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Just Say No? Shareholder Voting on Securities Class Actions

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Just Say No?
Shareholder Voting on Securities Class Actions

Albert H. Choi, Stephen J. Choi, & A.C. Pritchard[*]

The U.S. securities laws allow security-holders to bring a class action suit against a public company and its officers who make materially misleading statements to the market. The class action mechanism allows individual claimants to aggregate their claims. This procedure mitigates the collective action problem among claimants, and also creates potential economies of scale. Despite these efficiencies, the class action mechanism has been criticized for being driven by attorneys and also encouraging nuisance suits. Although various statutory and doctrinal "solutions" have been proposed and implemented over the years, the concerns over the agency problem and nuisance suits persist. This paper proposes and examines a novel mechanism that attempts to preserve the benefits of the class action system while curtailing its costs: allowing a company's shareholders to vote on securities class actions. The shareholders can vote on the structural dimensions of securities class actions, e.g., whether to allow class actions at all, limit discovery, impose fee-shifting, etc., before any class action suit has been filed (ex ante voting) or vote to determine the course of a specific class action suit, e.g., whether to terminate or settle a class action (ex post voting). The paper analyzes the conditions under which allowing shareholders to manage and control securities class actions can benefit the shareholders across the board and its potential limitations.

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I. INTRODUCTION

When a publicly traded company releases misleading information that distorts the market for the company's stock, investors who purchase at the inflated price suffer harm from the misleading information when it is corrected. Under Rule 10b–5 of the Securities Exchange Act of 1934, investors may bring a private cause of action against corporations and their officers who make materially misleading statements on which the investors rely when buying or selling a security.[1] Investors face practical impediments, however, in individually enforcing this legal remedy. A retail investor with only a few shares will expect a minimal benefit from any recovery but must bear the entire costs of filing suit and litigating a claim. Litigating a securities fraud case against a deep-pocketed public company can easily run into the hundreds of thousands or millions of dollars, so few investors can afford to litigate individually.

Apart from compensation, litigation can benefit investors by deterring managers from committing fraud. Discouraging fraud can improve various corporate governance mechanisms that rely on accurate securities prices. These governance tools include the market for corporate control, shareholder voting in director elections, and share-price-based incentive compensation for executives. These deterrence benefits accrue to all investors, however, and only fractionally (based on share ownership) to the investor filing an individual suit. This mismatch of individual and collective incentives means that, although the group of investors may collectively favor bringing a suit against a public company that

1 The securities laws also provide legal remedies for materially misleading omissions. For simplicity, we focus only on disclosures in this essay.

releases misleading information, most individual investors will not have incentives to file suit.

The class action mechanism provides a collective solution to the disincentives discouraging investors from bringing a securities fraud suit. In a class action, a collectivizing agent, the class representative, represents the interests of the class. Individual class members do not need to expend their own resources to obtain a recovery. Indeed, they do not even need to pay attention to the litigation until a settlement or a judgment is reached. All they need to do is submit a claim form once the litigation is concluded. Furthermore, aggregating claims in a class action allows shareholders to avoid incurring duplicative costs, e.g., having multiple attorneys investigate claims, conduct depositions, etc. This allows the claimants to reap the potential benefits of economies of scale.

The class action ameliorates the collective action problem facing dispersed investors to litigate claims and also achieve the benefits of potential economies of scale, but aggregation of claims brings its own set of problems. These problems stem from the incentives of the plaintiffs' attorney firms that serve as class counsel. Although in theory the class representative makes decisions on behalf of the class, in practice plaintiffs' attorneys make the critical decisions regarding the litigation.[2] He who pays the piper calls the tune: plaintiffs' attorneys will bankroll the litigation and bear the risk of loss if the case does not produce recovery. The class counsel is paid—as a percentage of the recovery—only if there is a settlement or judgment. Typically, class counsel receives a fee of 10 to 33 percent of the settlement fund. A relatively small number of plaintiffs' attorney firms—around twenty—litigate the majority of securities class actions.

These firms enjoy a lucrative practice, but the societal benefits of Rule 10b–5 class actions are questionable. Particularly troublesome are suits alleging that corporate defendants have made public disclosures that distorted the price of the company's securities in the secondary market, but the company itself did not profit by selling securities. These "open market" fraud cases are the lions' share of suits against public companies. Investors who transact with other investors can recover from the company

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[2] The fact that a shareholder may be unwilling to bring an individual suit against the company can also imply that, in a class action setting, the shareholder would be unwilling to expend resources in monitoring and directing the class action attorney. In some sense, the class action mechanism shifts the collective action problem from one area (filing and prosecuting a securities lawsuit) to another (monitoring a common agent). For a broader discussion of class actions and class action waivers, see Albert H. Choi & Kathryn Spier, *The Economics of Class Action Waivers*, 38 YALE J. ON REGUL. 543 (2021).

under Rule 10b–5 for their trading losses under the typical "out of pocket" measure of damages. Their counterparties, investors usually unconnected to the company other than through share ownership, make corresponding trading profits. The immediate net social cost of these trades is zero. Consequently, out-of-pocket damages substantially overstate the social loss.[3] Moreover, shareholders who do find themselves on the losing end can often protect themselves through diversification.[4] Nonetheless, for companies with a large trading volume, Rule 10b–5 damages in a class action can be enormous even when the company (or its managers) have not profited from the misleading disclosure.[5]

These outsized potential damages encourage nuisance litigation. Even when a company has not made a materially misleading disclosure, or has at least not done so intentionally, the company may have reasons to settle a suit. Settlement not only allows the company to save the costs of defending the suit but also to avoid even a small possibility that the company may lose. A loss after trial means paying potentially bankrupting damages.[6] If companies have an incentive to settle nuisance litigation, opportunistic plaintiffs' attorney firms will have an incentive to file such suits to exploit this corporate vulnerability.[7] Such suits have mushroomed in the last decade in the form of "deal tax" suits

[3] *See* Paul Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623 (1992).

[4] Presumably, when an investor holds a well-diversified portfolio, even though the investor may be on the losing side of a trade (due to a company's misleading statement), she may be on the winning side of a trade with a different company. At the same time, when more and more security prices become less reliable (due possibly to potential misleading statements), this will increase the general uncertainty in the market and potentially discourage investors from participating in the market.

[5] A company may profit from overvalued shares to the extent the company uses the share to acquire other companies and in other transactions. Managers may benefit from overvalued shares to the extent the managers sell their personal holdings of the company (and likewise may benefit from undervalued shares when they purchase company shares). The magnitude of both benefits to companies and managers, nonetheless, are not tied in any way to the amount of trading volume in the secondary market and thus the amount of Rule 10b–5 damages are likely to far exceed these benefits for companies with high trading volume.

[6] When there is a chance that a company can be falsely found liable due to the inaccuracy in the dispute resolution system, with large damages, this can turn a negative expected value (NEV) suit into a positive expected value (PEV) suit from the plaintiff's perspective. With a PEV suit, the plaintiffs would be willing to prosecute the claim and the companies would be willing to settle for a positive amount to avoid the cost of litigation.

[7] For an examination of the phenomenon of frivolous litigation in securities class actions, see Stephen J. Choi et al., *The Screening Effect of the Private Securities Litigation Reform Act*, 6 J. EMPIRICAL LEGAL STUD. 35, 44 (2009). *See also* Greg Markel et al., *Plaintiffs' Abusive Tax on M&A Deals Changed Form But Continued in 2021*, SEYFARTH (Feb. 18, 2022), https://perma.cc/78RA-27C5.

challenging disclosures made in connection with mergers and acquisitions.

Even if securities class actions produce social benefits from deterrence and more accurate securities prices, the outsized damages available for open market fraud cases under Rule 10b–5 may lead to social costs of litigation exceeding the social benefits in some cases. Nuisance litigation, when there is little or no indication of fraud, is the obvious case in which social costs exceed the (zero) social benefits. Such suits lack *any* deterrent value.[8]

Many of the developments in Rule 10b–5 legal doctrine over the past several decades have focused on how to filter out nuisance litigation while allowing meritorious litigation to proceed. Any litigation filter will have two types of errors: 1) nuisance suits may be falsely identified as meritorious and allowed (a false positive); and 2) meritorious suits may be falsely identified as nuisance and blocked (a false negative).[9] Doctrinal reforms to Rule 10b–5 implemented by both Congress and the courts—most notably the Private Securities Litigation Reform Act of 1995 (PSLRA)[10]—have attempted to filter out nuisance litigation. These reforms, however, have had only limited efficacy in more precisely distinguishing meritorious suits from frivolous ones. A major stumbling block is the need for federal district court judges, often with no training in financial economics or statistics, to determine economic issues unrelated to fraud. The economic issues include assessing market efficiency and the impact of disclosures on stock prices.

We propose a new decisionmaker for screening securities class actions involving corporate defendants: the corporation's shareholders. Presently, individual shareholders unhappy with a securities class action have no direct ability to stop the class action. Instead, the shareholders only can individually opt out of a class action, leaving the rest of the class intact for the class action. In this essay, we explore different ways to give shareholders as a group more control over a securities class action—focusing in particular on shareholder voting. We discuss both ex ante votes,

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[8] Indeed, to the extent nuisance suits lead companies to think they will get sued for fraud regardless of whether they actually commit fraud, the deterrence from Rule 10b–5 liability against committing fraud will diminish.

[9] These are more formally known as Type I (false positive) and Type II (false negative) errors. For a discussion of Type I and II errors in the securities litigation context, see Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711 (1996).

[10] Pub. L. No. 104–67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.).

which would allow shareholders to vote on whether to limit or modify class actions across the board, and ex post votes, which would allow shareholders to vote on whether to terminate a particular class action or allow it to move forward.

Shareholders increasingly vote on specific issues related to the corporation, such as say-on-pay votes for executive compensation. Direct shareholder control through voting promises increased accuracy in distinguishing between nuisance and meritorious litigation. More generally, direct shareholder control may help align the decision whether to allow securities class action litigation with the choice that would be made by the socially optimal decisionmaker. The growth of institutional ownership, the rise of activist investors, and the increasing influence of proxy advisory firms all support a bigger role for shareholders in controlling securities class actions. Shareholder voting is not a panacea; some institutional shareholders may use voting as a form of marketing "cheap talk." The goal of our proposal is to allow suits only when the net social benefits from litigation exceed the net social costs.

II. Doctrinal and Statutory Reforms

The revision of Rule 23 of the Federal Rules of Civil Procedure set the stage for the modern class action in 1967. Legal reforms to discourage nuisance securities fraud class actions have followed ever since. The Supreme Court in *Blue Chip Stamps*, for example, limited plaintiffs in a Rule 10b–5 suit to actual purchasers or sellers of a security.[11] Those who decided *not* to purchase securities because of fraud did not have standing. The *Blue Chip* Court emphasized the possibility of "vexatious" litigation if it afforded standing to those who are not actual purchasers or sellers. The Court worried that it would be too easy for opportunistic plaintiffs to say after-the-fact that they would have purchased (or sold) shares but for the fraud. Accordingly, the Court limited standing to those who could establish a transaction through objective evidence.

Congress has also attempted to limit nuisance litigation with the Private Securities Litigation Reform Act of 1995 (the PSLRA). The PSLRA imposes a stay on discovery until after the motion to dismiss, discouraging "fishing expeditions."[12] Courts are tasked with weeding out weak suits by applying heightened pleading standards to motions to dismiss. The most challenging barrier

[11] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 735–36 (1975).

[12] *See* 15 U.S.C. § 78u–4(b)(3)(B).

requires plaintiffs to plead with particularity facts giving rise to a strong inference of scienter.[13] To encourage companies to make financial projections, Congress codified a safe harbor for certain forward-looking statements.[14]

Congress also sought to reform the relationship between class members and plaintiffs' attorneys. The PSLRA creates a presumption for the selection of the lead plaintiff favoring the movant for lead plaintiff with the largest financial stake in the litigation.[15] Lead plaintiffs also may not receive a separate payment from the recovery unless ordered by the court.[16] Prior to the PSRLA, there was a concern that certain plaintiffs had repeat relationships with plaintiffs' attorney firms and received payments from the plaintiffs' firms. This raised concerns that the plaintiffs would cater to the interests of the plaintiffs' attorney firms—at the expense of the class—in the hope of being named plaintiff in subsequent lawsuits. The PSLRA limited the number of times a plaintiff can serve as lead plaintiff in a securities class action to reduce the possibility of professional lead plaintiffs who are beholden to particular plaintiffs' attorneys.[17] Congress also limited attorney fees to a reasonable percentage of the settlement.[18]

Focusing on the goal of blocking nuisance litigation, the various legal reforms by the federal courts and Congress under the PSLRA suffer from both false positive and false negative errors. *Blue Chip,* for example, does little to eliminate frivolous suits. Actual purchasers or sellers can still file suit to obtain a settlement even if there is no merit in their suit (a false positive error). Moreover, *Blue Chip* comes at a cost—it is possible that some investors chose not to buy or sell securities due to fraud. But for the fraud, these investors would have made money from entering into a securities transaction and are thus harmed by their decision not to trade. *Blue Chip*, however, bars such investors from bringing a Rule 10b–5 suit for their losses (a false negative error).[19] Moreover, as a standing rule, it has nothing to do with whether the defendants engaged in fraud.

The reforms in the PSLRA similarly suffer from both false positive and false negative errors. Plaintiffs with meritorious claims may lack the evidence necessary to plead with

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13 *See* 15 U.S.C. § 78u–4(b)(2)(A).
14 *See* 15 U.S.C. § 78u–5.
15 *See* 15 U.S.C. § 78u–4(a)(3)(B)(iii)(I)(bb).
16 *See* 15 U.S.C. § 78u–4(a)(4).
17 *See* 15 U.S.C. § 78u–4(a)(3)(B)(vi).
18 *See* 15 U.S.C. § 78u–4(a)(6).
19 Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 735–36 (1975).

particularity facts giving rise to a strong inference of scienter prior to discovery. Under the PSLRA, their claims will be dismissed (a false negative error). Similarly, limiting plaintiffs suing for false forward-looking statements may block some nuisance suits, but the safe harbor gives companies latitude to intentionally issue misleading forward-looking projections to inflate their stock prices. The safe harbor makes it harder for meritorious suits to go forward (another false negative error). Even first-time lead plaintiffs may serve as puppets for plaintiffs' attorneys in bringing frivolous suits (a false positive error), notwithstanding the PSLRA's prohibition against repeat lead plaintiffs.

