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DELAWARE AS DEMON: TWENTY-FIVE YEARS AFTER PROFESSOR CARY'S POLEMIC

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INTRODUCTION

Twenty-five years ago Professor William L. Cary of the Columbia Law School published an article entitled *Federalism and Corporate Law: Reflections Upon Delaware*[1] in the Yale Law Journal. Cary's prominence as a professor and former chairman of the Securities and Exchange Commission ("SEC"), and the article's placement in the Yale Law Journal, assured that legal scholars and practitioners would take note of it. The article's controversial thesis assured its notoriety.[2] Professor Cary theorized that, to garner incorporation and corporate franchise fees, the State of Delaware had developed a public policy of appealing to businesses to incorporate or reincorporate in Delaware.[3] To implement this policy, Cary said that Delaware would sacrifice shareholder protections in favor of pro-management statutory provisions and judicial decisions.[4]

Cary noted that, of the 1,505 companies listed on the New York Stock Exchange in January 1973, 606 of them, or forty percent, had incorporated in Delaware.[5] The dominance of

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* This article is based on the 1999 Austin W. Scott, Jr. Lecture, entitled "Lessons from the Race Debate: A Talk About Corporate Law," delivered by the author at the University of Colorado School of Law on April 22, 1999. References to the passage of time, such as the one in the first sentence, refer to the date of the lecture. The author thanks Jennifer Peters for her research assistance and his colleague, Dale Oesterle, for his helpful comments.

1. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).
2. Indeed, Cary's article is among the most cited law review articles, ranking 14th among those published in the Yale Law Journal. Fred R. Shapiro, *The Most-Cited Articles from the Yale Law Journal*, 100 YALE L.J. 1449, 1462 (1991).
3. *See* Cary, *supra* note 1, at 664–65.
4. *See id.*
5. *See* Cary, *supra* note 1, at 671.

Delaware in this peculiar market has continued to the present, and probably has increased. The Delaware Division of Corporations reports on its web site that sixty percent of the Fortune 500 companies and fifty percent of the companies listed on the New York Stock Exchange have incorporated in Delaware.[6] Long before Cary's article appeared, commentators explained Delaware's prominence on the basis that Delaware provided corporations with a "favorable forum" for incorporation—a modern statute that made the process of incorporation relatively simple and made the governance of the corporation relatively free from governmental restrictions.[7] Cary added a few nuances to this explanation. He argued that the revenue from initial incorporations and annual franchise fees was so significant to the State of Delaware that maintaining its position as a provider of corporate charters had become an economic necessity. In this regard, he noted corporation services generated roughly twenty-five percent of the state's revenue.[8]

To maintain its preeminence, Cary argued, the Delaware legislature and courts act in concert to provide a comprehensive law that is pro-management, because corporate managers decide where to incorporate initially and whether to reincorporate.[9] To Cary, the interests of corporate managers and shareholders are in hopeless conflict; if the law favors corporate managers, it must thereby disadvantage corporate shareholders.[10] One of the few examples of pro-management statutory provisions that Cary provided was Delaware's indemnification provisions for officers and directors. Comparing Delaware's provisions to the comparable provisions in New York, Cary observed that the Delaware provisions were broader.[11] Left unsaid was the presumed conclusion: indemnification provisions as broad as Delaware's advantage corporate managers at the expense of shareholders.

The heart of Cary's article, however, consisted of a review of several Delaware court decisions, which he believed demon-

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6. *See Delaware Division of Corporations* (last modified Aug. 26, 1999) <http://www.state.de.us/corp/index.htm>.

7. *See, e.g.*, Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861 (1969) [hereinafter *Law for Sale*].

8. *See* Cary, *supra* note 1, at 668–69.

9. *See id.* at 665–70.

10. *See id* at 669–72.

11. *See id.* at 669–70 & n.54.

strated the pro-management bias of the Delaware courts.[12] He contrasted these decisions to decisions of the federal courts, which, he believed, construed federal law in a more even-handed fashion.[13] Finally, Cary theorized if any other state offered a law that might attract the interest of corporate managers, Delaware would adjust its statutory law to meet the competition.[14] This possibility would lead to a "race to the bottom," in which states would compete with one another to provide the most attractive pro-management law.[15] To avoid this competition, and the resulting harm to America's shareholders, Cary recommended that the federal government intercede by creating minimum safeguards for corporate shareholders.[16]

Professor Cary's article received a generally warm reception, particularly among legal academics who shared Cary's skepticism of Delaware law and the manner in which Delaware law has evolved.[17] Cary's work was not without its detractors, however, who were led by then Professor, and now Federal Court of Appeals Judge Ralph K. Winter, Jr. In an article entitled *State Law, Shareholder Protection, and the Theory of the Corporation*,[18] which appeared in 1977 in the *Journal of Legal Studies*, Judge Winter was outspoken in his disagreement with Cary's thesis. While Winter agreed that the states competed to attract corporate chartering, he rejected the notion that this

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12. *See id.* at 670–84.

