agency costs and litigation agency costs in shareholder class actions involving acquisitions.

III. ACQUISITION-ORIENTED CLASS ACTIONS: ARE THEIR MANAGERIAL AGENCY COST REDUCTION BENEFITS GREATER THAN THEIR LITIGATION AGENCY COSTS?

One of the most surprising findings of this study is the tremendous number of acquisition-oriented class action lawsuits filed in the Delaware state courts. While securities fraud class actions have been closely scrutinized over the past decade, prior received wisdom was that state courts were primarily concerned with the frequently studied derivative suit.¹⁸⁶ While the proper balance between litigation agency costs and management agency costs has been studied for these familiar representative lawsuits, almost nothing has been said about the acquisition-based class actions in our sample. In this section, we seek to apply the received learning of representative suits to our sample to see what differences, if any, exist for these cases. We begin with a discussion of the indicia of litigation

186. See *supra* Part I.B.2 for further discussion of prior empirical work.

agency costs that reappear in our sample and then discuss parts of the traditional story that do not fit with this data set.

A. Litigation Agency Costs: The Same Old Story?

1. Litigation Agency Costs Indicators

When we look closely at the acquisition-oriented class action cases in our sample, we find that they exhibit several frequently criticized characteristics of securities fraud litigation prior to the passage of PSLRA in 1995. While there is far from universal agreement about the measures of litigation agency costs in class actions, these characteristics are perhaps the most commonly discussed perceived “abusive” features of representative litigation.¹⁸⁷ Without purporting to resolve this debate here, we report our findings below.

Beginning with Table 9, we see that Delaware class action suits challenging acquisitions are filed quickly. Almost 70 percent of the complaints are filed within three days of the announcement of the acquisition transactions. Similar speed in the filing of securities fraud cases, for example, raised concern during debate over securities fraud class actions prior to the passage of the PSLRA in 1995.¹⁸⁸

Filing times for derivative actions are also displayed in Table 9. As compared with class actions, we see that derivative suits are not filed nearly as quickly. Only 11 percent of the complaints in derivative suits are filed within three days of the date of the transaction challenged, whereas about two-thirds of class actions are filed within that time frame. Clearly, derivative lawsuit attorneys are not in a race to the courthouse.

187. Compare Macey & Miller, *supra* note 3, with Lerach, *supra* note 11.

188. Avery, *supra* note 73, at 375.

Table 9: Filing Times for Complaints

Type of Suits	0-3 Days	4-6 Days	6-10 Days	10-30 Days	31+ Days	N/A
Number of Acquisition-Oriented Class Action Suits Filed	508	92	46	57	57	63
Number of Derivative Suits Filed	9	6	6	20	37	59

For each transaction challenged in the acquisition context, many of the complaints filed are virtually identical, except for the names of the attorneys listed as counsel and the named plaintiff. For example, when multiple complaints are filed about the same acquisition, subsequent complaints often track word for word those that were filed first. This is by no means universal, and some transactions with multiple complaints will have two or more complaint patterns. Some will follow the first complaint filed, while others use a second model, even if they are all eventually filed by the same Delaware law firm.¹⁸⁹

Our sample does not, however, provide anything like the startling example cited in the debate over the PSLRA, where a complaint against a tobacco company mistakenly referred to the defendant as a toy company which had been sued in an earlier case and from which the current complaint apparently had been copied.¹⁹⁰ But we did find repeated use of identical language in complaints filed in different cases, suggesting a liberal use of prior complaints in formulating new ones in different matters.

Next, we examine another "indicator" of litigation agency costs, the filing of multiple lawsuits attacking the same transaction. As Table 10 shows, class action plaintiffs' lawyers commonly file multiple

189. Out-of-state law firms are required to use local Delaware counsel to assist them in filing litigation there. DEL. CH. CT. R. 3. Rosenthal Monhait appears to be serving this function in a large number of cases, as it is the attorney of record in more than 73 percent of the class action complaints. The lead firms in these cases are then listed as "of counsel."

Chimicles & Tikellis, LLP, is the only other law firm with a significant number of suits in which it is local counsel, with about 100 of the 1,000 cases.

190. See Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAW. 1009, 1011-12 (1996).

suits challenging the same transaction, a fact consistent with the pattern seen in other representative litigation.¹⁹¹ The 1003 fiduciary cases arise out of only 348 disputes, but the multiplier effect is much more dramatic in the acquisition cases. An acquisition that spawns a lawsuit will generally spawn multiple lawsuits, often in double figures for one transaction (litigation involving Warner, American Home, and Pfizer, for example, produced 41 suits). By contrast, when derivative suits are filed, a substantial percentage generate only one suit per transaction, and a much smaller fraction lead to large numbers of complaints.

Table 10: Number of Suits Filed Per Transaction/Controversy¹⁹²

Type of Litigation	1 Suit Filed	2-4 Suits Filed	5-10 Suits Filed	10+ Suits Filed
Class Actions	80	242	353	169
Derivative Suits	65	52	20	0

Multiple lawsuit filings also occur in federal securities fraud actions. Comparable data for 1992 shows that there were 223 securities fraud suits filed against 113 companies during that time period.¹⁹³ If we look at the breakdown of how many federal securities fraud suits were filed against each company, we find that one company was named in 21 complaints, a second company in 19 complaints, two companies in 12 complaints, and so on, concluding with 75 companies being named in only one suit.¹⁹⁴ This pattern is quite similar to the pattern shown in Table 10.

If we dig a bit deeper into our data, we find that there is a pattern to the filing of multiple lawsuits in the class action acquisition setting. The number of lawsuits filed attacking a single transaction is correlated with two features of each deal: first, the size of the company and second, whether a bidder has filed a suit along with a

191. See Romano, *supra* note 1, at 59 n.4.

192. This chart is for all complaints. If a lead case cohort included both derivative and class action suits, the number of class and derivative was included in each respective group.

193. *Private Litigation Under the Federal Securities Law: Hearings Before the Subcomm. on Sec. of the Senate Comm. on Banking, Housing, & Urban Affairs*, 103d Cong. 777 (1993) (statement of James Newman, Publisher & Editor, *Securities Class Action Alert*). Exhibit B to this statement contains a breakdown of how many suits were filed against each company. *Id.* at 780 exh.B.