The reforms in the PSLRA also depend on the active—but voluntary—participation of institutional investors. Congress hoped that institutional investors would wrest control of securities class actions from the plaintiffs' attorney firms. Institutional investors with a long-term view and continued securities holdings in the issuer would balance the deterrence value of bringing a securities class action against the cost to the firm of facing litigation, particularly nuisance litigation. Institutional investors would also act as a counterweight to the influence of the plaintiffs' attorney firms on behalf of the class, keeping plaintiffs' attorney fees in check.

Congress's hope has been only partially realized because only certain types of institutional investors participate as lead plaintiffs. Union and government pension funds seek lead plaintiff status in some cases; many have developed repeat relationships with several large plaintiffs' attorney firms. These institutional investors potentially have the leverage and expertise to negotiate favorable attorney fee contracts and to monitor how the plaintiffs' attorneys are litigating a class action. Nonetheless, there is a worry that union and government pension funds may not maximize the value of a class action for the entire class but instead may pursue their own self-interested agenda. Unions may favor pressuring management to benefit labor. Politicians that control public pension funds may be more interested in campaign contributions than furthering the interest of the class.[20]

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[20] *See* Stephen J. Choi et al., *The Price of Pay to Play in Securities Class Actions*, 8 J. EMPIRICAL LEGAL STUD. 650 (2011) (presenting evidence that campaign contributions from attorneys at plaintiffs' attorney firms to politicians that control public pension funds correlate with higher attorney fees); STEPHEN J. CHOI ET AL., U.S. CHAMBER INST. FOR LEGAL REFORM, FREQUENT FILERS: THE PROBLEMS OF SHAREHOLDER LAWSUITS AND THE PATH TO REFORM (2014) (documenting higher levels of campaign contributions from plaintiffs' attorney firms to the attorney general of Mississippi, with a public pension fund that

Most institutional investors, most notably mutual funds, eschew seeking lead plaintiff status.[21] Mutual funds do not want to antagonize corporate managers who control the selection of 401(k) plan providers for the corporation's employees. Moreover, the benefits to a mutual fund from becoming more active in litigation are limited. Suppose a fund believes that it has meritorious claims against a particular public company. Whether or not the fund participates in litigation, a plaintiffs' law firm is likely to bring the suit. Even if the fund remains passive, the lawyers will be able to obtain some lead plaintiff candidate, even when the lead plaintiff is only an individual investor. The fund can just free ride on the law firm's efforts. For the fund, participating in the lawsuit results in only the incremental benefit of being able to monitor hours, limit fees, and possibly influence the direction of litigation relative to what the individual investor would do. Moreover, if the fund decides to get more involved, it must compete to win the lead plaintiff contest. If it succeeds, the benefits from its monitoring only accrue fractionally to the mutual fund in proportion to its share of the class recovery. The costs of fighting to become lead plaintiff and then serving in the role of lead plaintiff are typically borne entirely by the lead plaintiff and are likely to exceed these incremental and fractional benefits.[22]

Consider the alternative scenario, in which the mutual fund believes that a securities class action is not desirable and wants to end it. Under the current regime, it is essentially impossible for a fund to stop a securities class action. Plaintiffs' attorney firms will always be able to find some shareholder to act as lead plaintiff.[23] To stop the litigation, a mutual fund must throw its hat in the ring to become lead plaintiff after the suit is filed and,

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is active in securities class action litigation, compared with the attorney general of Massachusetts, that is not as active in securities class action litigation).

21 *See* Sean J. Griffith & Dorothy S. Lund, *A Mission Statement for Mutual Funds in Shareholder Litigation*, 87 U. CHI. L. REV. 1149 (2020) (documenting how large mutual funds have "essentially forfeited" their right to bring securities lawsuits).

22 When an institutional investor is investing for the long-term and expects to remain as a shareholder of the company, this presents another disincentive for the investor to initiate or get actively involved in litigation. Given that the settlement will be paid and a large fraction of the litigation cost will be borne by the company, this will reduce the value of the institutional investors' holding and hurt the portfolio return for the investor. An investor with a long position on a company may decline to even bring a meritorious lawsuit against the company. *See* Albert H. Choi & Kathryn Spier, *Taking a Financial Position in Your Opponent in Litigation*, 108 AM. ECON. REV. 3626 (2018).

23 Note that the majority of lead plaintiffs in securities class actions are individuals. *See* Stephen J. Choi et al., *Coalitions Among Plaintiffs' Attorneys in Securities Class Actions* (N.Y.U. Sch. of L., Law and Economics Paper Series, Working Paper No. 20–42, 2020).

assuming it is selected, move to dismiss the suit. Any mutual fund that does so, however, will likely find it impossible to convince a plaintiffs' attorney firm to represent the fund on a contingency fee basis in the future. The fund will therefore need to pay attorney fees of a law firm to file the lead plaintiff motion—costs the fund will need to bear individually. Paying attorney fees to seek to become lead plaintiff only to terminate the litigation is essentially a non-starter. To the best of our knowledge, no fund has ever done this in a securities class action.

In practice, funds that oppose the litigation have no real ability to express opposition to a class action other than by opting out. Opting out, however, does not result in the same payoff for the fund as terminating the class action. If other investors do not opt out, the fund will bear the burden of the compensation paid to these other investors from the litigation if the fund continues to own shares in the corporate defendant.

Given the error rate in the legal filters for nuisance litigation and the failure of many institutional investors to become involved in securities class action litigation, a more draconian alternative would be to apply a one-size-fits-all filter: eliminate all nuisance litigation by removing the private cause of action entirely against public companies for open market fraud. This filter, while eliminating all false positives (nuisance suits are done!) also maximizes the false negative error rate—no meritorious suits will be filed either. Precluding open market suits makes sense if government enforcement efforts are sufficient to deter fraud by public companies. The SEC, however, has finite resources and suffers from its own enforcement pathologies. Private enforcement both adds enforcement resources and serves as a counterweight to the SEC's deficiencies in decision-making with respect to enforcement.[24]

In sum, existing doctrine struggles to navigate between allowing meritorious suits to go forward and deterring frivolous suits. Neither Congress nor the courts have been able to chart a course that eliminates frivolous suits while allowing meritorious suits to proceed. Judges adjudicating securities class actions often

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[24] *See* Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003); Stephen J. Choi et al., *Scandal Enforcement at the SEC: Salience and the Arc of the Option Backdating Investigations*, 15 AM. L. & ECON. REV. 542 (2013). Dispersed private enforcers may also innovate in their arguments before different courts, leading to greater legal innovation than a single public enforcer.

lack both information and expertise to screen out frivolous suits, leading to both false positive and false negative errors.

At a more fundamental level, the courts and Congress have not dealt with the policy question of whether securities class actions, even when meritorious, promote social welfare. Once one recognizes that open market class actions are typically zero-sum for investors collectively, only those meritorious actions for which social benefits—deterrence and more accurate securities prices—outweigh the social costs, should be allowed. Allowing an individual shareholder to decide to bring a class action makes little sense in this context even with judges playing a gatekeeper role. Is there a decisionmaker with incentives that approximate this social welfare maximizing calculus?

In the next section we discuss the incentives of shareholders to make decisions that maximize their collective welfare. We argue that shareholders voting on securities fraud class actions approximate the socially optimal decisionmaker. Moreover, shareholders have the potential to substantially upgrade the expertise applied to securities fraud class actions.

III. SHAREHOLDER VOTING VS. THE JUDICIAL STATUS QUO

Federal district judges currently decide whether securities class actions should be allowed to proceed. In doing so, judges only deal with the legal elements of the claim disputed by the litigants. A judge will assess whether the pleadings are sufficient to state an actionable claim when resolving a motion to dismiss, and rarely, whether there are facts to support a claim at summary judgment. Built into the various legal doctrines are rules designed to limit nuisance suits, such as the enhanced pleading requirements. But as discussed above, these rules are both under- and over-inclusive in screening for meritorious litigation. Although in theory there may be an eventual determination as to whether actual fraud occurred, absent a trial—unheard of in securities class action practice—the judge will never decide whether fraud occurred. More damning from a social welfare perspective, judges never even address the question of whether the litigation as a whole is value-increasing for shareholders. The topic is simply ignored by the existing legal doctrine. Even if a judge were to address the question of what is best for shareholders (or more broadly for the society), most federal judges lack business expertise and are ill-equipped to answer this question.

Introducing a different, perhaps better-informed, decisionmaker opens the possibility of a broader inquiry into whether

litigation generates net benefits for investors. In addition, even with respect to the narrower question of legal merit, there is potential for more accurate assessment of a particular class action relative to an assessment made by an inexpert judge. Increased accuracy would reduce the need for further legal reform to weed out nuisance litigation and make the class action system overall more beneficial for investors and society. We argue below that the shareholders of the corporate defendant, under certain conditions, are a good approximation to the socially optimal decision-maker. Shareholders voting as a group will make more accurate decisions compared with a federal district judge on the question of whether a securities class action is in the best interests of investors and, indirectly, of society.

A. Shareholder Proxy Voting

Institutional ownership has been growing for decades. Of relevance to our topic here is the emergence of activist investors such as hedge funds. These investors are willing to challenge incumbent corporate managers by voting on the election of directors and other issues. Corporate voting is no longer a rubber stamp for managers. Could this newfound accountability be harnessed to make securities class actions work better for shareholders?

Currently, unions and public pension funds are the institutional investors most frequently participating as lead plaintiffs in class actions. Unfortunately, neither group has ideal incentives. Unions are typically focused on their members' employment interests and their involvement in litigation against public corporations may be largely symbolic. Public pension funds may similarly be focused on the interests of their members and typically must answer to elected officials. Politicians may seek campaign contributions by pushing the public pension funds to play an active role in securities class actions and influencing the choice of counsel. These incentives may not align with those of the rest of the class.

Other types of institutional investors, including mutual funds and hedge funds, rarely participate as lead plaintiffs in securities class actions. Mutual fund managers, which often seek business from corporations to manage the company's 401(k) plans, are hesitant to take the lead plaintiff role in a class action suit against corporations that may be potential clients. Our proposal seeks to harness the interest and collective power of these profit-driven institutional investors. These investors typically are driven by the quest to maximize investment returns, not ideology or political advantage. Harnessing that interest requires opening

a new channel for participation in securities class actions allowing mutual fund managers to express their preferences without incurring the negative reputational penalty from taking the lead plaintiff role in a class action.

Although most institutional investors shy away from playing the role of lead plaintiff, they may be willing to express their views on securities class actions in less-visible, low-cost ways. We conjecture that institutional investors would be more willing to vote to express their preferences respecting securities class actions. Most mutual funds do not want to be the "face" of litigation. They may also be unwilling to expend the time to direct the litigation. Voting, on the other hand, gives such institutions a low-visibility and low-cost way of expressing their preference on securities class actions, especially if votes are confidential. In addition, the emergence of the internet has reduced the costs for shareholders to communicate with one another and participate in shareholders' meetings.

Proxy advisory services, which provide voting advice to a wide range of institutional investor clients, could further reduce the cost of voting. Academic research has found that Institutional Shareholder Services (ISS), Glass Lewis, and other proxy advisors exercise significant influence over shareholder votes. For many institutions that lack the scale to invest in research over voting issues, proxy advisory services represent a relatively low-cost source of information on how to vote on specific issues.[25]

The recent rise of shareholder democracy in the United States highlights the promise and limits of shareholder voting. In the Dodd-Frank Act of 2010 (Dodd-Frank),[26] Congress gave shareholders a non-binding, advisory vote on executive compensation packages (known as "say-on-pay").[27] In addition, Dodd-Frank requires a non-binding, advisory shareholder vote on payments to executives triggered by a change-in-control, so-called golden parachute payments (known as "say-on-golden-parachute").

When these provisions were adopted, some commentators argued that shareholder voting on pay would result in investors and proxy advisory firms taking a one-size-fits-all approach.

[25] A complicating factor here is that ISS also provides services to institutions in filing claims in securities class actions. Our point here is not that ISS itself could offer advice, but rather that there is a role for a proxy advisory service to play in offering advice on securities fraud class actions.

[26] Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), Pub. L. No. 111–203, 124 Stat. 1375 (2010) (codified as amended in scattered sections of U.S. Code).

[27] *Id.*; 15 U.S.C. § 78n–1.

Optimally matching pay to performance at a particular firm is a difficult task that can depend on firm-specific and executive-specific factors.[28] Many investors with diversified portfolios may not want to undertake the expense of determining how to vote on executive compensation at a particular firm and will instead outsource the decision to a proxy advisory firm. Proxy advisory firms may minimize their own research costs by applying formulaic approaches—"best practices"— to assess executive compensation.[29] If proxy advisory firms take such a "best practices" approach, then companies wanting to avoid a negative say-on-pay vote may converge toward uniform pay practices.[30] Insofar as one size does not fit all, this trend toward increased pay homogeneity will diminish firm performance, ultimately harming shareholders.

Notwithstanding these concerns, empirical studies generally suggest that institutional investors and proxy advisory firms take a firm-specific approach to say-on-pay voting. Yonca Ertimur, Fabrizio Ferri, and David Oesch examine say-on-pay voting in 2011 to assess whether proxy advisory firms follow a one-size-fits-all approach in making say-on-pay recommendations.[31] They report that ISS and Glass Lewis give "*Against*" recommendations particularly due to "pay for performance" concerns.[32] They write

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28 *See* Jeffrey N. Gordon, *"Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. LEG. 323, 333 (2009) (noting that, for example, a firm with a particularly demanding board of directors that is willing to terminate its executives may need to pay its executives more guaranteed compensation to account for the higher risk of termination).