13. *See id.* at 692–96.

14. *See id.* at 663–66 (describing competition among states to attract incorporations).

15. *See id.* at 705.

16. *See id.* at 696–703.

17. *See generally* RALPH NADER ET AL., TAMING THE GIANT CORPORATION (1976); Christopher J. Bebel, *Why the Approach of* Heckmann v. Ahmanson *Will Not Become the Prevailing Greenmail Viewpoint: Race to the Bottom Continues*, 18 TEX. TECH L. REV. 1083 (1987); Richard W. Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. LAW. 991 (1976); Stanley A. Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883 (1976); Charles W. Murdock, *Delaware: The Race to the Bottom—Is an End in Sight?*, 9 LOY. U. CHI. L.J. 643 (1978); Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947 (1990); *see also* Joel F. Henning, *Federal Corporate Chartering for Big Business: An Idea Whose Time Has Come?*, 21 DEPAUL L. REV. 915 (1972); Linda C. Quinn, *Federal Chartering of Corporations: A Proposal*, 61 GEO. L.J. 89 (1972) (illustrating the skepticism predating the Cary article).

18. Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

competition constituted a race to the bottom.[19] To the contrary, Winter argued, this competition would lead to corporate laws that would favor rather than disadvantage shareholders.[20] Over time, Winter believed, the best, not the worst, corporate law would emerge.[21]

Winter theorized that corporate managers have a powerful incentive to choose a state of incorporation that meets with the approval of the potential investors in the company.[22] If investors perceive a state's law as being hostile to their interests, they will discount their investment in a company accordingly.[23] Relying on the efficient market hypothesis, Winter argued that investors will factor in the underlying corporate law like any other information relating to the investment.[24] If the law is unfavorable, investors will pay less for the stock. Winter argued that corporate managers who choose a governing law for the corporation that investors view unfavorably will be punished for their decision. They will face a higher cost of capital than their competitors who choose a more investor-friendly law.[25] Companies with a higher cost of capital will have difficulty competing in the product markets, as capital is a cost, like any other cost, in producing a good or service. That higher cost of capital, in turn, will lead to lower profit margins, lower earnings, and lower share prices.

Winter believed that this scenario—a higher cost of capital leading to lower earnings, and, consequentially, lower share prices—would ultimately harm corporate managers who chose the bad law in the first place, because a company whose stock price is low provides an inviting target for a hostile takeover.[26] In theory, an entrepreneur could purchase the company, or a controlling interest in it, and then reincorporate the company in a more shareholder-friendly jurisdiction.[27] This move would lower the cost of capital, allowing the company to compete more effectively and raising its value.

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19. *See id.* at 254–62.
20. *See id.* at 256.
21. *See id.* at 289–92.
22. *See id.* at 256–58.
23. *See id.*
24. *See id.*
25. *See id.* at 257.
26. *See id.* at 264–66.
27. *See id.*

In short, Winter argued that managers will select a corporate law that appeals to investors because they want to entice investment. If investors view Delaware law unfavorably, they will shun investments in Delaware corporations, to the disadvantage of managers seeking those investments. If states want to attract incorporations, they will have to provide economically efficient laws. Winter did not discuss the statutory provisions or judicial precedent that persuaded Cary of Delaware's pro-management bias. He might have said, however, that investors, not law professors, are best able to decide what is in shareholders' best interests.

The Cary/Winter debate about whether corporate laws evolve as a race to the bottom or to the top poses an attractive but incomplete choice of theories to explain the content of corporate law in America today.[28] The twenty-five years that have passed since the appearance of Cary's article have not borne out his dire predictions of the progress of Delaware law. That law has not moved inexorably in favor of managers, and to the detriment of the interests of shareholders. Moreover, the basic premise of Cary's and Winter's theses is suspect—states do not compete with one another to attract corporate charters, at least not to the degree that Cary and Winter assumed. States do not, therefore, draft or amend their corporate laws *merely* to attract new incorporations any more than they amend their partnership laws to provide incentives to form partnerships