194. *Id.*

representative shareholder. These data are presented in Table 11. There are only 10 cases in the data set where the bidder has filed suit (these occur in the hostile bid and second bidder categories). Seven of these 10, however, are in suits against the 33 companies against which six or more suits have been filed, and all ten are against larger companies.¹⁹⁵

Table 11: Size of Companies Subject to Multiple Suits

Number of Suits Filed	Median Size of Defendant Market Capitalization	NYSE Defendant	NASDAQ Defendant	# of Cases Where Bidder Suit
>10	2.2 Billion	9	2	2
6-10	1.06 Billion	27	6	5
3-5	400 Million	31	29	1

Another potential “indicator” of litigation agency costs concerns the identity of the law firms filing these cases. We find that class action acquisition suits are brought by an identified plaintiff’s bar, as shown in Table 12. Sixteen firms brought at least 20 suits during the period.¹⁹⁶ These 16 firms, located mostly in New York City (although many also have other offices), collectively are involved in more than 65 percent of the suits in the entire database, and about 75 percent of the class action cases.¹⁹⁷

Many of these firms are the same ones that frequently appear in securities fraud class actions. For example, Milberg Weiss Bershad Hynes & Lerach, LLP (“Milberg Weiss”), the dominant firm in securities fraud cases,¹⁹⁸ appears in the top ten list of firms in our data

195. In two of the cases, the bidder’s suit was the only complaint.

196. These firms were listed as “of counsel” on the complaints filed in Delaware, which is the term used to designate an out of state firm that uses local counsel to file its suit in Delaware. See *supra* note 189.

197. The earliest study of shareholder litigation, conducted using data from the 1930s, found that a small number of law firms and lawyers filed most shareholder litigation. WOOD, *supra* note 1, at 57.

198. There are various ways to measure Milberg Weiss’s market share in that area. For example, if one looks at the number of settled federal securities class actions from 1996 through 2001, they have appeared in 51.5 percent of these cases. SIMMONS, *supra* note 135, at 10.

set, although with a much smaller market share than it has in the context of securities fraud.

If we compare the “portfolios” of the top plaintiffs’ law firms with the profile of the remaining shareholder suits, we see some marked differences. These repeat law firms are a much more common presence in class actions (76 percent of all class actions) than in derivative suits (they are in 32 percent of all derivative suits) or direct suits (only in 3 percent of direct suits). These firms are more likely than other firms to have filed a complaint in an action where there are multiple suits per transactions.¹⁹⁹ Their suits settle more quickly on average than suits filed by other attorneys (only 10 percent still open vs. 30 percent for others). These law firms are over-represented in hostile transactions, second bidder transactions, and MBO transactions (more than 85 percent of the total cases for each).²⁰⁰ They are also present in a higher percentage of suits where there is a settlement giving additional consideration to the plaintiff and an attorneys’ fee award, which we discuss below.

Table 12: Law Firms Bringing Largest Number of Delaware Complaints

Plaintiff Firm	Number of Appearances
Goodkind Labaton Rudoff & Sucharow, LLP	86
Schiffirin & Barroway, LLP	82
Wechsler, Harwood, Halebian & Feffer, LLP	69
Abbey, Gardy & Squitieri, LLP	67
Bernstein, Liebhard & Lifshitz, LLP	67
Stull, Stull & Brody	56
Weiss & Yourman	51
Cauley, Geller, Bowman & Coates, LLC	50
Milberg, Weiss, Bershad, Hynes & Lerach, LLP	46
Faruqi & Faruqi, LLP	43
Wolf Popper LLP	41
Wolf, Haldenstein, Adler, Freeman & Herz, LLP	40
Bull & Lifshitz, LLP	27

199. Of the lead cases that relate to transactions that have three or more suits filed, the top 16 law firms are involved in 91.74 percent of the suits. When considering all suits that are part of a cohort of three or more suits per transactions, the top 16 firms are associated with 72 percent of those suits.

200. The percentage of suits is 87.5 percent for hostile transactions, 90.1 percent for second bidder transactions, and 85.7 percent for MBOs.

Shepherd & Geller, LLC	27
Lowey, Dannenberg, Bemporad & Selinger, PC	26
Kirby, McInerney, & Squire, LLP	21
Chimicles & Tikellis, LLP	16
Law Offices of Charles J. Piven, PA	13
Susman & Watkins	12
Beatie & Osborn	11
Berger & Montague, PC	11
Law Offices of Jeffrey S. Abraham	11
Fruchter & Twersky	10
Garwin, Bronzaft, Gerstein & Fisher, LLP	10
Law Offices of Curtis V. Trinko, LLP	10
Law Offices of James V. Bashian, PC	10

Another aspect of class action litigation that stimulated much criticism prior to the passage of PSLRA was the use of so-called “professional plaintiffs,” that is, named plaintiffs that appeared in many suits filed often by the same firm. As discussed *supra* Part II, in a class action the potential return to a single plaintiff will often be so small as to provide little in the way of incentive to file a complaint. Thus, plaintiff law firms have the greater incentive to bring these cases and to find plaintiffs to name as the class representative, allegedly leading to the use of professional plaintiffs. This makes the characteristics of the named plaintiffs in class actions another potential indicator of litigation agency costs.

In our data, we find a wide dispersion of plaintiffs. They are almost always individuals. Unlike plaintiffs in securities fraud cases since the passage of PSLRA and its lead plaintiff provision that favored the use of institutional investors, only a handful of institutional investors file fiduciary litigation in Delaware courts. Table 13 lists those plaintiffs named in five or more complaints. These 14 plaintiffs filed 111 class action lawsuits in 1999 and 2000 in Delaware alone. If we applied the current standards set forth in PSLRA to this group of plaintiffs, that is, that no single plaintiff can appear in more than five securities fraud class actions during any three year period,²⁰¹ then nine of these plaintiffs would have exceeded this limit in two years.

If we expand our examination to consider all plaintiffs that would have been likely to reach the five-complaint threshold in five years, we find that there are 34 plaintiffs listed as plaintiffs in three

201. 15 U.S.C. §78u-4(a)(3)(B)(vi) (2000). The statute does provide for an exception with leave of the court.

or more suits during the two-year period, collectively filing a total of 176 class actions.

As for derivative suit plaintiffs, the only ones with more than two filings are two partnerships that we also see at the top of the list in the class action area: Harbor Finance with five suits and Crandon Capital with four cases. We note that the derivative cases these entities filed were never the only suit filed and were often associated with class actions or federal securities litigation against the same company.

Table 13: Most Frequently Named Plaintiffs in Delaware Complaints

Plaintiff Name	Number of Causes of Action
Crandon Capital Partners	17
Harbor Finance Partners	17
Steiner, William	11
Brickell Partners	10
Steiner, Kenneth	7
Kahan, Isaac	6
Green, Paul	6
Great Neck Capital Appreciation Investment Partnership	6
Rand, Harriet	6
Hack, Ernest	5
Ellis Investments	5
Miller, Charles	5
Brody, Adele	5
Susser, Leslie	5

Turning back to examine more closely those named plaintiffs that would have definitely exceeded the PSLRA professional plaintiff threshold, we note that three of the top four plaintiffs listed in Table 13 are claimed to be partnerships: Crandon Capital Partners, Harbor Finance Partners, and Brickell Partners. While we cannot be sure based on the data that we have, these entities appear to be related. We say this for two reasons. First, the press has reported that Crandon Capital Partners is the managing general partner of Harbor Finance Partners.²⁰² Second, in 34 of the 44 cases filed by these three

202. Cameron McWhirter, *Two More Shareholders File Suits Against Chiquita*, CINCINNATI ENQUIRER, May 28, 1998, <http://www.geocities.com/capitolhill/lobby/6305/chiquita/052898-1-33.html>.

plaintiffs, the same law firm is listed as one of the firms representing the plaintiff.²⁰³ We see this same pattern for most recurring plaintiffs with each plaintiff having a continuing relationship with a particular law firm.²⁰⁴ While this data is hardly conclusive, it does suggest that the three entities may well be related.