29 The outsourcing of vote decision-making to proxy advisory firms may also lead to potential conflicts among proxy advisory firms that also sell compensation consulting services directly to firms. *See id.* at 353 ("In a mandatory 'say on pay' world in the United States, it is easy to imagine that a single entity could create guidelines, establish rating systems for good compensation, consult with firms on how to improve their compensation ratings in light of their particular circumstances, and then, behind purported ethical and physical barriers, provide proxy voting advice to shareholders."). To avoid the perception of conflicts, proxy advisory firms may more stringently follow a transparent formulaic approach in their recommendations, further exacerbating the one-size-fits-all problem. *See id.*

30 *See id.* at 325 ("This narrow range, close to a 'one size fits all,' is highly likely because the burden of annual voting would lead investors, particularly institutional investors, to farm out evaluation of most pay plans to a handful of proxy advisory firms who themselves will seek to economize on proxy review costs. Custom-tailored evaluation is costly; monitoring for adherence to 'guidelines' or 'best practices' is cheap.").

31 *See* Yonca Ertimur et al., *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay*, 51 J. ACCT. RSCH. 951, 953 (2013) (describing the proxy advisory firm recommendations on say-on-pay as follows: "Both [proxy advisory firms] provide a quantitative and qualitative analysis of the executive pay plan, structured around certain categories (e.g., pay for performance, disclosures), assign a rating for each category, and issue a final voting recommendation").

32 *Id.*

that both advisory firms "are significantly more likely to issue an *Against* [recommendation] at firms with poor performance and higher levels of CEO pay."[33] In addition, "firms with the strongest disconnect between pay and performance are more likely to receive an *Against* [recommendation] from both [proxy advisors]."[34] Ertimur et al. also report that proxy advisory firms typically did not apply a formulaic approach to making recommendations: "it does not appear that [proxy advisors] gave negative recommendations simply based on whether the compensation plan includes a certain provision."[35] They write,

> in most cases, the presence of certain provisions in the compensation plan does not automatically translate into negative recommendations. Instead, firms with similar controversial provisions receive different ratings or recommendations, with [proxy advisors] taking into account mitigating firm-specific circumstances, the severity of the issue, the rationale provided by the firm, and the overall quality of the compensation plan.[36]

Ertimur et al. also provide evidence that shareholders do not blindly follow proxy advisor recommendations. In particular, the sensitivity of shareholder votes depends on the level of institutional investor ownership in a particular firm and the advisor's rationale for the recommendation. These findings are inconsistent with a one-size-fits-all approach to voting.[37] They also find that the association between proxy advisory firm recommendations and shareholder votes is not higher for say-on-pay votes compared with other voting issues such as director elections and shareholder issue proposals.[38] This does not suggest that investors are unwilling to expend resources on say-on-pay votes or that they unduly rely on proxy advisory firms.[39]

Even though say-on-pay votes are advisory, a negative (or even tepidly positive) say-on-pay vote pressures firm management. Especially given that the company must explain, in subsequent proxy, how it has responded to an earlier negative say-on-pay vote, management that ignores a say-on-pay advisory vote runs the risk of greater shareholder opposition in future say-on-

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[33] *Id.*
[34] *Id.*
[35] *Id.* at 967.
[36] *Id.* at 953.
[37] *Id.* at 980–81, 988.
[38] *Id.* at 953–54.
[39] *Id.*

pay votes. As generalized opposition grows among shareholders, directors also run the risk of diminished support in board elections. In an extreme case, directors could face a full-blown proxy contest. The repeat nature of interactions between shareholders and management elevates the importance of say-on-pay votes. Consequently, shareholders—and proxy advisory firms—have incentives to focus on say-on-pay votes. James Cotter, Alan Palmiter, and Randall Thomas found that companies that experienced a negative say-on-pay vote typically responded either by making changes to their executive pay or communicating with shareholders.[40] Ertimur et al. similarly reported that firms were responsive to negative say-on-pay votes with firms receiving a more negative say-on-pay vote being more likely to change their compensation plans.[41] Thus, say-on-pay votes are influential despite their advisory nature.

The experience in the U.S. with say-on-pay votes has demonstrated an increased willingness of proxy advisors to recommend against pay packages. The empirical evidence suggests that shareholders also use the say-on-pay vote actively to voice their displeasure with management on compensation issues. For example, a study of say-on-pay votes at Russell 3000 companies found that ISS gave an "Against" vote recommendation at 11 percent of companies in 2011; this percentage rose to 43 percent of companies in 2018.[42] The study also looked at "suboptimal" say-on-pay voting outcomes where the say-on-pay vote received less than 85 percent support.[43] The percentage of Russell 3000 companies with suboptimal support rose from 15 percent in 2011 to 49 percent in 2018.[44]

By contrast, say-on-golden-parachute votes, which give shareholders an advisory vote on executive compensation in connection with a change of control transaction, have attracted less attention from institutional investors. Shareholders devote fewer resources in determining how to vote on golden parachutes. These votes typically are held only when a merger is about to happen and the shareholders are about to lose their control. After a merger, executives of the target firm are likely to be terminated and the shareholders would no longer remain as shareholders of the

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[40] *See* James F. Cotter et al., *The First Year of Say-on-Pay Under Dodd-Frank: An Empirical Analysis and Look Forward*, 81 GEO. WASH. L. REV. 967, 995 (2013).

[41] Ertimur et al., *supra* note 31, at 985.

[42] *See* Terry Newth & Dean Chaffee, *Ten Years of Say-on-Pay Data*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 9, 2019), https://perma.cc/BAN7-2VGC.

[43] *Id.*

[44] *Id.*

company. The last period nature of the say-on-golden-parachute vote makes those votes less influential in promoting managerial accountability. Albert Choi, Andrew Lund, and Robert Schonlau assess the impact of say-on-golden-parachute votes for the first six years of votes after the enactment of the Dodd-Frank Act in 2010.[45] Say-on-golden-parachute votes have been less effective in changing pay practices relative to say-on-pay votes. They report that the say-on-golden-parachute vote did not correlate with a reduction in golden parachutes—indeed, golden parachutes became systematically larger after 2010.[46] Because management is not responsive to say-on-golden-parachute votes, institutional investors rationally will pay less attention to such votes. Proxy advisory firms, in turn, will expend fewer resources in assessing specific say-on-golden-parachute proposals, leading to more homogeneity ("one size fits all") in proxy advisory firm recommendations. As evidence of ISS one-size-fits-all recommendations, Choi et al. show that two factors generally drive how ISS makes decisions on whether to recommend an Against vote on a say-on-golden-parachute: 1) the size of the golden parachute; and 2) whether there is a tax gross-up provision in the golden parachute.[47] Notwithstanding the apparently narrow range of analysis by proxy advisory firms, Choi et al. report that the most important factor driving shareholder vote outcomes is the ISS recommendation.[48] Among other policy recommendations, they suggest making the advisory vote on say-on-golden-parachute (partially) mandatory to give such votes more teeth.[49] Such a change would encourage institutional investors to devote more attention to the vote. More specific recommendations from proxy advisory firms would likely follow.

Overall, the voting track record for advisory say-on-pay votes makes us cautiously optimistic that shareholders will devote sufficient resources, either individually or through the assistance of proxy advisors, to make firm-specific determinations on a securities class action vote. A critical factor driving shareholder engagement is whether their aggregate vote will be determinative. But, even if the vote is purely advisory, votes may nonetheless matter if the managers in the firm care about the negative signal and the negative reputational consequences from a poor voting outcome.

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[45] Albert H. Choi et al., *Golden Parachutes and the Limits of Shareholder Voting*, 73 VAND. L. REV. 223 (2020).

[46] *Id.* at 257.

[47] *Id.* at 252–54.

[48] *Id.* at 255.

[49] *Id.* at 262–64.

In the say-on-pay context, a negative (or low positive) vote outcome may generate bad publicity, subsequent negative shareholder votes, and encourage shareholder activists to target the company. To fend off these possibilities, managers may respond to a negative vote outcome by changing compensation practices.

Not all advisory votes matter to management, of course. If managers are in their last period, as they are in the say-on-golden-parachute context, they may not care about a negative advisory vote. Given that the shareholders will no longer remain as shareholders of the target company, there is little or no chance that a negative advisory vote will affect the managers' future behavior. This may lead shareholders and proxy advisory firms to limit the resources they invest in a meaningless advisory vote.

Another critical factor is whether the voting issue affects shareholder welfare significantly. The evidence on say-on-pay suggests that executive compensation matters to shareholders. Other issues may be less significant for shareholders. Shareholders propose a number of corporate social responsibility changes through Exchange Act Rule 14a–8 at every annual meeting season. Many of these proposals garner few votes. Consequently, corporations often ignore the proposals. For example, between 1997 and 2012, corporate social responsibility issue proposals related to animal rights received an average of 4.99 percent votes in favor; none of the proposals received majority approval.[50]

With this background on shareholder voting in mind, we now turn to our proposal to allow shareholder voting on securities class actions. We argue that our voting scheme will engage shareholders much like say-on-pay votes. Unlike the experience with say-on-golden-parachute advisory votes, companies with a shareholder vote on securities class actions expect to remain in business. This expectation of repeated interactions makes it much more likely that, even if the votes are advisory, the managers will care about the voting outcome. We start with ex ante shareholder proposals that limit or modify all securities class actions for a particular firm. We then examine ex post shareholder proposals that continue or terminate a specific class action that has been filed.

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[50] *See* Caroline Flammer, *Does Corporate Social Responsibility Lead to Superior Financial Performance? A Regression Discontinuity Approach*, 61 MGMT. SCI. 2549, 2553 (2015).

B. Ex Ante Proposals

Our first class of shareholder voting proposals focus on whether—and on what terms—a particular firm should allow securities class actions in general. These determinations would be made prior to the filing of a specific class action. We refer to these as ex ante proposals.

We would allow shareholders to use the existing proxy proposal mechanism to make mandatory proposals to modify the use of securities class actions for enforcing Rule 10b–5. The proposals would be made binding on shareholders through amendments to the corporate charter or the bylaws.[51]

1. Shareholder Wealth Maximization and the Social Welfare Calculus

Shareholders as a group will have strong incentives to maximize the utility of securities class actions for shareholder value. Unlike federal district judges, shareholders have a direct financial interest in securities class actions. Shareholders will focus on their own wealth maximization in weighing the pros and cons of allowing securities class actions.

On the benefits side, the shareholders will consider the value of deterring fraud by their own firm. Reduced fraud lessens the risk to shareholders of purchasing overvalued (or selling undervalued) securities and will lead to more accurate corporate disclosures. More accurate disclosures also:

- promote increased market efficiency and more accurate securities prices;
- reduce uncertainties shareholders face when trading in securities, which may correlate with lower bid-ask spreads and increased market liquidity;[52]
- facilitate private capital market mechanisms, such as hostile takeovers, that discipline poorly performing managers and lead to better corporate financing and investment decisions.[53]

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[51] The Delaware Supreme Court recently held that a Delaware corporation can use its charter or bylaws to dictate the forum for federal securities litigation. *Salzberg v. Sciabacucchi*, 227 A.3d 102 (Del. 2020). *See generally* Dhruv Aggarwal et al., *Federal Forum Provisions and the Internal Affairs Doctrine*, 10 HARV. BUS. L. REV. 383 (2020).

[52] *See* Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 297, 312–13 (2009).

[53] *See id.* at 311; Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 335 (2009).

All of these benefits should be reflected in the firm's stock price. Particularly relevant here, more accurate corporate disclosures also promote more informed shareholder votes in general, including the election of directors, which, in turn, could improve the overall corporate governance of a firm.[54]

In terms of private costs, the shareholders will consider the corporation's expenses in defending class actions. Although initially borne by the company (and its liability insurers to the extent the defense costs do not exceed policy limits),[55] these costs will ultimately be borne by the shareholders.[56] Insurers will incorporate the expected costs of litigation in insurance premiums charged to the firm. Firms will pay the premiums from corporate assets thereby reducing shareholder value. Shareholders also will consider the harm to corporate value from indirect costs such as distraction of management and harm to the corporation's reputation. Other costs from allowing class actions include the ex ante chill on managerial risk-taking created by the possibility of litigation. Managers will tend to be conservative if decisions that do not pan out are met with second-guessing in the form of a securities class action. That second-guessing, of course, will be sharpened by hindsight.

Lastly, an important private cost of securities class actions flows from the potential settlement costs to the firm. Even if a liability insurer ultimately pays any settlement, the firm will bear the costs of the liability insurance premium which will reduce shareholder welfare. Shareholders, however, will also factor in the possibility that they may receive a payment as a member of a class action. To the extent that the settlement is being paid by the company, however, the payment will also decrease the value of their continued holdings. Much of the expected settlement payments, in other words, will likely be a wash from an ex ante perspective.[57] The net cost of a settlement to shareholders will come from the plaintiffs' attorneys' fees and expenses typically taken out of the settlement fund and transferred to the plaintiffs' attorneys. This net settlement cost will reflect the private costs to the plaintiffs of litigating the class action. Indirectly, shareholders will therefore consider the cost of class action

[54] *See* Fox, *supra* note 52, at 310–11.

[55] The largest settlements are typically paid by companies and not insurers. *See id.* at 306.

[56] Such damages have been referred to as circular for this reason. *See id.* at 303.