To summarize the discussion to this point, there are several attributes of the class action acquisition-oriented cases filed in Delaware that mirror features of securities fraud class actions prior to the passage of PSLRA. These features have been identified by some commentators as indicative of high levels of litigation agency costs. They were certainly a focus of Congress' efforts to change the rules for filing federal securities fraud claims.

2. Are There Indicators That Litigation Agency Costs May Be Lower in Delaware Class Actions Than in Federal Securities Fraud Cases?

The class actions challenging acquisitions that are found in our data set differ in important ways from federal securities fraud class actions. Some of these differences could indicate lower litigation agency costs for the Delaware cases. We begin with the settlement and dismissal patterns for these suits.

Table 14: Settlement and Dismissal Rates for Acquisition-Oriented Class Action Lead Cases

Number of Suits	0-180 Days	181-365 Days	1-2 Years	2+ Years
Number of Suits Settled	10	22	30	5
Number of Suits Dismissed	31	34	64	2

Most of these cases settle or are dismissed quickly. As of August 2002, almost 88 percent of the class actions (196 of 224) had been settled or dismissed. In 41 cases, a settlement or dismissal occurred within six months of filing. Looking further out, we find another 56 cases were resolved within a year and 94 more within two years of filing.

203. The firm is Wechsler Harwood.

204. Weiss & Beckerman, *supra* note 85, at 2061 ("The most common recruitment practice followed by plaintiffs' attorneys apparently is to maintain a list of potential plaintiffs and their stockholdings.").

By comparison, derivative cases stay open longer than class actions. In our database, about three times as high a percentage of the derivative suits were still open (45 of 135 or 35 percent) as compared to class actions (25 out of 213 or 12 percent).²⁰⁵ Furthermore, for the cases that have settled, the median time to settlement was 20 percent longer for derivative suits (478 days) than for class actions (397 days).

In contrast, federal securities cases remain open much longer, and, among those that are resolved, there are more settlements than dismissals, the opposite of what we see in the state cases. Prior to the passage of PSLRA, an average of 2.67 percent of the federal securities fraud cases filed settled within one year.²⁰⁶ If we expand this time frame outward to two years, we find 18.54 percent of these federal cases settling, with this number continuing to increase so that within four years 57.59 percent of these federal class actions settled.²⁰⁷ Overall, a very high percentage of these cases eventually settled. If, for example, we look at all federal securities fraud class actions filed between April 1988 and September 1996, 87.6 percent resulted in a settlement, "with the large majority of the remainder being resolved by dispositive motions or voluntary dismissals."²⁰⁸

PSLRA further slowed the settlement process in federal securities fraud class actions. If we look at federal securities fraud class actions after PSLRA, we find that over the period 1996-1999, less than 1 percent of these cases settled within one year, and only 11.58 percent of these actions settled in less than two years.²⁰⁹ If we look at settlement rates further out, only 26.06 percent of these cases were settled four years after filing.²¹⁰ While it is too soon to determine the ultimate fate of many post-PSLRA cases, we can report that in 1998, for example, 85 percent of all dispositions of federal securities fraud class actions were settlements.²¹¹

205. The data is as of August 2002. This difference is more noticeable for closely held corporations and for the largest public corporations (the NYSE listed companies). For NASDAQ companies, or companies traded on smaller markets, the percentage of open cases was roughly similar to class actions. The number of open cases for close corporations likely reflects the more contentious differences among a small set of shareholders. The NYSE cases are those that most overlap with federal securities actions and include some of the most high profile business controversies in the pre-Enron era of litigation. For example, this group of open cases included suits against Raytheon, Rite Aid, Providian, and Mattel.

206. BAJAJ ET AL., *supra* note 118, at 17.

207. *Id.*

208. GRUNDFEST & PERINO, *supra* note 103, § IX (footnote omitted).

209. BAJAJ ET AL., *supra* note 118, at 17.

210. *Id.*

211. FOSTER ET AL., *supra* note 104, at 6 & fig.10.

We see that federal securities fraud class actions are dismissed much more slowly than our cases. Pre-PSLRA dismissal rates start at around 2 percent within one year, 8.23 percent after two years, and 10.89 percent within four years.²¹² Post-PSLRA these rates have dropped substantially: 0.22 percent within one year, 4.01 percent within two years, and 5.79 percent within four years.²¹³

What are the reasons for the large differences in the settlement and dismissal rates for Delaware fiduciary duty class actions and federal securities fraud class actions? One possible explanation of these variations is that the Delaware cases are tied to the completion of mergers and acquisitions, and therefore are likely to be resolved at or around the time that these transactions close. The value of the underlying claims is well known to the plaintiffs and defendants in these cases, so it is unnecessary to spend lots of time litigating the cases. Early settlement or dismissal is therefore socially desirable: defendants can get on with their business, shareholders get any relief to which they are entitled, and the cases are resolved quickly with a minimum of costs and judicial resources expended. In short, the class action provides a mechanism for quickly resolving all of the claims arising out of the transaction.

A second possible explanation is that federal securities fraud claims raise much greater potential liability for the defendants, both because the legal claims are stronger and easier to prove and because the potential damages are much more substantial. Firms are unwilling to settle such cases for large amounts early on in the case, and the plaintiffs will not accept small percentage awards on their claims. By contrast, the value of the claims under Delaware law may be relatively small because the legal claims are hard to prove and/or the potential damages are low. This makes little litigation activity and early settlement (or dismissal) of the Delaware class actions a rational decision for plaintiffs, especially if defendants want to tie up the loose ends of a completed acquisition. In other words, plaintiffs invest little in the cases because there is little to be gained, and those gains do not increase with additional time and effort.²¹⁴

212. BAJAJ ET AL., *supra* note 118, at 19.

213. *Id.*

214. There may also be institutional reasons for the differences. For example, the Delaware courts have great expertise in handling class actions, and may move cases along more quickly than their federal cousins. Another possible factor could be that the larger damage claims in federal actions could mean that there are more insurance carriers (given the practice of layers of insurance coverage) that must be represented in settlement negotiations. This could make settlement negotiations more complex in the federal cases.