[57] This assumes, of course, that the fraction of the settlement payment an investor expects to receive is roughly equal to the fraction of her ownership of the company.

lawsuits, as measured by the attorneys' fees and other expenses, and potential benefits, represented by improved accuracy in security prices and other governance benefits.[58]

The private costs and benefits that shareholders internalize may not match the social costs and benefits of securities class actions. From a societal perspective, the value of a securities class action turns on the overall deterrence produced by such actions. The social benefit from reduced fraud and more accurate disclosures includes not only the benefit to shareholders of a specific firm, but also spillover benefits to other investors from an overall increase in the accuracy of disclosures and increased investor confidence in the capital markets. Non-shareholders may also benefit from more accurate securities prices.[59] The social costs will include not only the litigation costs to the shareholders of a specific firm, but also the costs to the court system of administering class actions, which will not be internalized by the shareholders.[60] That is, one group of shareholders' decision can potentially impose both positive and negative externalities on society.

Although there may be a divergence between private and social costs and benefits, we are skeptical that the gap is large. A shareholder with only one corporation in her portfolio will not care about spillover benefits from a general increase in investor confidence or more accurate securities prices. Such single-stock investors, however, are the rare exception rather than the rule. Institutional investors, such as mutual funds and pension funds, typically own diverse portfolios of securities and therefore will assess the benefits of securities fraud deterrence from a portfolio-wide perspective. Because institutional investors own the overwhelming majority of shares, giving them greater incentives to research voting issues than individual investors, they are more

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58 For our analysis, we assume that the plaintiffs' attorneys' fee and expense award from the settlement is directly related to the plaintiffs' attorneys' resources expended in litigating the class action. The award of plaintiffs' attorneys' fees and expenses usually comes out of the settlement award, typically as a percentage of the settlement award. For many circuits, at least in theory, the percentage award of the settlement amount must be supported by a lodestar calculation based on the multiplication of number of hours worked by a reasonable hourly rate for the work with a risk multiplier to compensate plaintiffs' attorneys for the chance that they will get no return if the case does not settle.

59 For a discussion of such spillover benefits, see Fox, *supra* note 52, at 317–18. More accurate disclosures may also help shareholders detect self-dealing and other types of conflict transactions. *See* Fisch, *supra* note 53, at 342.

60 *See* John C. Coffee Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1540 (2006) (noting that "securities class actions have averaged between 47% and 48% of all class actions pending in federal court" and that "they necessarily consume significant judicial resources").

likely to be the pivotal voters on ex ante securities class action proposals. In addition, although court administration costs are real, these costs are typically not borne by private actors, other than de minimis filing fees. Instead, they are part of the overall public good provided by the government. Society at large presumably benefits from maintaining an economy under the rule of law; funding such public goods through tax dollars is likely to be more efficient.[61]

One private benefit to some shareholders from a securities class action is compensation. Shareholders who are members of the class and thus stand to receive compensation for losses from fraud may view class actions as beneficial. From a social welfare perspective, however, compensation is zero sum at least in the short run. In the securities class action context, compensation will transfer money from those shareholders who remain as shareholders when compensation is paid (or at time the market anticipates compensation will be paid) to those shareholders who are members of the class who sold their shares prior to that time.

Despite the wedge compensation creates between shareholders' private benefits and social welfare, we believe that this divergence may be quite small for shareholders voting on ex ante class action proposals. First, payment is typically only pennies on the dollar for losses; many investors do not bother to even submit claims for class action settlements. Moreover, roughly half of the cases are dismissed with no compensation being paid. Second, shareholders making an ex ante decision on securities class actions may not know whether they will be the shareholder who will receive a transfer (if they are members of the class), or one who will pay a transfer (if they are not members of the class). For shareholders unable to predict whether they will be a net payor or payee, the expected value from the possibility of such a transfer is zero.

We therefore can proceed on the assumption that shareholder wealth maximization from ex ante shareholder voting on securities class actions will approximate social welfare maximization.

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[61] One private cost that is not a social cost is the possibility that more accurate disclosures by a firm may help their competitors. This cost is private because the cost to the firm of helping competitors is balanced out by the benefit to competitors. *See* Fox, *supra* note 52, at 317. The magnitude of such costs is unclear. Moreover, larger institutional investors with more votes will typically hold portfolios of many companies, including companies which are competitors in the same industry, and thus will internalize both the social costs and benefits from more accurate disclosures that assist competitors. Privately held firms are the exception, as they can free ride on disclosures by their publicly-held competitors.

Although not all social benefits and costs will be taken into account by shareholders, we believe that shareholders in the ex ante voting context will make decisions that will closely mirror the social optimum. We refer to this form of shareholder wealth maximization as the "second-best" social optimum. In case there is a material social benefit or cost that the shareholders do not consider in their ex ante voting decision, we can restrict the voting right to those shareholders who own a fraction of the firm that is roughly equal to their ownership of the diversified portfolio. As mentioned above, a single shareholder who has a concentrated ownership on a firm will not care *enough* about the spillover effects while shareholders whose ownership interest in other firms is much higher than that of the firm may care *too* much about the spillover effects. By restricting the voting rights to those with roughly equal ownership, we can get closer to the "first-best" solution that takes into account not only the effect on the firm but also the effect on the society at large.[62]

2. Types of Ex Ante Proposals

Shareholders of different firms may diverge in valuing securities class actions. Firms that are not typically targeted by plaintiffs' attorneys may have little incentive to change the existing regime. Other firms—biotech companies, for example—may face greater expected litigation costs.[63] Shareholders in such firms may find it wealth-increasing to cut off all such private causes of action. Alternatively, they may want to reduce their firms' potential exposure by limiting recovery to disgorgement of any benefit from the fraud.

We propose maintaining the existing regime as the default. Shareholders would be allowed to "self-tailor" their securities class action regime through ex ante voting. Shareholders could consider several types of ex ante proposals to modify Rule 10b–5 class actions. Shareholders may vote to eliminate Rule 10b–5 class actions altogether, eliminating the need for a company and its management to expend resources on such litigation. Dismissals in a securities class action can take years. For securities class actions filed between 2009 and 2017, less than 20 percent were

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[62] This issue about equating the ownership fractions will be discussed in more detail when we examine voting on ex post proposals in part C.

[63] *See* Aggarwal, *supra* note 51, at 400 (documenting how companies in more "vulnerable" industries are more likely to adopt a forum provision that requires a Securities Act lawsuit to be brought only in a federal court).

dismissed within one year of the filing date.[64] If shareholders believe that a significant number of securities class actions lack merit, then an ex ante blanket prohibition saves the company from the costs of defending unfounded litigation. In addition, management would be freed to make corporate decisions without fear of second-guessing in a class action by plaintiffs and judges who may suffer from hindsight bias. Blocking all class actions, of course, comes at the cost of eliminating the deterrence benefits of Rule 10b–5 class actions; the baby is thrown out with the bath water.

More narrowly, shareholders could limit recovery in securities class actions. Shareholders could opt for a disgorgement measure or place a cap on damages.[65] Both of these reforms would limit the pressure on firms to settle nuisance litigation to avoid even a low probability of paying outsized out-of-pocket damages in open market fraud cases.[66] Determining a generally optimal damages cap, which also applies to meritorious suits, is a daunting task. Regulators are bound to fail if they attempt to determine a damages cap that applies equally to all companies. Shareholders at a specific company, however, may have a better view on the optimal damages cap for that company. Armed with better information, shareholders can decide to adjust the cap when they believe that doing so would discourage meritless lawsuits from being filed while not unduly screening meritorious ones. Smaller damages shift the calculus for filing suit to focus on probability of recovery, that is, the likelihood that fraud occurred.

Instead of attempting to estimate the optimal damages, the shareholders could alter the compensation structure of class actions through fee-shifting. For instance, the shareholders can, ex ante, agree that the loser of the litigation will pay for the winner's litigation costs (for instance, attorney fees). This reform presumes that the plaintiff-shareholders (or, more realistically, the plaintiffs' attorneys) will have at least some information regarding the merit of the lawsuit at the time of filing. By implementing a loser-pays-all system, the shareholders can encourage more meritorious lawsuits to be filed while discouraging non-meritorious

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[64] *See* CORNERSTONE RSCH., SECURITIES CLASS ACTION FILINGS: 2018 YEAR IN REVIEW 17 (2019).

[65] A.C. Pritchard, Stoneridge Investment Partners v. Scientific-Atlanta*: The Political Economy of Securities Class Action Reform*, 2007–2008 CATO SUP. CT. REV. 217 (2008).

[66] *See* Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 660 (1996) (arguing for the "use [of] the civil penalty model in defining the maximum amount of recovery").

lawsuits from going forward.[67] When a plaintiff's attorney is aware that the case has little chance of winning in court, the fact that she will have to compensate the corporate defendant's litigation cost can work as a powerful deterrent against instituting suit. Conversely, when she believes that the suit has a strong merit but is concerned about having to expend a large amount of resources in prosecution, the fact that the expenses will be reimbursed by the corporation can bolster the incentive to file suit. Both incentives encourage accurate screening.

Another possibility is to tailor the forum in which shareholder-plaintiffs can bring suit. Currently, with respect to Rule 10b–5 (and other Exchange Act) lawsuits, plaintiffs can bring claims in any federal district court that has personal jurisdiction over the defendants, subject to the venue requirements of the Federal Rules of Civil Procedure. For a Securities Act claim, on the other hand, plaintiffs can choose to bring a claim in either a state or federal court.[68] There is no justification for these divergent rules, and the latter encourages forum shopping. With respect to both Exchange and Securities Act claims, perhaps the shareholders should be entitled to designate, ex ante, the forum in which a future plaintiff can file. For instance, for a corporation that is incorporated in Delaware and is headquartered in Northern California, by stipulating that a securities claim can be brought only in either the federal District of Delaware or the Northern District of California, the shareholders can better attempt to manage the cost of litigation. By doing so, the shareholders can also discourage future plaintiffs from inefficient forum-shopping.

A final option for shareholders would be to limit the scope of liability. Shareholders could remove liability for corporations while maintaining the exposure of corporate managers or intermediaries, such as auditors.[69] Alternatively, shareholders could limit actionable allegations to those which can more easily be verified through litigation, such as GAAP accounting violations, thereby screening out "event driven" class actions driven by

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[67] Albert H. Choi, *Fee-Shifting and Shareholder Litigation*, 104 VA. L. REV. 59 (2018) (arguing how symmetric, loser-pays-all fee-shifting can encourage meritorious lawsuits while discouraging non-meritorious ones).

[68] *See* Aggarwal et al., *supra* note 51.

[69] Commentators have argued for such a reform as a mandate for all firms. *See* Fox, *supra* note 52, at 321; *see also* Coffee, *supra* note 60, at 1538 (arguing that for deterrence, "the incidence of such damages should be shifted so they fall more on the culpable (and less on the innocent)"). Limiting recovery to disgorgement would push substantially in this direction. *See* Pritchard, *supra* note 65, at 38.

business reversals. In the same vein, shareholders could further limit suits involving forward-looking statements, expanding the existing safe harbor in Section 21E of the Exchange Act. Shareholders could vote to remove all private liability for forward-looking statements regardless of cautionary language. Depending on the specific context of the firm, these limits may help tailor Rule 10b–5 liability to promote deterrence while reducing nuisance suits.

Shareholder modifications to Rule 10b–5 class actions might go in the opposite direction. We can imagine shareholders choosing to expand liability or damages in certain situations. The present securities class action regime focuses actions on larger public company defendants, leaving a gap in enforcement against smaller companies.[70] Plaintiffs' attorneys face substantial fixed costs in litigating a securities class action, including the costs to draft and file a complaint, defend against a motion to dismiss, conduct discovery, and seek class certification. Moreover, attorneys' fees correlate with potential damages, leading plaintiffs' attorneys to target smaller issuers less frequently.

This bias against suing smaller issuers is exacerbated by the fraud on the market presumption of reliance. Under the current doctrine, plaintiffs' attorneys must demonstrate market efficiency to obtain the fraud on the market presumption for class certification. Market efficiency is easier to demonstrate for larger market capitalization issuers because they typically have greater trading volumes and are more widely-held by institutional investors. Consequently, larger firms are followed by more analysts and other information intermediaries.

Shareholders of smaller issuers who value deterrence could bolster the incentives of plaintiffs' attorneys by increasing the fraction of the settlement award that goes to attorneys' fees, a bounty scheme of sorts. Currently, there is a de facto cap of one-third of the settlement for attorneys' fees, which may discourage suits against smaller issuers. Shareholders could also modify Rule 10b–5 liability by adopting a presumption of reliance that does not require a showing of market efficiency to facilitate class actions against smaller market capitalization issuers. Both of these changes would encourage more litigation against smaller firms, a relatively under-enforced sector under the current regime. Altering the presumption of reliance would produce the

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[70] *See* Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1473–1474, 1480–1481 (2004).

collateral benefit of eliminating a costly issue for litigation that is only tangentially related to fraud.

To improve the accountability of plaintiffs' attorneys, shareholders could choose to provide incentives for objectors to settlements. Objectors could provide the monitoring of attorneys' fees requests that is lacking under the current regime. Ensuring that objectors receive a reasonable attorney's fee for their efforts on behalf of the class could help keep fee requests by class counsel in check.

Under our proposal, shareholders could self-tailor Rule 10b–5 for their firm's situation. Allowing shareholders to decide on securities class actions accommodates variation among companies in the benefits and costs of securities class actions outlined above. For example, if a company has a robust corporate compliance department with strong internal controls, then shareholders of that company might waive Rule 10b–5 class actions entirely. The goal is to limit the incidence of fraud; the optimal path to discouraging fraud may vary with firms' circumstances. Self-tailoring also allows shareholders to alter the regime as the firm's circumstances change. If a company's financials start to deteriorate, shareholders may worry that management has greater incentives to cook the books. Shareholders of a weakening firm may respond by voting to implement a more powerful securities class action regime, perhaps applying out-of-pocket damages in addition to disgorgement, to further discourage management misbehavior.