Both theories are plausible. The data do not precisely fit either one. In considering the first theory, we find that while some cases settle around the time of the closing of the transaction, many cases settle months later with little activity visible at any point in the case. This suggests the efficient resolution of claims story is not a complete explanation for the settlement and dismissal pattern. On the other hand, as we saw *supra* Part II.F, the median settlement award is higher in Delaware cases than in the federal securities lawsuits. While there are fewer settlements in the state court cases than in the federal cases, this disparity would still seem to indicate that state law claims have some teeth in them, and cannot simply be dismissed as strike suit settlements.

If we look at attorneys' fees awards, we see some evidence supporting the claim that Delaware class action litigation has lower litigation agency costs. The attorneys' fees that the Delaware courts award are relatively modest as a percentage of recovery received by the plaintiff shareholders, far lower than those awarded in federal securities class actions. In the 20 control shareholder transactions settled in the Delaware courts, the median amount of additional consideration paid to shareholders was about \$15 million.²¹⁵ The median percentage of attorneys' fees for these cases was 5 percent of the additional consideration (with a range extending up to 37 percent). In dollar terms, the median attorneys' fees awarded by the court were \$875,000 (with a range extending up to \$4.4 million).²¹⁶

Attorneys' fees in derivative suits are generally less in absolute amount. Of the 15 derivative suits for which we found some form of relief for the plaintiff, eight were treated as class actions for purposes of settlement, were part of a series of suits from the same transaction in which most of the suits were class actions, were part of a complaint that included class action counts as well as derivative counts in the complaint, or had a settlement that was paid directly into a securities fraud fund. Of the seven remaining derivative suits, only two had attorneys' fees over \$1 million, one had fees of \$625,000, and the others had fees that ranged between \$80,000-\$250,000.

By contrast, the median attorneys' fees awards in federal securities fraud cases from 1991 to 1996 were about 32 percent of the

215. Since in these cases the controlling shareholder already owned between 54 percent and 91 percent of the company, the per share amount of additional consideration was paid only on a fraction of the outstanding shares. We are calculating these amounts based on the difference between the initial price offered in the transaction and the final consideration paid to shareholders in the transaction at or before the time of the settlement.

216. Nine of the 17 cases in which attorneys' fees exceeded \$1 million were control shareholder acquisitions.

settlement value.²¹⁷ This figure varies little across industries and location of the litigation.²¹⁸ Obviously, this is a far greater percentage of the settlement than the median percentage for the cases in our Delaware data. Furthermore, the awards in the cases in our database are a much smaller percentage of recoveries than earlier studies of shareholder litigation have found.²¹⁹ The low percentage of the settlement going to the plaintiffs' counsel supports the claim that Delaware class actions efficiently resolve the claims surrounding mergers and acquisitions with low litigation agency costs, but it could also support an argument that the litigation contributed relatively little to the consideration that otherwise would have been achieved in negotiations between the controlling shareholder and a special litigation committee of the board.

Any claim that Delaware class actions have low litigation agency costs, however, would be undercut if it turned out that the hourly returns to the attorneys in these Delaware cases were very high. If hourly fees were quite high, then it could be argued that the plaintiffs' attorneys did little work on these cases, which settled quickly, and they received a high return for their time.

We can calculate the actual hourly rates paid in the Delaware class actions. Plaintiffs' law firms must file briefs to accompany their fee petitions to the Delaware Chancery Court. These documents show that plaintiffs' law firms report spending 550 hours on the median case (with a range between 200 hours and 1400 hours). Using this information and the size of the attorneys' fees award, we can calculate the hourly fee for each case settled.²²⁰ If we do this, we find that these hourly fees range from \$420 to \$3600 with a median of \$1260.²²¹ Of course, these are the plaintiffs' attorneys' fees for those cases that settled and do not factor in the absence of attorneys' fees for those cases that are dismissed without settlement (and for which we have no information on time spent for which no fees are recovered).²²²

217. MARTIN ET AL., *supra* note 118, at 12-13.

218. *Id.* at 14-15.

219. Jones's study of shareholder litigation found an average attorney fee award of 16.2 percent of the total plaintiff recovery. Jones, *supra* note 95, at 567.

220. We note that we cannot determine the percentage of these hours that were put into the case prior to the negotiation of the settlement and the number of hours that plaintiffs' counsel spent after an agreement had been reached. For example, it was impossible to determine the percentage of hours spent on confirmatory discovery to show the court that the settlement was reasonable.

221. This reflects information in 20 of the 31 cases for which there was sufficient information to calculate hourly attorneys' fees awarded in acquisition cases.

222. The contingent nature of these cases is one factor courts use in deciding on fee requests. Attorneys' fees are supported using a multi-factor test that includes discussion of the contingent nature of the case, the difficulty of the case, the quality of opposing counsel and other factors.

To accurately calculate average attorneys' fees for all of the class actions, we would need to greatly reduce these estimates to reflect time invested in cases that do not result in settlements (about 61 percent of cases are resolved without an award of attorneys' fees). Furthermore, we cannot determine the median hourly attorneys' fee award to plaintiffs' attorneys in federal securities fraud cases, so as to generate a comparative benchmark. Thus, once again, we cannot conclusively determine if the size of attorneys' fees awards is evidence of lower litigation agency costs.

There is one final aspect of the attorneys' fees data that bears comment. If we focus on how attorneys' fees awards vary across settlements, we find that duty of loyalty allegations result in the largest fee awards in acquisition cases (such allegations have the highest settlements, too). The highest awards in non-acquisition cases were in two cases that both involved management self-dealing around the time of an acquisition.²²³ In third-party transactions, attorneys' fees awards were higher when there was an allegation of improper allocation of merger consideration among different classes of stock or of self-dealing behavior in buying and selling assets in connection with an acquisition. For MBOs, there is always a conflict of interest, and fee awards fall into a relatively narrow range between \$225,000 and \$750,000.

In settlements where shareholders receive relief other than additional consideration, attorneys' fees are modest, with a median around \$300,000 and only two cases awarding above \$1 million. Attorneys' fees awards where there is no other relief to the shareholders almost always occur in acquisition transactions where the filing of the case preceded an increase in the merger consideration, but where the plaintiffs' attorneys have not been able to clearly establish any causal link between the two events.²²⁴

We interpret this pattern of attorneys' fees awards as reflective of the strength of the underlying substantive legal claims. Delaware case law is most demanding of directors in conflict-of-interest scenarios. This leads us to consider the evidence on any management agency costs reductions that result from these acquisition class actions.

223. In a case arising around Plains All-American, a recovery of \$10.6 million paid to the partnership brought attorneys' fees of \$1.056 million. In litigation against Waste Management, Inc. cancellation of executive compensation said to be worth \$23 million brought attorneys' fees of \$1.6 million.