A substantial benefit of an ex ante voting regime is that it will promote learning over time. Companies adopting varying Rule 10b–5 regimes will serve as mini-laboratories of private ordering, providing information to the market on the efficacy of various reforms. That learning would promote more precise self-tailoring over time.

3. Shareholder Engagement in the Vote

Will shareholders individually expend resources to vote on class actions? Rational apathy is a worry. Research on voting is costly and borne individually, while the benefits of informed voting require collective effort and accrue to all shareholders. As a result, individual shareholders may free ride on the efforts of others and shirk on research. To the extent an individual shareholder rationally believes that her vote will not be pivotal, there is even less benefit to research because the specific shareholder's vote is unlikely to matter. Alternatively, some institutional shareholders may publicize their votes as a branding mechanism:

"We're tough on fraud." In this scenario, voting can be a form of "cheap talk." Thus, shareholders acting rationally as individuals may lead to collectively suboptimal investment in voting, or distorted votes.

The collective action and rational apathy problem can potentially be ameliorated. Shareholders can outsource voting research to a proxy advisory firm. Instead of conducting costly and time-consuming research themselves, shareholders can rely on recommendations from proxy advisors. Although this may mitigate the collective action and rational apathy problem, the discussion of say-on-golden-parachute voting above, however, raises the concern that there is a risk that proxy advisors may not devote substantial resources to determining the optimal securities class action policy for specific firms.[71] Instead, proxy advisory firms might adopt a one-size-fits-all policy for all firms or large subsets of firms. For example, proxy advisors might use rules of thumb like market capitalization and industry to determine which proposals to support rather than looking at a company's particular circumstances. Companies may vary, however, in their optimal regime, even within a particular sector. For example, a company with relatively new management that faces an uncertain business environment may benefit from not having to worry about plaintiffs' attorneys second guessing the management's decisions. Under these circumstances, a one-size-fits-all approach will impose a suboptimal uniformity on securities class action regimes, replicating one of the problems with the current regime.[72]

To help overcome the incentives for shareholders to remain passive, or use their vote as cheap talk, a critical aspect of our proposal is that shareholder class actions proposals should take the form of mandatory bylaw amendments. Making the vote mandatory raises the stakes of the vote, encouraging shareholders to pay more attention and consider the cost of their votes. In addition, the growing influence of institutional investors, activist shareholders, and engagement of proxy advisory firms on multiple different voting issues for firms, all point toward an informed shareholder vote on securities class actions. Proxy advisors will enjoy economies of scale in assessing securities class action proposals based on the advisor's experience with director elections, say-on-pay, and other proposals for the company. The rise of shareholder voting on multiple issues has also promoted a voting

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[71] *See* Choi et al., *supra* note 45, and the surrounding discussion.

[72] Of course, if the current default regime is generally suboptimal across the board, shifting to a new default regime can, at least in theory, improve welfare.

culture among institutional investors. That culture may encourage investors to pay more attention to a vote on securities class actions. We believe that voting on securities class action proposals will more closely resemble shareholder voting on say-on-pay proposals than voting on other company proposals. For say-on-pay, the available evidence suggests that at least in egregious cases shareholders become engaged and proxy advisory firms tailor their recommendations.[73]

Securities class actions potentially can impose large costs on firms, further increasing the likelihood of shareholder engagement while discouraging symbolic voting. In 2018, there were 403 new federal securities class action filings in the United States.[74] For U.S. exchange-listed companies, 4.5 percent faced a new federal securities class action filing; for S&P 500 firms, the number was 9.4 percent.[75] For those actions that settle, between 1996 and 2017, the mean settlement was $57.1 million.[76] That average conceals considerable variance: the largest settlement was $9 billion.[77]

Add to that the harder to quantify lost reputational capital and the cost of management distraction. In the SEC context, Jonathan Karpoff, D. Scott Lee, and Gerald Martin estimate that the reputational cost of an SEC enforcement action is over 7.5 times the sum of all direct legal penalties.[78] We expect that securities class actions impose a lesser, but non-negligible, reputational cost on firms.

4. Shareholder Ex Ante Incentives

Our analysis assumes that a shareholder voting on an ex ante proposal to modify the securities class action regime for a particular firm will not know whether the shareholder is more or less likely to be a member of a future class. Such a shareholder will have just as much chance to receive compensation, as a member of a future class, as to pay compensation indirectly as corporate assets are used to pay the compensation to the class (either directly or in the form of higher insurance premiums if liability

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[73] *See* Choi et al., *supra* note 45; Cotter et al., *supra* note 40.

[74] *See* CORNERSTONE RSCH., *supra* note 64, at 1.

[75] *See id.* at 2.

[76] *See* LAARNI T. BULAN ET AL., CORNERSTONE RSCH., SECURITIES CLASS ACTION SETTLEMENTS: 2018 REVIEW AND ANALYSIS 1 (2019).

[77] *Id.*

[78] *See* Jonathan M. Karpoff et al., *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANTITATIVE ANALYSIS 581, 600–01 (2008).

insurance covers the class payment). For this shareholder, compensation is a wash and not part of the ex ante calculus on how to vote.

It is possible that some shareholders may have knowledge that they are relatively more (or less) likely to receive net compensation from a future class. Individual investors may purchase shares once and then hold these shares over long periods of time. These individual investors may expect to receive less in compensation from securities class actions since they are unlikely to transact during the class period given their buy and hold strategy. Conversely, institutional investors are more likely to turn over their shares, leading to a greater likelihood compared to buy-and-hold investors that the institutional investors will be members of a future class and receive class compensation.

We conjecture that the pivotal voter in an ex ante shareholder vote is more likely to be an institutional investor. Institutional investors both own more shares than most individual investors and are more likely to vote their shares. Because institutional investors may expect to be more likely than buy-and-hold individual investors to be members of a future class, the institutional investors may have a bias toward expanding securities class action liability, implicitly benefiting from the subsidy from the buy-and-hold investors who are net payors of class compensation.

Nonetheless, as discussed above, compensation is typically pennies on the dollar in a securities class action. We are therefore uncertain how great a bias there will be for institutional investors. If bias is significant, one could limit the ability of shareholders to modify the securities class action regime to only modifications that reduce the regime from the present status quo and not allow any expansions of liability. In cases where the downsides of class actions outweigh the expected benefits to institutional investors from this bias, our proposal would allow institutional investors to reduce or eliminate the securities class action regime for a particular company ex ante.

5. Legal Barriers and the Path to Reform

What legal barriers currently obstruct shareholders seeking to modify the securities class action regime through charter or bylaw amendments? Pursuant to Rule 14a–8 of the Securities Exchange Act, shareholders have the right to include certain voting issues on the management's own proxy statement, but the rule

limits the range of proposals.[79] Relevant here, Rule 14a–8(i)(2) allows companies to exclude proposals that would cause the company to violate federal law.[80]

A proposal that restricts the ability of investors to bring a Rule 10b–5 suit could be construed as interfering with the policies of the federal securities laws. The SEC staff has given no-action relief to a company seeking to exclude a shareholder proposal to limit damages in Rule 10b–5 fraud-on-the-market class actions.[81] If courts agree with the SEC staff, then companies could exclude a fraud-on-the-market shareholder proposal pursuant to Rule 14a–8(i)(2). It may therefore require either the SEC or Congress to clarify that waivers and modifications of private Rule 10b–5 liability by shareholders would be consistent with the underlying policy objectives of the federal securities laws. Specifically, empowering shareholders to tailor their own class action regime furthers both investor protection and capital formation. In the context of securities class actions, we believe investors are best placed to choose the protections that will most efficiently protect them. The SEC and Congress should defer to these choices by shareholders.

6. Closing Thoughts on the Ex Ante Approach

If shareholders vote against proposals to adopt a tailored securities class action regime, the existing regime would remain as the default. Inertia preserves the status quo, but shareholder voting does not have to be perfect to improve on the current regime. If a proposal is made and shareholders are not inclined to research, they may simply vote no. Even if shareholders vote only based on partial or imperfect information to modify the securities class action regime, we believe that shareholder voting would nonetheless improve on the inexpert decisions of judges attempting to reform Rule 10b–5. It is also likely that there will be a suboptimal level of diversity in class actions regimes under our proposal due to proxy advisory firms economizing on research. Even so, this diversity would better approximate what shareholders prefer with regard to their securities class actions regime relative to the current one-size-fits-all approach. To the extent shareholders adopt varying securities class action regimes,

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79 *See, e.g.*, 17 C.F.R. § 240.14a–8 (2022).

80 *Id.* at § 240.14a–8(i)(2).

81 Alaska Air Grp., Inc., SEC Staff No-Action Letter, 2009 SEC No-Act. LEXIS 254 (Mar. 5, 2009).

learning about the value of these different regimes will further inform shareholders and proxy advisory firms.

One other benefit of our proposal relates to political economy. The main opposition to our proposal is likely to come from the plaintiffs' bar, which benefits from the existing regime. Promoting diversity among firms in procedures and damages for securities class actions while maintaining the existing regime as the default undercuts that opposition. The plaintiffs' bar will have a harder time lobbying against our proposal relative to one-size-fits-all legislative reform proposals, such as damages caps, that reduce or limit all securities class actions for all firms. Self-tailoring is less apt to be over-inclusive in its reforms.

Plaintiffs' attorneys style themselves as shareholder advocates; who are they to oppose shareholder empowerment when it comes to class actions? Plaintiffs' attorneys may also benefit from our regime in certain circumstances. If experimentation demonstrates the value of securities class actions and some shareholders vote for ex ante modifications that expand securities class action liability, then the plaintiffs' bar will profit from a larger range of targets, albeit with less potential for mega-settlements.

Another important feature of ex ante shareholder control over securities class actions is it establishes a single, certain rule for all securities class actions against a particular company. That clarity allows shareholders to price in the value of deterrence and the cost of potential nuisance suits from the regime chosen by shareholders. That pricing mechanism provides valuable information to the shareholders of other companies.

An ex ante approach, however, even if tailored to a specific company, also carries costs. The ex ante approach treats all possible actions against that company the same—either allowing or blocking them regardless of the suit's merits. Even a company that poses a low ex ante risk of fraud may release misleading disclosures that harm investors. If the shareholders have previously voted to eliminate all Rule 10b–5 class actions under the ex ante approach, investors would be unable to bring a suit even in an egregious case. Only the SEC would be left to enforce the securities laws against the company and its officers and directors. Thus, the ex ante approach creates space for moral hazard. The SEC is limited in its ability to detect and enforce securities law violations, so opportunistic managers may face fewer constraints in issuing misleading disclosures if shareholders substantially reduce private Rule 10b–5 liability. Even companies that pose a low

ex ante risk of fraud may pose a greater risk if they eliminate all securities class actions.

In the next section we discuss an ex post alternative for shareholder voting on class actions. Under an ex post regime, instead of deciding on an across-the-board approach for a specific company, shareholders would assess each class action after it was filed. This would allow shareholders to assess the merits of the filed class action and its cost and benefits.

C. Ex Post Proposals

Instead of deciding in advance to regulate all securities class actions for a specific firm, investors under an ex post approach would decide after the filing of a specific class action whether to continue or terminate it. An ex post approach potentially allows shareholders to block specific litigation when the expected costs outweigh the expected benefits. We anticipate this approach would be particularly effective in stopping nuisance litigation. For example, shareholders would be likely to vote against "deal tax" suits filed in most mergers and acquisitions. As with our ex ante proposals, we would keep the existing regime as the default for ex post proposals. Because securities market participants are already familiar with the existing regime, this default will minimize disruption and uncertainty in the market.

Unlike our ex ante proposals, which contemplate both reductions and expansions of the existing securities class action regime, our proposed ex post shareholder vote would do only one thing—terminate the securities class action—the most drastic form of reduction to the regime for a given class action. In particular, we would allow shareholders to use the management's proxy statement for the annual meeting to propose terminating a class action as a shareholder proposal under Rule 14a–8.[82] Thus, shareholders would be allowed to make a proposal to their fellow shareholders to terminate a securities class action after its filing. If no proposal is made or the proposal does not pass the requisite threshold, the class action would continue. To avoid repeated disruption to an ongoing class action, only one vote would be allowed per suit. If more than one shareholder proposal to terminate a specific class action is received, management could reject

[82] As we discuss above, the SEC or Congress may need to intervene to clarify that shareholder proposals to terminate a class action under Rule 14a–8 are consistent with the objectives of the securities laws.

substantially similar proposals. This approach is consistent with the current shareholder proposal regime.[83]

As with ex ante proposals on class actions, the vote would be binding to increase the incentives of investors to vote and proxy advisory firms to evaluate the securities class action. Shareholders that do not focus on an abstract proposal to limit class actions generally, might pay attention to a vote for a specific class action. Likewise, with more at stake and shareholders engaged, proxy advisory firms will have an incentive to research class-action specific recommendations for the vote, leading to more informed votes.

A mandatory vote would also reduce the role of judges. If the shareholders vote goes against the class action, then a judge need not assess the merits of the case. Judges lack expertise in assessing the business aspects of the securities law violation, so shareholders may be better equipped to make an informed decision.

We now sketch the basic features of our proposal for ex post shareholder voting to terminate a securities class action: eligibility, voting thresholds, timing of the vote, and required disclosure. As we detail below, our proposal involves balancing different considerations, which may vary among companies. Our framework is merely offered as a starting point for the procedures shareholders may desire in an ex post shareholder vote to terminate a securities class action.

1. Who Should Vote and At What Vote Threshold

A filed securities class action carries with it a defined class, typically investors who transacted during the class period. Only class members receive compensation from the securities class action. If the shareholders who transact during the class period differ from the shareholders at the time of a vote on termination, this raises a question of who should be entitled to vote whether to terminate the securities class action. For simplicity, we focus here on the typical case of frauds that overvalue shares. We also assume that the corrective disclosure occurs at the end of the class period.

One approach would be to try to match votes with the financial interest in the recovery for each member of the class. This would require identifying the shareholders who purchased during the class period, the amounts they purchased, and whether they

[83] *See* 17 C.F.R. § 240.14a–8 (2022).

held the shares until the end of the class period. To be eligible to vote, each class member would have to document their securities transactions in the class period.[84] Assembling and verifying the accuracy of these records would take some effort on the part of potential class members, which suggests many investors may simply forego voting.

Technology may reduce these administrative costs. For instance, if share ownership moves toward a blockchain structure, a computerized protocol could determine which investors bought during the class period and the extent of their losses at the time they sold. Alternatively, if they still hold their securities, their losses could be calculated based on the price on the date immediately following the corrective disclosures. Votes could be assigned in proportion to losses.

Such a procedure for allocating votes would be complicated. Moreover, shareholder losses from fraud do not correspond with social losses. Rather than focus on shareholders purchasing during the class period, we argue for a different method of assigning votes. Instead of trying to match votes with losses, our procedure allocates votes based on the underlying social welfare objectives of the securities class action system.[85] If we take shareholder wealth maximization as our goal, which as we argue above results in a second-best social optimum, then much of the same analysis for ex ante shareholder voting applies in the ex post context.

We start by considering varying scenarios involving shareholders that transacted in the class period and owned shares at the time of the vote on the class action. We assume that those shareholders who purchased during the class period and held the shares to the end of the class period are eligible for damages under Rule 10b–5. To assess the different scenarios, we compare the incentives of damages-eligible shareholders with those of shareholders voting on an ex ante class action proposal. Recall that shareholders voting on an ex ante proposal take into account: (1) the deterrence value of the class action, including benefits from more accurate securities prices for the specific firm; and (2) the costs of litigating the class action (both defendants' direct and indirect costs and, through the expected settlement, the plaintiffs'

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84 Shareholders who purchased during the class period but prior to any corrective disclosure would not ordinarily suffer loss due to fraud.

85 Our approach mirrors that of others who have sought to determine the appropriate justification for securities class actions and moved away from focusing on the narrow harm to only those investors who trade securities the values of which have been affected by fraud. *See* Fisch, *supra* note 53, at 335.

direct costs). They do not take into account compensation, which is a wash ex ante. This cost-benefit shareholder wealth maximization calculus approximates the social welfare calculus, the second-best social optimum.

To simplify the analysis, consider the following starting point. Assume *all* of the shares outstanding of a corporate defendant in a securities class action are purchased during the class period by a single shareholder and then held until after the corrective disclosure date. Moreover, the single shareholder holds all the shares until the date of the vote to terminate the class action. Also assume that the corporation does not have D&O insurance. In this situation, compensation is a wash—the single shareholder on the date of the vote will weigh both the compensation it will receive for its purchases and the reduction in its share value resulting from the corporation paying the compensation. In the aggregate, the reduction in the corporation's value from paying the compensation will exactly equal the compensation paid.[86] The single shareholder will thus consider only: (1) the deterrence value;[87] and (2) the costs to both the defendant corporation and to the plaintiffs of litigation, similar to shareholders in ex ante voting. Giving the vote to the single shareholder will empower a

[86] D&O insurance complicates the analysis, but only to a degree. The single stockholder might want to tap the proceeds of the D&O policy but would bear the cost of increased premia thereafter.

[87] One issue with ex post voting is that a shareholder faced with a specific class action will underweight the deterrence value from the action. The fraud will likely have already stopped by the time of the action. Deterrence value, if any, will come from the impact on the incentive of corporate managers and others to commit *future* fraud. A shareholder that will continue to hold shares in a company will have an incentive to develop a reputation as a fraud enforcer, or send a credible signal of future enforcement, by voting in favor of meritorious actions. Such a reputation or a credible signal will lead managers and others at the company to consider the possibility of a class action if they commit fraud in the future.

Another deterrence factor for a shareholder to consider when voting on whether to terminate a specific action derives from the cost structure of plaintiffs' attorney firms. Bigger plaintiffs' attorney firms enjoy economies of scale and may be able to spread the fixed cost of monitoring the market for fraud. In addition, bigger firms may also enjoy cost advantages from having attorneys specialize in specific aspects of litigation. If shareholders vote to terminate a suit, this will reduce the overall number of suits available to plaintiffs' attorney firms. Over time, firms will respond by decreasing their number of attorneys as well as investments in monitoring, reducing scale economies. Deterrence could suffer as a result. Alternatively, the plaintiffs' attorney industry may become more concentrated as the overall number of suits drops, leading possibly to higher fees that increase the cost of a class action to shareholders, making some otherwise meritorious class actions no longer cost justified. To the extent the shareholder holds a diversified portfolio of securities covering the public market, the shareholder will internalize the reduction in share value across all public firms generally from the reduced deterrence from fewer actions brought by plaintiffs' attorney firms.

shareholder who will make decisions according to the second-best socially optimal incentives.

Now consider the situation in which the shares outstanding are purchased by multiple shareholders at different times. Who should be allowed to vote on whether to allow the litigation to proceed when shareholders' interests diverge? To aid our analysis, let's start with some notations. Suppose the main issue in question is whether to terminate or continue the class action, and if the class action were to continue, the company can expect to pay D either as settlement or as damages at trial. Letting the class action continue imposes a cost of C on the company. We will assume that C is aggregate, in that, it includes not only the direct cost of litigation (such as the compensation for the lawyers), but also other non-litigation costs, such as the directors' and officers' time diverted from managing the company. Without the litigation, on the other hand, the (market) value of the company is equal to V.

On the benefits side of the ledger, we can imagine that allowing the litigation to go forward will generate two potential benefits: one firm-specific and the other market-wide. If the class action were to continue, suppose the future shareholders of the company would get the benefit of B_1. If there indeed was wrongdoing, allowing the litigation to go forward can deter management from making fraudulent statements in the future. On the other hand, if there was no fraud and the lawsuit is without merit, letting the litigation go forward could potentially generate a net cost for the company. In other words, B_1 can be positive, negative, or zero. In addition to the firm-specific benefit, the capital market could also receive some benefit when the class action proceeds. Let B_2 represent the benefit that can accrue to the entire financial market (excluding the company). We can imagine that letting a meritorious case go forward can build more confidence among investors that the legal system is deterring future fraud at other companies. Or, perhaps, allowing the case to go to judgment could clarify some uncertain areas of the securities law. Just like firm-specific deterrence benefit, market-wide benefit could also be negative if the overall deterrence effect of class actions is reduced by the possibility of frivolous litigation. Table 1 shows the relevant costs and benefits parameters.

Expected Class Action Payment by Corporation (either settlement or judgment)	$D > 0$
Firm-Specific Benefits from Lawsuit	$B_1 \gtreqless 0$
Market-Wide Benefits from Lawsuit	$B_2 \gtreqless 0$
Litigation Cost (legal and non-legal)	$C > 0$

Table 1: Lawsuit Characteristics

From the social welfare perspective, the lawsuit should proceed when the aggregate (deterrence) benefit is larger than the aggregate cost of litigation. Furthermore, given that the company's payment, either as part of settlement or as judgment, is a wash from the social welfare perspective, the expected payment by the company should be completely discounted. In short, from the social welfare perspective, the class action should go forward if $B_1 + B_2 > C$, whereas the class action should be terminated if $B_1 + B_2 < C$. As a matter of convenience, let's assume that the lawsuit should not go forward when the aggregate benefits are exactly equal to the aggregate costs: $B_1 + B_2 = C$.

With this social welfare benchmark in place, will a shareholder have the right incentive to vote on allowing the lawsuit to proceed? To analyze this problem, we examine a shareholder's financial incentive. We can let a shareholder's financial interest be governed by three parameters. First, suppose a shareholder is entitled to receive α fraction of the payment (either from settlement or judgment) that the company will make to the plaintiff class. This fraction can be anywhere between zero and one: $\alpha \in [0,1]$. The special case of $\alpha = 0$ can be thought of as the shareholder having no standing, because she did not make any transaction during the class period or made a transaction that is not eligible for recovery. Second, at the time that the decision over the litigation is to be made, suppose a shareholder owns β fraction of the outstanding shares of the company. Just like the first parameter, this can also be anywhere between zero and one. Third, and finally, with respect to the rest of the financial market, suppose a shareholder owns γ fraction of the market. So, for instance, if a shareholder is well diversified and owns 1 percent of the rest of the financial market, we get $\gamma = 0.01$. In short, we can represent

a shareholder's interest in the lawsuit, the firm, and the market as being represented by three symbols: (α, β, γ).

Fraction of the Payment the Shareholder is Entitled to	$\alpha \in [0,1]$
Fraction of the Outstanding Shares of the Firm the Shareholder Owns	$\beta \in [0,1]$
Fraction of the Rest of the Financial Market that the Shareholder Owns	$\gamma \in [0,1]$

Table 2: Shareholder Characteristics

Now, let's examine how a shareholder with (α, β, γ) interest would be inclined to vote with respect to a lawsuit. If the lawsuit against the firm were to proceed, the shareholder's return is given by:

$$\alpha \cdot D + \beta \cdot (B_1 - D - C) + \gamma \cdot B_2$$

The first term, $\alpha \cdot D$, represents the fact that the shareholder is entitled to receive α fraction of the company's expected payment. The second expression, $\beta \cdot (B_1 - D - C)$, represents the change in the (market) value of the shareholder's holding of the company. Inside the parentheses there are three terms, and they show that the company's value will increase by the firm-specific (deterrence) benefit of B_1 but will decrease by the amount of payment (D) and the aggregate cost of litigation (C). The last term, $\gamma \cdot B_2$, represents the shareholder's fractional interest from general, market-wide benefit from the lawsuit.

The shareholder will vote in favor of letting the class action proceed when the shareholder's return is greater than zero:

$$\alpha \cdot D + \beta \cdot (B_1 - D - C) + \gamma \cdot B_2 > 0$$

When we rearrange the expression, we get:

$$(\alpha - \beta) \cdot D + (\beta \cdot B_1 + \gamma \cdot B_2) - \beta \cdot C > 0$$

The first term, $(\alpha - \beta) \cdot D$, represents the net return for the shareholder from the company's damages payment: when the company pays D, the shareholder receives $\alpha \cdot D$ but the value of her shares in the company decreases by $\beta \cdot D$. The second set of terms, $(\beta \cdot B_1 + \gamma \cdot B_2)$, represents the shareholder's respective shares of firm-specific and market-wide (deterrence) benefit. When the lawsuit generates a (positive or negative) firm-specific and market-wide benefit of B_1 and B_2, respectively, the shareholder gets β and γ fractions of the respective benefits. The third term, $\beta \cdot C$, represents the shareholder's share of the firm's

aggregate litigation cost. As the firm value decreases by C, the value of her shares decreases by $\beta \cdot C$.

If we recall that the socially optimal decision is to allow the litigation to go forward when $B_1 + B_2 > C$, we can see that the shareholder's incentive is synchronized with the social welfare objective when:

$$\alpha = \beta = \gamma$$

With $\alpha = \beta = \gamma$, the shareholder will vote in favor of allowing the litigation to go forward only when

$$\beta \cdot (B_1 + B_2 - C) > 0$$

This inequality is satisfied when $B_1 + B_2 - C > 0$. Why does having $\alpha = \beta = \gamma$ harmonize the shareholder's incentive with social welfare objective? By having the first equality, $\alpha = \beta$, the shareholder is indifferent with respect to the company's damages payment ($(\alpha - \beta) \cdot D = 0$). This is optimal since, from the social welfare perspective, the damages payment by the company, from the ex post perspective, is a zero sum transfer and is welfare-neutral. When $\alpha > \beta$, so that the shareholder's share of damages is larger than the shareholder's current ownership of the company, the shareholder would be, holding everything else constant, inclined to vote in favor of allowing the lawsuit to proceed even though this may be inefficient. The opposite incentive results when $\alpha < \beta$: the shareholder would be too hostile to the lawsuit even though the lawsuit can add value to the company and the financial market.

Second, when the shareholder's fractional ownership of the company is the same as that of the rest of the financial market, i.e., $\beta = \gamma$, the shareholder will value the firm-specific deterrence value and cost at the equal rate as the value of market-wide deterrence. When $\beta > \gamma$, the shareholder values the firm-specific benefit and cost more than the market-wide benefit. So, for instance, when the litigation is quite costly ($C \gg 0$) but the market-wide benefit is also large ($B_2 \gg 0$), a shareholder with $\beta > \gamma$ will care much more about the former than the latter and would be inclined to vote to terminate the lawsuit, even though letting the lawsuit proceed can be socially optimal.

Combining these two equalities, what does it mean for a shareholder to have $\alpha = \beta = \gamma$? The equality $\beta = \gamma$ means that the shareholder's fractional ownership of the company is the same as the shareholder's fractional ownership of the "market." This will be an investor that holds a fully diversified portfolio with roughly the same fractional ownership of companies across the entire market. At the same time, the equality $\alpha = \beta$ requires that the

fraction of the damages that the shareholder is entitled to is the same as the shareholder's current fractional ownership. If the equality of $\beta = \gamma$ represents the degree of diversification, the equality of $\alpha = \beta$ measures the relative degree with which a shareholder cares about receiving class damages as opposed to paying class damages (indirectly through the corporation).

If a shareholder were purely passive and does not increase her ownership of the company's shares in response to an (potentially fraudulent) increase in share price, the shareholder will not have standing in the lawsuit and will not be entitled to receive any damages: $\alpha = 0 < \beta$. Such a shareholder will want to minimize class damages. In other words, $(\alpha - \beta) \cdot D < 0$. If the shareholder's responsiveness relative to the rest of the market to new information on a company is roughly proportionate the shareholder's ownership of the company's shares, one can imagine that the fraction of damages that the shareholder is entitled to is roughly equal to the shareholder's long-term fractional ownership: $\alpha \approx \beta$. Such a shareholder will be indifferent to receiving or paying class damages (although will care about the portion of damages used to pay attorney fees and expenses). This follows from the result $(\alpha - \beta) \cdot D = 0$. Lastly, some shareholders will purchase shares during the class period such that the shareholders' fraction of damages from the class exceed the fraction of shares that the shareholders own by the time of a vote on the class period. For example, a shareholder may purchase during the class period and then sell most of their shares prior to the shareholder vote. In this situation, $\alpha > \beta$. These shareholders will care more about receiving payment through class damages than the cost to the company of making such payment. In our framework, $(\alpha - \beta) \cdot D > 0$.