224. See *supra* note 184 and accompanying text.

B. Affirmative Relief in Acquisition Class Actions: Managerial Agency Cost Reductions?

Having reviewed the evidence concerning litigation agency costs, we turn now to the impact of acquisition-oriented litigation on managerial agency costs. When we look at the impact of these class actions on managerial agency costs, we are forced to use proxies for how these costs are impacted by litigation. We cannot measure, for example, the deterrent effect of class actions on potential managerial misconduct, although most commentators would readily agree that such an effect exists.²²⁵ What we can measure with our data are the types of claims made in the cases and the value conferred to shareholders from settlements of these cases. This value may be monetary or come in other forms.

These class actions universally raise claims of high managerial agency costs such as allegations of failure to maximize shareholder value in a sale of control under *Revlon* or *Unocal*, or challenges under *Weinberger* to the fairness of potential conflict-of-interest transactions such as control shareholder acquisitions and management buyouts. In Table 15, we show the frequency with which these claims are made and the type of relief that is granted in the cases in which they are made.

Table 15: Claims Made in Complaints Filed in Acquisition Cases

Type of Claim	Number of Complaints	Frequency of Substantive Relief
<i>Revlon</i> Claims	233	0 ²²⁶
<i>Unocal</i> Claims	10	0
<i>Weinberger</i>	581	228 ²²⁷

Looking first at *Revlon* and *Unocal* claims, what Table 15 shows is that, in a database almost entirely made up acquisition cases, the impact of these two stalwart Delaware cases is remarkably

225. The studies of whether litigation is correlated with changes in shareholder value are one effort at such a measurement. See, e.g., sources cited *supra* note 99.

226. In one case, a settlement included attorneys' fees but no other identified relief.

227. The 228 complaints in this category represent the total number of cases originally filed connected to lead cases reported as producing substantive relief. Recall from Table 9 that most of the lead cases have more than one complaint filed against the same company for the same controversy.

slight.²²⁸ Certainly *Revlon* is frequently included in plaintiff's arguments, with more than 30 percent of all acquisition complaints making reference to its requirement to maximize shareholder value. *Revlon*, however, is only properly invoked in very limited factual settings: either in cash for stock transactions (36 cases involved such facts), or where an acquiring company in a stock for stock merger has a controlling shareholder (20 cases had this fact pattern). If we examine the complaints that contain factual allegations that would satisfy *Revlon*, we find that no substantive relief occurred in any of those cases.

Unocal is notable for how infrequently it appears. Only a very small number of complaints include allegations based on *Unocal* and none of these produce substantive relief. We should expect, however, that most *Unocal* claims would be brought by a bidder trying to strike down takeover defenses that are blocking an acquisition. By contrast, in most of the class actions in our data set, the target has already agreed to a transaction. Still, the lack of *Unocal* claims is consistent with other published reports that show that Delaware courts have rarely used *Unocal* in the past ten years, even in direct suits brought by a frustrated bidder to strike down a defensive tactics.²²⁹

Duty of loyalty claims are by far the most commonly made allegations, arising primarily in friendly deals with conflicts of interest, such as control shareholder transactions and MBO cases. By comparison to *Revlon* and *Unocal* claims, these allegations appear in settled cases much more frequently. We interpret this as an indication that such claims have greater legal bite.

Table 16: Impact of Multiple Lawsuits on Likelihood of Settlement

	0-4 Lawsuits	5-9 Lawsuits	10+ Lawsuits
Likelihood of	57/279	19/56	8/14
Relief (%)	20%	39%	57%

228. We remind the reader that we are discussing class action cases here and not bidder suits. Bidder suits have often led to important decisions by the Delaware courts concerning the validity of antitakeover defenses, and of various forms of deal protection measures. See, e.g., cases cited *supra* note 47. These cases illustrate the important impact of the Delaware courts on mergers and acquisitions practices, such as how takeover defenses are used and merger agreements are drafted.

229. See, e.g., *Chesapeake Corp. v. Shore*, 771 A.2d 293 (Del. Ch. 2000). Such exceptions have usually come from the Chancery Court and only rarely from the Delaware Supreme Court. See *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 934-39 (Del. 2003) (holding that deal protection measures preclude target company's directors from exercising their fiduciary duties to shareholders); see also Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: Sacred Space in Corporate Takeovers*, 80 TEX. L. REV. 261, 285 (2001).

The data in Table 16 show that there is a positive correlation between monetary recovery and the number of suits generated in an acquisition. As the number of law suits per controversy increases, there is an increase in the likelihood of additional consideration being obtained. For 0-4 lawsuits per controversy, 57 of 279 (20 percent) lawsuits produce some relief; for 5-9 lawsuits 19 of 56 (39 percent) produce some relief; for 10 and above, 8 of 14 (57 percent) produce some affirmative relief. In other words, we find that there is a connection between the likelihood of a settlement (managerial agency cost reduction) and the number of complaints filed in the case (litigation agency cost increase).

We cannot be sure of the causal connection here. We think it likely that plaintiffs' attorneys can preliminarily assess the merits of these class actions before deciding to invest the (minimal) amount of resources necessary to file a complaint. If this is correct, then we would expect that more complaints would be filed in cases with high settlement potential. This would seem to indicate that the filing of multiple complaints is a sign that a particular case is strong (high managerial agency costs are present).

It is possible that the causal connection runs in the opposite direction though. In this scenario, plaintiffs' attorneys file multiple complaints not because of the merits of the case, but for other reasons, such as the ease of finding a shareholder to act as the named plaintiff, the degree of publicity surrounding the case, or the size of the defendant, all of which (the theory goes) are uncorrelated with the merits of the action. The filing of many complaints leads companies to settle the case, again not because of the merits, but for other reasons such as the adverse publicity, the concern for the high costs of fighting so many suits, etc. In this scenario, we are concerned that frivolous claims are getting settled for too much.

We also find a positive correlation between a settlement with monetary relief and the filing of a complaint by one of the top 16 plaintiffs' law firms shown in Table 12. One possible implication of this connection is that the plaintiffs' bar may be the most effective group in representing shareholder interests. This could undercut any claim that the presence of a well-established plaintiffs' bar is solely an indicator of high litigation agency costs—it may also indicate higher management agency cost reductions.²³⁰

230. Of course, there are other possible interpretations of the causal connection here. For example, these law firms could be most likely to file complaints when the consideration offered in the deal will be inevitably increased. We have heard anecdotal stories of plaintiffs' lawyers (or their paralegals) sitting in front of computers watching for the announcement of transactions on

The friendly transactions that were the subject of litigation were mostly successfully closed in all categories, but with some variation. About 85 percent of the third-party acquisitions, and 88 percent of the control shareholder transactions, closed. The MBOs had a less compelling closure rate of about 75 percent.²³¹

A slightly different picture emerges for the hostile and second bidder transactions. In the hostile bidder transactions, there can be a bidder vying with incumbent management for control of the target company, and in the second bidder cases there are at least two bidders in the hunt. From the plaintiff shareholders' perspective, this means that the transaction will be completed if either bidder succeeds. In other words, to get a complete picture of the transaction's success we need to add together the number of times that either the first or other bidder(s) gain control of the target company.

In our sample, we find that there were 23 hostile bidder lead cases. Out of these 23 cases, the hostile bidder succeeded in their bid 8 times and the target company was sold to another bidder 6 times. In 8 of the remaining cases, the target defeated all control bids, and in one case, we could not determine the outcome. So in 14 out of 22 hostile bids for which an outcome is known, or about 64 percent of the time, a deal was completed. We note that this evidence runs counter to popular perceptions that hostile bids are no longer successful, and suggests that the "Just Say No" defense is not foolproof.

In the second bidder transactions, completion rates are even higher. In the 11 suits classified as second bidder lead cases, the second bidder won in five. A different bidder succeeded in another two lead cases, the first bidder acquired the target in three cases, and in one case no deal was struck. Thus, in more than 90 percent of the cases, some kind of deal was struck and shareholders received an alternative transaction to that originally proposed by management in 7 out of 11 cases, or about 63 percent of the time.

Of those acquisitions that were completed (about three-fourths of the acquisition sample), plaintiffs got some kind of relief in about one-third of the cases. Not surprisingly, when the underlying transaction terminates for business reasons, the shareholder litigation

Bloomberg's new services and filing a complaint whenever the premium offered in the deal is less than a certain range.

231. Comparable data for the closure rate as to similar transactions in which there was not litigation would be useful; such data, however, is unavailable at this point.

is almost always dismissed with no relief (31 of 33 cases), with only one case of any substantive relief.²³²

Table 17 documents the types of settlements that occur in acquisition cases. We find four different types of settlement in these cases: additional monetary consideration paid to the target company shareholders (above what was originally promised in the announcement of the transaction); other substantive relief, such as changes in the corporate governance structure of the corporation; additional disclosures about the transaction (and no other relief); and no relief to the shareholders, but an award of attorneys' fees to the class counsel.²³³

Table 17: Form of Relief in Acquisition Cases by Type of Transaction

Type of Transaction Challenged	Additional Monetary Consideration	Other Substantive Relief	Additional Disclosure Only	Atty. Fees Only	Total Cases With Relief	Total Lead Cases
Control Shareholder Acquisition	20	3	1	1	25	65
MBO Type Transaction	5	4	1	0	10	42
Third-Party Transaction	6	5	4	5	20	72
Second Bidder Deals	0	2	0	0	2	11
Hostile Transactions	0	2	0	1	3	23
Total	31	16	6	7	60	213

Table 17 shows that settlements are not evenly distributed across the different forms of deals. Control shareholder acquisition settlements are statistically significantly more likely to result in additional monetary consideration than other types of settlements (with P-values all less than .05). There are also other differences in the settlement frequency and the form of the settlement across the

232. Thirty-one cases were dismissed with no relief; in one there was additional consideration and in another there was other substantive relief. Two cases remain open and in three, the status could not be determined.

233. The cases in this last category are largely instances where the case became moot after the bidder took actions, such as raising the bid price to a higher level. See *supra* note 184 and accompanying text.

types of transactions. In order to explore this data more fully, we look at each type of transaction below.

1. Control Shareholder Transactions

The most striking feature of Table 17 is that the pattern of affirmative relief is strongest in those cases in which there is a controlling shareholder who has proposed an acquisition that will effectively cash-out the minority shareholders. This type of transaction is accompanied by a high likelihood of substantial management agency costs.

Looking at the data, we find that in 20 of 65 of the controlling shareholder cases, additional consideration was paid to the minority shareholders, and in another five cases there were attorneys' fees paid in a settlement. Among the larger group of all acquisitions in which additional consideration was reported, two-thirds of them (20/30) are controlling shareholder cash-out transactions. These cases, which make up 30 percent of all acquisition complaints, constitute up to two-thirds of the settlements in which additional monies are paid.²³⁴

Some commentators have argued that these settlements simply result in bidders paying target company shareholders what they would have received anyway without the litigation.²³⁵ The logic behind this argument runs as follows: a knowledgeable acquirer will not make its best offer when it announces its offer, but rather will expect that shareholder litigation will be filed after it announces the deal, and therefore will offer a very low price in expectation that it will later raise the price as part of a settlement of the anticipated litigation. The bidder thus pays no more in the deal than it would have anyway, and gets the additional benefit of obtaining a release of all potential claims that arise out of the transaction.

If this argument were correct, then we would expect several things to flow from it. First, if all bidders were rationally engaging in this game, we would expect to see all deals uniformly priced low and all class actions settling so that shareholders get roughly the same (slightly higher) premium for their shares. As Table 17 shows, less

234. Nine of these cases are still open and could provide additional consideration, so that when all cases are completed, the recovery rate in controlling shareholder cases will probably be in the 50 percent range of the 65 cases.

235. Professor Steve Choi, however, argues that settlements result because controlling shareholders are more vulnerable to frivolous litigation, as illustrated by cases like *Sinclair Oil v. Levien*, 280 A.2d 717 (Del. 1971). E-mail from Steve Choi to Robert B. Thompson and Randall Thomas (Jan. 23, 2003) (on file with author). Thus, payments in these settlements may reflect vulnerability, and not otherwise bad conduct. See generally Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785 (2003).

than one-third of all cases produce any affirmative relief, and, even for controlling shareholder cases, relief occurs in less than half of the cases, which we interpret as a sign that not all bidders are following this practice. If some bidders are settling cases, while others are not, then we must dig deeper to understand why this is the case.

We decided to examine how the total consideration (offer price plus settlement value) paid to shareholders in these settled cases compared with the consideration paid in the remainder of the control shareholder transactions that were resolved without relief. As Table 18 shows, if we divide our sample of control shareholder cases into those cases where a monetary settlement is obtained and those where there was no such payment, a very interesting pattern emerges.

Table 18: Control Shareholder Transaction Premiums

Transaction Type	Number of Cases	Median Offer Price: % of Premium Over Market Price	Median Additional Consideration: % of Offer Price	Median Total Consideration: % of Premium Over Market Price ²³⁶
With Monetary Settlement	20	15	11.9	30.04
Without Monetary Settlement	28	25.5	0	25.5

We first observe that *the median of the premium offered to target company shareholders in cases in which there is a settlement averages almost 10 percent less than the median paid in transactions in which there is no monetary settlement.* As the data shows, the median of the original offer price is slightly more than 25 percent higher than the previous trading price for the stock in cases where there is no monetary settlement, but only 15 percent higher in the cases involving a monetary settlement.²³⁷ These initial differences are statistically significant at the 5 percent level of significance.