It will be the rare company where all the shareholders meet the condition that $\alpha = \beta = \gamma$. Nonetheless, we posit that there will be scenarios where certain subsets of shareholders, often the likely pivotal votes in our proposal, will have incentives that come close to the social optimal.

Consider a company with many shareholders. For this analysis, assume for now that B_2, the benefit to other firms from deterrence, is equal to 0. In this case, the social optimum will be to allow litigation if:

$$(B_1 - C) > 0$$

Now consider a particular shareholder. Whether the prospect of compensation will cause this shareholder to consider compensation a net positive or negative depends on the shareholder's

comparison of α, the fraction of shares the shareholder purchased during the class period relative to all other shares purchased during the class period that are eligible for damages, with β, the fraction of shares outstanding that the shareholder owns at the time damages are imposed on the firm (or the market expects damages to be imposed on the firm). This then gives us three possible groups of shareholders:

Group #1: $\alpha < \beta$

Imagine that a shareholder owns 10 percent of the outstanding shares prior to the class period. During the class period, she purchases 1,000 shares, holds onto these shares until the corrective disclosure, and then sells the 1,000 shares at a loss. These 1,000 shares represent 1 percent of the shares eligible for damages (i.e., $\alpha = 0.01$). By the time of the vote, the shareholder owns 11 percent of the shares, having purchased additional shares after the end of the class period (i.e., $\beta = 0.11$). In this case, she will receive 1 percent of any compensation but bear 11 percent of the cost. The shareholder will consider not only: (a) the deterrent value to the firm (B_1), and (b) the costs of litigation (C), but also (c) the net cost to her of compensation paid to the class. Put another way, for this particular shareholder litigation is value-increasing if:

$$-0.10 \cdot D + 0.11 \cdot (B_1 - C) > 0$$

Compared with the second-best social optimum decision-maker, the shareholder in Group #1 will have excessive incentives to terminate the class action, due to the net cost of paying compensation to other shareholders from the litigation (as given by $-0.10 \cdot D$).

An extreme example of Group #1 is the investor who owns significant numbers of shares prior to the class period, purchases no shares during the class period, and continues to hold significant numbers of shares at the time of the vote. This prototypical buy-and-hold shareholder will receive zero recovery from the class action and accordingly view compensation as a pure loss. Another extreme example of Group #1 would be an investor who does not own any shares until after the class period and then holds these shares at the time of the vote (i.e., $\alpha = 0$ and $\beta > 0$).

Group #2: $\alpha = \beta$

Imagine that a shareholder owns 2 percent of the outstanding shares prior to the class period. During the class period, she purchases 20,000 shares and holds onto these shares until the end of the class period. These 20,000 shares represent 2 percent of the shares eligible for damages (i.e., $\alpha = 0.02$). The shareholder sells

the 20,000 shares after the corrective disclosure but prior to the vote, leaving her with 2 percent of the outstanding shares at the time of the vote (i.e., $\beta = 0.02$). In this case, she will receive 2 percent of any compensation and will experience an equivalent drop in its share value. Compensation for this shareholder is a wash. The shareholder, much like the single shareholder above, will consider only: (a) deterrent value, and (b) the costs of litigation. Put another way, for this particular shareholder litigation is value-increasing if:

$$0.02 \cdot (B_1 - C) > 0$$

The shareholder in Group #2 will have the same incentives as the second-best socially optimal decision-maker.

Group #3: $\alpha > \beta$

Imagine that a shareholder owns 1 percent of the outstanding shares prior to the class period. During the class period, she purchases 50,000 shares and holds onto these shares until the end of the class period. These 50,000 shares represent 5 percent of the shares eligible for damages (i.e., $\alpha = 0.05$). The shareholder sells the 50,000 shares prior to the vote, leaving her with 1 percent of the outstanding shares at the time of the vote (i.e., $\beta = 0.01$). In this case, she will receive 5 percent of any compensation and will experience a drop in its share value equal to the 1 percent of the compensation paid. The shareholder will view compensation as a positive. In weighing the deterrence value of a securities class action against the costs of litigation, the shareholder will favor allowing a class action to the extent of any expected compensation.

$$0.04 \cdot D + 0.01 \cdot (B_1 - C) > 0$$

This shareholder will have insufficient incentives to terminate a class action compared with the second-best social optimum. Compared with the social optimum, the shareholder will consider the $0.04 \cdot D$ net benefit that the shareholder will derive from securities class action damage; that is a private, not social, benefit.

An extreme example of Group #3 is the investor who owns no shares prior to the class period, purchases shares during the class period, holds until the end of the class period, and then sells all her shares before the date of the vote (i.e., $\alpha > 0$ and $\beta = 0$). In this case, the investor will consider only the prospect of compensation, and nothing else, in voting.

Given these groups, who should vote? The tradeoff is between creating a voter base that approaches the same incentives as the second-best socially optimal decision-maker and the difficulty in identifying such voters where $\alpha = \beta$. Indeed, even if $\alpha = \beta$

precisely, γ, the proportional interest in the rest of the market, may differ. It may be that no single shareholder meets the criteria that $\alpha = \beta = \gamma$. Nonetheless, it is possible to fashion a voting rule that does better than the current system that leaves it to a judge to determine whether a specific class action goes forward.

Imagine that it is possible to identify at reasonable costs the number of shares purchased during the class that are held until after the end of the class period (and thus those shares potentially eligible for damages) and the ownership of shares on the date of the vote. If one could identify α and β for each shareholder at little or no cost, one could simply have Group #2 shareholders vote on whether to terminate a securities class action (the "first option"). However, in any given securities class action, there may not be any shareholders for whom α precisely is equal to β. Moreover, identification of α and β for each shareholder at the time of the vote may not be possible even with information on class period trades and ownership at the time of the vote. Not all shares purchased during the class period and held until the end of the class period will be eligible for damages. For example, some investors may not have relied on the alleged misstatements at issue in the litigation, making an α calculated based on shares purchased in the class period and held to the end of the class period too high. Other investors may fail to submit a claim form for damages, leading the α calculated based on shares purchased in the class period and held to the end of the class period to be too high for such investors and too low for those investors that do submit claim forms (to the extent the pool of settlement money is re-allocated to investors that submit claim forms).

2. A Modified Voting Rule

Given some indeterminacy in computing α and β, even with information on shares purchased during the class that are held until after the end of the class and the ownership of shares on the date of the vote, what voting rule makes sense? We propose the following rule (our "first option"): votes should be allocated in proportion to the shares purchased in the class period and still held at the time of the vote.

Imagine that three investors each purchase 100 shares in a defendant company during the class period. Investor A sells all 100 shares immediately after the corrective disclosure date. Investor B sells 50 shares immediately after the corrective disclosure date and holds 50 shares as of the date of the vote on the securities class action which occurs several months after the

corrective disclosure date. Investor C holds onto all 100 shares up to the date of the vote. Although each investor in our example would potentially receive the same recovery from the class action based on their 100 shares purchased in the class period and held until after the corrective disclosure date, the investors would receive different votes under our proposal. Investor A would receive 0 votes, Investor B would receive 50 votes, and Investor C would receive 100 votes.

Although under our rule there will be a mix of investors under Groups #1 through #3 voting, the extremes in this distribution are eliminated. Our rule eliminates shareholders who own shares at the time of the vote but did not purchase shares in the class period (the buy-and-hold investors). These shareholders have no shares eligible for damages. Such investors, as discussed above in Group #1, will have sub-optimally *high* incentives to terminate the class action because they disproportionately bear the costs of compensating the class period investors. They themselves are not eligible for damages since they did not purchase during the class period.

At the other extreme, our rule eliminates shareholders who purchased in the class period and then sold all their shares prior to the time of the vote. Consider an investor who purchased shares in the class period, held until the end of the class period, and then sold all her shares before the vote. This is the extreme investor in Group #3 where $\alpha > 0$ and $\beta = 0$. This investor will have sub-optimally *low* incentives to terminate the class action and instead will want the class action to go forward solely to get compensation without regard to deterrence or litigation costs. Requiring that investors continue to hold the shares purchased in the class period until the time of the vote will give this investor zero votes.

Under our rule, we are left with a mix of shareholders that fit Groups #1 through #3, all of whom have at least some shares that are eligible for damages and some share ownership at the time of the vote. These shareholders will at least partially weigh the effect of compensation against the deterrence value and the costs of litigating.

Of course, a mix of shareholders with both too high and too low incentives to terminate a class action may not precisely duplicate the vote of a second-best socially optimal decisionmaker. A large fraction of investors will be buy-and-hold investors who purchased some but not many shares during the class period, entitling them to a lower fraction of damages relative to their overall

fractional ownership interest (Group #1). This group is likely to be predominantly individual investors and index funds. Both of these groups tend to have low turnover. Our rule would nonetheless reduce the voting power of such investors down to only those shares purchased during the class and held at the time of the vote. So if a buy-and-hold investor purchased just one share in the class period and still holds this share at the time of the vote the investor would have only one vote.

If individual buy-and-hold investors are left with few votes under our proposal, who gets the majority of votes and thus are likely to be the pivotal voters? We conjecture that for most publicly traded corporations, votes will go primarily to institutional investors that are disproportionally in Groups #2 and #3 because such institutional investors will systematically trade more than individuals and index funds in the class period and thus obtain a greater fraction of the class damages relative to the buy-and-hold investors.[88] We posit the for most institutional investors $\alpha > 0$ (they purchase in the class period), $\beta > 0$ (they retain ownership at the time of the vote), and $\alpha \geq \beta$.

Why is $\alpha \geq \beta$ for most active institutional investors? Recall that α is the relative fraction of class action damages an investor can expect. The amount of class action damages in turn will turn on the amount of trading an investor does during the class period relative to other investors. In response to fraud that overstates the value of shares, damages will depend on purchases in the class period during which the shares are overvalued.

We think that many institutional shareholders will approximate shareholders in Group #2 and thus will vote close to the second-best social optimum. We conjecture that for active institutional investors, the investor's responsiveness relative to the rest of the market to new information on a company is roughly proportionate the shareholder's ownership of the company's shares. An institutional investor with a significant fraction of shares in the company will pay more attention to news related to that company. When the company puts out fraudulent information overstating the value of its shares, the institutional investor with significant ownership, without knowing of the fraud, will be more likely compared to other investors to purchase shares in response to the information. As a result, one can imagine that the fraction of

[88] *See* Coffee, *supra* note 60, at 1560 (noting that "securities class actions seem likely to transfer wealth systematically from 'buy and hold' investors (who bought on average outside the class period) to more rapidly trading investors (who purchase on average within the class period)").

damages that the shareholder is entitled to is roughly proportional to the shareholder's long-term fractional ownership: $\alpha \approx \beta$. Such a shareholder will be indifferent to receiving or paying class damages (although will care about the portion of damages used to pay attorney fees and expenses). This follows from the result $(\alpha - \beta) \cdot D = 0$.

It may be that some institutional investors will react to new information and make purchases in the class period that results in a greater fraction of damages relative to their existing share ownership fraction. This is particularly the case for companies with more passive investors, which will result in a higher α for all other shareholders that do transact in response to fraudulent disclosure. For such investors, the relative amount they purchase in response to fraudulent information may exceed their share ownership, leading $\alpha > \beta$. Suppose a company has two shareholders with 50 percent share ownership each. Only one shareholder purchases shares in the class period, suppose from the company. For this one shareholder $\alpha = 1$, because the other shareholder does not transact in the class period, while $\beta < 1$.

Depending on the company, it is possible that the pivotal shareholder in a vote will be from Group #3, thus biasing the voting base toward approving a class action. Put another way, the individual buy-and-hold investors implicitly subsidize the damages paid to the frequently trading institutional investors in class actions, leading the institutional investors to value such damage payments. Insofar as these voters are inclined toward "cheap talk" voting, the bias will be exacerbated. That is, even if an investor were to receive little or no net positive benefit from allowing a class action to proceed, if the investor is inclined to send a tough "signal" against the management, such sentiment would make the investor likely to vote in favor of a class action.

While the bias in our voting proposal will not always result in a vote to terminate a class action when warranted under the social optimum, our voting proposal is nonetheless an improvement on the current securities class action regime. In particular, because only *termination* of a class action would be voted on, the pro-class action bias in voting will not result in a sub-optimal *expansion* of a class action relative to the status quo. This one-sided nature of our ex post class action voting proposal, even with a pro-class action bias, would instead only allow shareholders to terminate class actions when the value to such shareholders of the class action does not exceed the costs.

Return to the example of the shareholder that owns 1 percent of the outstanding shares prior to the class period. During the class period, she purchases 50,000 shares and holds onto these shares until the end of the class period. These 50,000 shares represent 5 percent of the shares eligible for damages (i.e., $\alpha = 0.05$). She will receive 5 percent of any compensation and will experience a drop in its share value equal to the 1 percent of the compensation paid. The shareholders will have the following decision threshold in determining whether to vote to allow a suit to go forward:

$$0.04 \cdot D + 0.01 \cdot (B_1 - C) > 0$$

Note that the social optimal decision threshold is:

$$0.01 \cdot (B_1 - C) > 0$$

Thus the pro-class action bias for the shareholder is given by $0.04 \cdot D$. Note though that a bias does not mean that the shareholder will vote to allow all class actions. If C (the cost of litigation) is sufficiently greater than the deterrence benefit to the shareholder from the class action B_1, the shareholder will vote to terminate. In this example, suppose D is $10,000. The shareholder with a pro-class action bias will still vote to terminate the class action so long as C exceeds B_1 by more than $40,000.