236. The sum of median offer price and median additional consideration does not equal the median total consideration because median additional consideration is calculated as a percentage of the premium over the initial market price, not as an increase over the offer price.

237. Of course, this premium may not reflect the long-term value of the corporation, and plaintiffs argue in all of these cases that the acquisition was timed to take advantage of a

Monetary settlements more than make up this difference. For the cases that settle with an award of additional monetary relief, the median amount paid in the settlement is about 12 percent of the price offered in the takeover. This relief is in addition to what the shareholders received for their shares in the transaction, the original offer price. If we add the original offer price and the value of the settlement together, we see that the total median consideration paid to shareholders in the settling cases is more than 30 percent over the market price at the time of the announcement of the transaction. When we compare this figure with the value that shareholders receive in cases where there is no settlement, we find that shareholders do better when bidders start low and are forced to raise the value paid by litigation. However, the differences in the final prices are not statistically significant.

These results show that the impact of the monetary class action settlements is to raise the premium paid in the lowest-priced control shareholder transactions above the average level for all of these transactions in our sample. In other words, acquisition-oriented class action litigation polices the worst control shareholder deals, and benefits target company shareholders by insuring that they get compensated as well as, or better than, shareholders in deals that are more fully priced.

Returning to the earlier discussion about why bidders settle cases, and whether such settlements are pre-priced into a lower deal price, this evidence suggests that controlling shareholders wind up paying target company shareholders more in the settled cases. Many bidders price their offer at a reasonable premium over the market price (25 percent on average), and when litigation is filed, refuse to settle the case. Other bidders try to cash out minority shareholders at a low price, and when confronted with litigation over the terms of the deal, raise the price to a higher premium. In other words, the initial low bidders pay more to target shareholders in the form of additional consideration in the settlement, plus they must pay the plaintiff class' attorneys' fees. These fees average \$1.379 million in the settled cases.

A rational bidder must therefore decide whether the benefits of starting low and later settling the case, such as obtaining a release of all claims arising out of the transaction, are worth these additional costs.²³⁸ In addition, the bidder must factor in the potential savings in

depressed price of the stock and that the managers executing the transaction have an information advantage over the public.

238. We note that such a release can eliminate not only state law claims arising out of the transaction, but also federal securities law claims that could be raised on the same fact pattern. However, unless the federal claim arose out of an acquisition, or one of the other listed

making a low offer in cases in which the bidder does not get sued by shareholders. While we presently lack data on the percentage of announced deals in which litigation is not filed, and the characteristics of those deals, we speculate that the larger, public companies are less likely to be able to announce a low ball offer without attracting lawsuits. If we are correct, then there may be different bidding and settlement patterns for larger and smaller deals.

Another set of questions concerns the impact on shareholder wealth when a target company's board of directors appoints a special committee to negotiate on behalf of its shareholders in a control shareholder transaction.²³⁹ The special committee's negotiations on behalf of the shareholders often are accompanied by increases in the consideration paid in these transactions. These increases may reflect hard-nosed bargaining by these independent directors, or they could just be paid as part of a cynical ploy by the majority shareholder to insure that the courts approve the terms of the deal. We cannot be sure which is the case by examining only the value paid to shareholders.

This problem is of more than passing concern to our work. In most of the settlements that we discuss in this section, we find that there is both a special committee working on behalf of the target shareholders, and a group of class action lawyers seeking an increase in the price paid in the deal. If the majority shareholder raises the offer price after negotiations with the special committee and the plaintiffs' lawyers, then how do we determine how to allocate responsibility for the increase between the two groups?

In this paper, we report the full increase in consideration as a benefit of the litigation, although we recognize that in some cases this overstates the value of the litigation. As a rough approximation it may be largely accurate, though, even if the special committee's efforts are part of the reason for the increase. Without the presence, or at least the threat, of shareholder litigation, there would be little incentive for the special committee to put forth maximum effort for the minority shareholders. Furthermore, the special committee would have less negotiating power with the majority shareholder to push for increases

exceptions that Delaware carves out, a state law class action would be pre-empted by the Uniform Standards Act of 1998. For a discussion of the Delaware carve out, see *supra* note 40.

239. A special committee may be commonly employed in this context to insure that the board satisfies its duties under *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983). If the special committee is truly independent and acts as an aggressive negotiator on behalf of the target's minority shareholders, then the Delaware courts have considered that an important factor in determining whether the board has met its fiduciary obligations.

in the price paid if the majority shareholder did not need to worry about shareholders' attorneys monitoring the process.

2. Management Buyout Transactions

There are five monetary settlements in the MBO class actions filed in our sample. Table 19 presents information on the value of these settlements and the comparison between settled and nonsettled cases.

Table 19: Management Buyout Transaction Premiums

Transaction Type	# Cases with Premium Info	Median Offer Price: % Premium Over Market Price	Median Monetary Settlement Over Offer Price (%)	Median Total Return Over Market Price (%)
Monetary Settlement	5	27.25	7.00	29.40
Without Monetary Settlement	36	27.95	0	27.95

What can we say about how these settlements impact the total consideration paid to shareholders? First, we begin with the caution that we have far fewer monetary settlements of management buyout transactions. Working with such a small sample makes generalizations hazardous, and thus we must be more careful in what we say about these cases.

The first thing that jumps out of Table 19 is that the average initial premiums in the two sets of cases are almost identical. If we consider monetary settlements, though, we find that the target company shareholders in those cases receive a small increase in the amount of cash they get for their shares. The total amount that shareholders receive in the two groups, however, looks quite similar, with less than a two percent difference in settled cases. This suggests that we have the same pattern that we saw with the control shareholder cases: settlements boost target shareholders' gain in settled cases to at least the same level as those achieved in other cases. Although these results are not as striking as those in Table 18 and are not statistically significant, they can support a claim that class action litigation is policing these MBO transactions.

3. Third-Party Friendly Transactions

As we saw in Table 17, there are six settlements where additional consideration was paid to the target company shareholders in a suit challenging a friendly third-party merger transaction. Because there is no direct conflict of interest in a friendly third-party merger, the presence of these settlements suggests class action litigation is performing a role beyond policing direct conflicts of interest. If we look closer at these settlements, however, most of them arise out of a claim that managers have shifted too much consideration to themselves in negotiating the terms of the deal. In two of the six monetary settlements, the underlying cases challenge the terms of preferred stock or dual class stock where the terms of the merger were said to significantly favor the insiders' stock over the public, and in two others the plaintiffs challenge self-dealing transactions prior to the mergers. In short, most of these settled cases are conflict-of-interest claims even though the underlying transaction appears on the surface to be an arm's-length sale.

Table 20: Third-Party Merger Transaction Premiums

Transaction Type	Number of Cases with Premium information	Offer Price: Percentage of Premium Over Market Price
With Monetary Settlement	2	23.24%
Without Monetary Settlement	45	23.00%

4. Hostile Bidder and Second Bidder Transactions

In contrast to the disposition of the conflict-of-interest cases discussed above, hostile and second bidder acquisitions produce no monetary settlements and little other relief. Beginning with the hostile deals, all 23 of the transaction-oriented lead cases have been concluded.²⁴⁰ Twenty-two of the 23 cases were class actions. Out of the class actions, 20 of the 22 class actions were dismissed with no

240. Twenty of them involved at least one of our top 16 plaintiffs' law firms.

relief. In the two class action cases that settled, one produced no relief with only an award of attorneys' fees, while the other resulted in some additional disclosure plus attorneys' fees.

The suits arising when a second bidder appeared on the scene after the announcement of a third-party merger fare little better. Transactions arising in this context generate the most suits per transactions (including 41 in one transaction, but still a higher average of suits per transaction without that case included). Three of the 11 cases are still pending, but in the eight that have been concluded, there were only two settlements and both resulted in no relief but a payment of attorneys' fees.

Table 21: Hostile Bidder Transaction Premiums

Transaction Type	Number of Cases with Premium Information	Total Consideration: Percentage of Premium Over Market Price
Hostile Transactions	16	36.47%

When we turn to the data on the premiums paid in these transactions, we see from Table 21 that the premiums proposed for hostile deals are substantially higher than those in the friendly deals. We believe that the absence of a conflict of interest and the high premiums paid are the most important reasons why there are no substantive settlements in these cases. When acquirers pay a full price in an arm's-length acquisition, there is much less ground for legal claims that shareholders did not receive a fair price for their stock. Furthermore, proposed hostile transactions fail to lead to a completed transaction more often than friendly deals, and this would be an additional reason why hostile actions do not settle.

There is another distinguishing characteristic of these cases—the class action lawsuits filed are frequently companion cases to direct suits filed by the bidder itself. Bidder suits usually challenge the target company's implementation or use of defensive tactics as a method of depriving its shareholders of the right to sell their shares to the bidder via tendering into a tender offer, or to vote their shares in favor of a bidder's proposed course of action, such as removing the target's board of directors. As we discussed above, shareholder litigation challenging director action in these instances does not result in any substantive relief for shareholders, and this conclusion is not affected by the presence of bidder suits. What we have yet to discuss, however, is whether bidder suits have a positive impact on the

likelihood that the bidder is successful in acquiring the target company.

Turning to this question, in the second bidder cases, we have 11 lead cases filed, and in five of them we find both a bidder suit and shareholder class action complaints. In all five transactions where a second bidder suit was filed, we find that the second bidder failed to gain control of the target company (four of these companies were bought by another bidder and in one case no transaction was completed with any bidder). By contrast, in the remaining six second bidder transactions where only shareholder litigation was filed, the second bidder was successful in winning the bidding contest for the target company in every case. Thus, it seems as if the second bidders filed their own suit only when they sensed that their bids were in trouble, and that litigation might shift things in their direction, but that the bidder lawsuit was unable to accomplish this objective.

In the hostile bidder transactions, we find five bidder lawsuits among the 23 lead cases. In these five transactions, the hostile bidder acquired the target company in two of them, two other companies were sold to a different bidder, and in one transaction the target remained independent. In the remaining 18 hostile bid transactions, in which no bidder suit was filed, we see six instances in which the hostile bidder gained control of the target, four sales to different bidders, and seven cases where the target remained independent.²⁴¹ We conclude that the hostile bidder suits may have had some positive effect on that bidder's chances of gaining control of the target, but that the evidence is not compelling.

IV. CONCLUSIONS

Shareholder litigation has often been cast in the role of the evil stepsister of modern corporate governance: worthless and expensive to keep around. Based on the empirical evidence we have reported, we conclude that the acquisition-oriented shareholder class actions filed in Delaware add value, even if they also have costs. These suits have become the most visible form of shareholder litigation in state courts and rival federal securities fraud suits in importance. When we analyze the managerial agency cost reduction, and litigation agency cost increases, associated with these Delaware cases, we find some familiar patterns, as well as some very different ones.

With respect to litigation agency costs, we find that there are some parts of the traditional story about representative litigation that

241. In one case, we were unable to determine the outcome.

are also visible in this new outpost. For example, these acquisition-oriented class actions are brought very quickly after the announcement of a possible litigation-producing event, and there are multiple suits per transaction. Both phenomena are consistent with lawyers seeking to secure their position as lead counsel, perhaps at the expense of the class. In addition, as in the earlier forms of shareholder litigation, there is an identifiable set of plaintiffs' law firms that show up in these suits and there are also many repeat plaintiffs.

At the same time, however, we find that there are parts of the standard picture of high litigation agency costs that do not show up here. The old story is one of small settlements for shareholders, large attorneys' fees, and frequent nuisance settlements. In this data set, we find settlements that are larger than in the other forms of representative litigation and attorneys' fees that are a smaller percentage of the amount recovered. Overall, these suits appear to have lower litigation agency costs than the older forms of representative litigation.

As far as managerial agency cost reductions go, some of the results presented here suggest that these class action suits do result in significant reductions.²⁴² First, while these lawsuits are brought in a variety of acquisition transactions, affirmative relief does not occur across the board. Rather, the cases in which there is additional consideration paid to shareholders are decidedly skewed toward control shareholder settings, the transactions in which there is the greatest likelihood of a conflict of interest by management.

Second, if we take only those control shareholder transactions that evidence this larger likelihood of conflict of interest, we find that affirmative relief occurs only in those cases in which the initial premium offered by the conflicted controlling shareholder was the lowest in relation to the prior market price. This finding suggests that the merits of litigation do make a difference, and that shareholder litigation deserves a seat at the table of corporate governance.

None of these findings disturb the basic reality that the net value of shareholder litigation will always depend on the balance between the benefits that come from its constraining managerial agency costs and the offsetting possibility that the representative litigation will spawn its own litigation agency costs. Attention to this

242. We remind the reader that causation is always difficult to establish in these settings, and that it may be that the planning strategy of a company, or the actions of another group such as a special litigation committee of the board, contribute to, or cause, these reductions.

balance remains a necessary focus for law reform efforts as new opportunities arise to increase the benefits while limiting the costs.²⁴³

243. Two policy initiatives that we are particularly interested in studying are whether state courts should adopt lead plaintiff provisions and enact restrictions on professional plaintiffs, similar to those provisions that were adopted in PSLRA. We think that these may present opportunities for litigation agency cost reductions without increasing management agency costs.