We believe that situations where C exceeds B_1 sufficiently to result in institutional investors with a pro-class action bias to vote to terminate will occur frequently—in particular in the case of frivolous suits. Even institutional investors in Group #3 with a pro-class action bias are likely to reject a frivolous case. Such cases offer little in the way of either deterrence or compensation (i.e., B_1 and D are both close to zero). Recall that shareholders in Group #3 are biased toward allowing a class action because they get more in compensation from their shares eligible for damages relative to the burden they bear from paying, given their overall share ownership at the time of the vote. Buy-and-hold investors, by contrast, disproportionally bear the cost of compensation. If litigation is frivolous, however, settlements are typically low—nuisance value of a few millions of dollars at best. If the settlement amount, and thus compensation, are expected to be low, the increased incentive to allow a class action above the second-best social optimum is correspondingly reduced. Decisions to reject nuisance litigation, even if made primarily by shareholders in Group #3, will therefore approach the second-best social optimum. And these are the suits that offer the least in the form of investor protection.

More formally, allowing for a vote to terminate the class action will allow shareholders to terminate at least those infra-marginal class actions where the costs of litigation clearly outweigh the deterrence benefit to the shareholders. In particular, this occurs where:

$$(B_1 - C) > \frac{(\alpha - \beta) \cdot D}{\beta}$$

Note that as $(\alpha - \beta) \cdot D/\beta$ gets closer to zero, this decision threshold approaches the second best social optimum decision threshold. The right-hand side term $(\alpha - \beta) \cdot D/\beta$ will be closer to zero as β gets larger. While a pro-class action bias may exist in our voting rule, those institutional investors that own a relatively larger fraction of shares at the time of the vote will have a relatively lower bias. Such investors are also more likely to be the pivotal voter given their large share ownership at the time of the vote.

3. Variations on the Voting Rule

Variations are possible on ex post voting proposals to terminate a class action to ameliorate the impact of pro-class action bias in voting. One way to correct for the pro-class action bias among active institutional investors would be to change the voting threshold to make it easier to terminate the class action, perhaps reducing the threshold below a majority vote, say 40 percent. A lower threshold for termination effectively requires a supermajority of the votes cast to be in favor of allowing the class action to proceed. Even allowing a simple majority vote to terminate a class action, however, would still improve on the existing system, despite the pro-class action bias. The pro-class action bias will at worst result in continuing some marginal class actions. Compared with the current regime, which gives shareholders no input on whether a class action goes forward, even pro-class action biased shareholders will make class actions more efficient if they vote to block the weakest class actions.[89]

[89] Other divergences are possible. Shareholders who are also defendants in the litigation (or related parties) choose to end the class action even if the litigation benefits the group of all shareholders eligible to vote. Shareholders with demonstrable conflicts, such as defendants in the litigation, should be excluded from voting on the termination of the class action. These shareholders are typically excluded from the class definition. Plaintiffs may attempt to exploit conflicts of interest. Perhaps plaintiffs that know that a specific shareholder tends to vote for terminating class actions will list the shareholder as a defendant to generate a conflict to prevent the shareholder from voting. Absent any evidence,

A downside of our first option vote allocation rule is that it requires information from each voter on their purchases during the class period, as well as the identity of shareholders at the time of the vote. Blockchain technology that records transactions as part of an electronic form of a security holds promise to reduce such identification costs, but our first option may be too costly to administer using current clearing systems. If administrative costs are too high, then we suggest a "second option" for allocating votes: votes allocated in proportion solely to the shares owned at the time of the vote. We argue that vote allocation will approximate the same voting outcome as in our first option above.

The main difference in our second option for vote allocation is that more shares will vote that lack an interest in the class recovery. Shareholders in Group #1, who bear a greater proportion of the settlement payment relative to what they receive in compensation (because $\alpha < \beta$), will be able to vote all their shares held at the time of the vote, increasing the impact of their negative bias against class actions on the outcome of the vote. Indeed, shareholders who did not purchase any shares in the class (or purchased shares in the class but did not hold these shares until the end of the class period), would have votes if they hold shares on the record date for the vote. These shareholders bear all of the costs of compensation but receive no payments. As such, they would have excessive incentives compared with the second-best social optimum to terminate class actions.

Despite this additional bias for some voters under the second option, we believe that the second option may approximate our first voting outcome. To the extent the investors (typically individuals) who have no shares eligible for damages own fewer shares compared with the investors who did trade in the class period (typically institutional investors), the individual investors are unlikely to be pivotal in the vote. Many of these investors may not bother to vote due to rational apathy. Because the pivotal voter will determine the vote outcome, we conjecture that the second option vote allocation will result in similar outcomes as our first option above. Choosing a rule that allocates votes based on share ownership at the time of the vote would therefore provide an easy to administer rule that approximates a more complicated vote allocation based on class period purchases that are eligible

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however, plaintiffs must worry about Rule 11 sanctions for such manufactured claims. *See* FED. R. CIV. P. 11.

for damages combined with share ownership at the time of the vote.

As with our first option vote allocation rule, we can address the concern that the pivotal voter might shift toward too negative a bias against class actions under our second option by modifying the voting threshold. Rather than require a majority vote to terminate a class action, a supermajority vote, for example a 60 percent threshold, could be required to terminate under our second option. Setting a higher voting threshold will counter the increased number of shareholders who disfavor compensation because they are not class members. Although a supermajority voting rule may go too far and bias the vote toward allowing the class action to proceed, as discussed above, having a pro-class action bias still improves on the current class action system. Cases that are clearly meritless will be terminated through a shareholder vote even with a pro-class action bias.

What of the deterrent impact on other firms from securities class actions? In our analysis of the different groups above we omitted consideration of the benefit to shareholders who own shares in other firms. They benefit from the overall deterrent effect from securities class actions (B_2 in our framework). To the extent the pivotal voter under either of our proposed voting options is likely to be an institutional investor, the fraction of shares of the rest of the market that the pivotal voter holds will be $\gamma > 0$. Indeed, in the case of a fully diversified institutional investor that is the pivotal voter, the investor will balance its share of the costs of litigation (β) against the deterrent benefit to the rest of their portfolio (γ) in the same way as the social optimum. Non-diversified institutional investors (a small proportion) may underweight the deterrent benefit to the rest of the market which may exacerbate the overly high incentive compared with the social optimum to terminate securities class actions. Nonetheless, the benefit to other firms will generally be quite diffuse relative to the benefit to the specific firm facing the class action. Even if the magnitude is appreciable, changing the voting threshold to make it more difficult to terminate a securities class action can reduce the divergence with social welfare. Ultimately, even if our voting proposal is imperfect, we believe by adding the possibility of diversity and experimentation relative to the current regime, our proposal has the potential to improve private securities enforcement.

4. The Information Environment and the Timing of the Vote

The same forces that lead to more informed votes for shareholder ex ante proposals, including institutional share ownership, activist shareholders, and proxy advisory firms, will lead to an informed shareholder vote on whether to allow a specific securities class action to proceed. In addition, there will be specific information available on the particular class action at issue. After the filing of a class action, the allegations in the complaint will be known, as will management's role in these violations. Shareholders will also be able to assess the skill and reputation of the plaintiffs' attorneys, the prospects for recovery, and whether the class action is likely to enhance future deterrence.

We also expect that proxy advisory firms will enjoy economies of scale in making recommendations on securities class actions for public companies. Given that advisors already provide voting recommendations for the election of directors and approval of executive compensation plans, they have a reservoir of knowledge about the firms. This reservoir of knowledge will help inform proxy advisors' recommendations on whether to vote for or against allowing a securities class action to move forward at a relatively low cost.

The timing of a vote may affect the amount of information available about a securities class action. Complete information on the value of the class action may not be available until after discovery. Even with discovery, in the present class action regime much of the information that is produced is sealed by the court as confidential.

For our proposal, we would not require mandatory disclosure. In addition to publicly available court documents and the recommendations from proxy advisory firms, we believe that both management and plaintiffs' attorneys will have strong incentives to voluntarily supplement that information. If management favors a shareholder proposal to dismiss the class action, corporate executives will voluntarily provide information to the shareholders, balancing the benefit of providing information against the cost of disclosing confidences. Managers do not have to provide information, but a failure to do so reduces the chance that shareholders will vote for dismissal. Indeed, a failure to disclose could signal a "lemon," i.e., officers complicit in the fraud. Similarly, we believe that plaintiffs' attorneys firms will provide information to shareholders to encourage a vote against a proposal to terminate. Plaintiffs' attorneys currently maintain webpages for class

actions as a means of communicating with class members which could be deployed for this purpose.[90]

More information becomes available when litigation proceeds to discovery, which raises the question of timing for an ex post vote to terminate a securities class action. One possibility would be to allow a vote to terminate a class action at any time after its filing. This would allow shareholders to eliminate nuisance litigation earlier, thereby reducing the corporation's defense costs. Weighing against those savings, however, is the need for time to uncover evidence to determine whether the action has merit.

Individual shareholders may not balance these factors in the same way as the aggregate group of shareholders would. If we allow only one proposal for each class action then there might be a race among individual shareholders to make a proposal to terminate the class action (to gain control over the proposal), leading to a vote before sufficient information about the class action is uncovered.

We therefore propose allowing a vote to terminate a securities class action only after the litigation has progressed far enough to develop information on the underlying allegations and the suit's prosecution. In our view, allowing management or shareholders to make a proposal to terminate a securities class action at any time after the motion to dismiss has been decided would strike a reasonable balance. Having the case survive a motion to dismiss ensures that at least the presiding judge views the case as plausible. Moreover, it will provide the shareholders voting on the proposal more information in the form of the motion to dismiss briefs and the judge's decision. An alternative would be to hold the vote after discovery. This would allow for plaintiffs' attorneys to uncover more information to help make a case to the shareholders to allow the class action to continue. On the other hand, delaying a vote until after discovery greatly diminishes the litigation savings available from termination: discovery is the principal cost of securities class actions.

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90 For example, Robbins Geller Rudman & Dowd LLP, one of the largest plaintiffs' attorney firms, maintains a website of recently filed class actions. *See Recently Filed Securities Cases*, ROBBINS GELLER RUDMAN & DOWD LLP, https://perma.cc/69GK-JG86 (last visited Feb. 8, 2022). Labaton Sucharow, another large plaintiffs' attorney firm, maintains webpages for its ongoing securities class actions. *See Ongoing Cases*, LABATON SUCHAROW, https://perma.cc/G4JP-CHNJ (last visited Feb. 8, 2022).

5. Information Creation and Signaling

A further benefit of voting on specific class actions is additional information on shareholder sentiment. Presently, if investors are unhappy with management as a result of the misconduct underlying the allegations, they can express their unhappiness by voting against the election of the incumbent directors. Depending on the size of the company, however, and other issues it may be facing, this signal may be muddy. For example, a company may be doing well financially and experience large positive stock returns in the year prior to the vote for directors.[91] Nonetheless, due to weak internal controls, the company may have overstated its revenues in a material way. Shareholders, even if unhappy about the allegations of misconduct, may still vote to re-elect the board because of the positive financial results and stock returns.

The possibility of a vote specifically assessing the securities class action allows shareholders to separately express their views on the lawsuit's allegations and the members of management implicated in the misconduct. Evidence from say-on-pay votes suggests that shareholders have used the say-on-pay vote to send a more precise signal on executive compensation. Cotter et al., for example, noted that after the 2011 proxy season, "rather than express displeasure with executive pay by voting against particular directors, shareholders used the say-on-pay vote to voice their opinions about pay practices."[92]

6. Ex Ante Voting on Ex Post Regimes

We have proposed a particular form of ex post voting on securities class actions: whether to terminate the class action. We have noted variations on our proposal, including specific voting thresholds. We believe that good reasons exist for limiting ex post voting proposals to the termination of a class action. This limitation helps address the likely pro-class action bias among ex post voting institutional investors. It is possible, however, that the pro-class action bias is so strong that shareholders ex ante may wish not to allow for any ex post votes on a particular class action. It could also be that shareholders ex ante may wish to set the specific ex post voting threshold based on their expectations of the shareholder base for a specific corporation. We propose therefore to allow shareholders to vote ex ante on variations on our ex post voting proposal. One approach would be to start with the status

[91] *See* Ertimur et al., *supra* note 31; Choi et al., *supra* note 45.
[92] Cotter et al., *supra* note 40, at 996.

quo and allow shareholders ex ante to vote on whether to implement ex post voting to terminate a class action at all. Once authorized, shareholders could also vote on a limited range of choice in this regime, including the voting threshold and how to allocate votes (including either our option one or two described above).

IV. CONCLUSION

Shareholder voting on securities class actions can help distinguish suits that enhance social welfare from those that diminish it. Judges currently decide whether to allow a securities class action to go forward at various stages in litigation, with the motion to dismiss being the most important screening device. Legal doctrines that constrain the information that judges can consider in making their decision may increase the consistency of decisions across judges, but that consistency may come at the cost of accuracy in screening out nuisance suits. In the end, the accuracy of these decisions often turns on the expertise, experience, and temperament of the specific judge.

Shareholder voting promises greater accuracy in assessing whether a securities class action promotes shareholder value. That improvement would reflect the second-best social optimum. Having a successful voting regime will take pressure off inexpert judges to screen meritless suits. The screening doctrines employed by judges inevitably have both false positive and false negative errors. Transferring control to shareholders would also allow for more positive inducements to encourage value-increasing class actions, such as increasing attorney fees in smaller cases. We should allow shareholders to "Just Say No" to securities fraud class actions. When shareholders vote "Yes," we can be confident that a shareholder class action actually serves shareholders' interests.