28. To be sure, Cary and Winter are not the only scholars who have explored this question. *See, e.g.*, RICHARD POSNER & KENNETH SCOTT, ECONOMICS OF CORPORATION AND SECURITIES REGULATION (1980) (claiming states offer different codes to attract corporations with various needs); Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. REV. 179 (1985) (finding states draft their corporate codes to match the needs of corporations with varying share ownership patterns); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995) (arguing Delaware's preeminence is attributable to "network externalities;" that is, the large number of Delaware corporations provides an incentive for others to incorporate there); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987) (maintaining transaction cost analysis explains where firms incorporate or reincorporate). *See also* Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" versus Federal Regulation*, 53 J. BUS. 259 (1980) (concluding, on the basis of empirical research, that investors are not harmed when corporations reincorporate in Delaware, suggesting that the competition among the states for incorporation business is not a "race to the bottom"). Each of these theories proceeds from the assumption that state legislatures are motivated to attract at least a portion of the market for corporate charters and, to that extent, these theses are challenged in this article.

under their laws, nor should they. Because states do not compete to the extent that Cary and Winter assumed, they generally do not fashion their "product"—that is, the corporate code—to appeal to the "consumers" of that product, corporate promoters and managers. Rather, legislators' perception of public policy is an important and overlooked factor explaining corporate law.

In challenging both Cary and Winter, Part I of this article discusses the premise that underlies both theories, that states compete for corporate charters. Although it is the accepted wisdom that states do compete,[29] the supporting evidence is unpersuasive. The article will then move to what the last twenty-five years have taught us about the "race debate," focusing in Part II on Professor Cary's and Judge Winter's theses. This Part also considers the increasingly important role played by stock exchanges in standardizing corporate law for publicly-held corporations. Part III considers the evolution of corporate democracy which, like the role of the stock exchanges, was not considered either by Cary or Winter. Part IV concludes with some observations on the role of state legislatures in the development of corporate law, and emphasizes the importance of providing protections in the corporate code for shareholders against abuses by officers and directors.

I. THE COMPETITION FOR CHARTERS

Both Cary and Winter simply assumed that states compete with one another to attract promoters to choose their state in which to incorporate. If the law of State A is succeeding in the competition, presumably the legislatures of other states will amend their codes and close the gap. Cary and Winter both suggested that this competition will take place for fiscal reasons—states can make money by being the jurisdiction of in-

29. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1–40 (1991) (hereinafter, ECONOMIC STRUCTURE); Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540 (1984). *See generally* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 14–31 (1993) and sources cited therein.

corporation.[30] Both Cary and Winter quoted language from a New Jersey law revision committee that said that states cannot protect investors, creditors, employees, customers, or the general public through their state corporation laws because doing so would, in the committee's words, "drive corporations out of the state to more hospitable jurisdictions."[31] Neither Cary nor Winter commented on this language, as each assumed that it proves the presence of competitive pressures. Some comment, however, is in order.

First, corporate law does not drive corporations anywhere. Corporations can choose the state in which they wish to incorporate and the state in which they wish to do business. The two need not be the same. Businesses choose where they *operate* based on factors such as the availability of labor and other inputs of production, tax laws, and proximity to markets, not on the basis of the state's corporate laws. Aside from Delaware, attracting and retaining *operations* is far more important to a state's economy than being the state that issues the corporate charter.

Second, state corporate laws typically do not regulate corporate conduct to protect investors, creditors, employees, customers, or the general public. Many other state laws, however, do. State securities laws protect investors, commercial laws protect creditors, environmental and public safety laws protect the general public, and so forth. To the extent that we look to state corporate laws to protect any discreet constituency, the concern is with the relationship between corporate shareholders and corporate managers. While this is of obvious concern to shareholders, the broader public impact is limited.

If state corporate laws do not influence where a corporation operates, and do not have the impact that the New Jersey law revision committee attributes to them, then one might reasonably ask why the committee suggested otherwise. This question leads to a third observation. Corporate lawyers do have an interest in the content of state corporate law. In the course of discharging their professional obligations, corporate lawyers at times advise promoters and corporate managers

30. *See* Cary, *supra* note 1, at 669 ("For revenue reasons, 'creating a favorable climate' is declared to be public policy of the state."); Winter, *supra* note 18, at 253.

31. Cary, *supra* note 1, at 666; Winter, *supra* note 18, at 255 n.14.; N.J. STAT. ANN. § 14A, xi (West 1969).

about where to incorporate or whether to reincorporate. The corporate lawyers of a state have a primary responsibility for advising the state legislature on statutory law, and have an interest in a corporate statute that is attractive to their clients, who tend to be promoters and corporate managers. The lawyer-lobbyist's interest is, however, a narrow one. Having a "modern" corporate code is primarily a matter of convenience and pride. As to convenience, the lawyer need only track the changes to the law of his or her state if the lawyer's clients are incorporated in the state. As to pride, lawyers who practice in a specialized area, such as corporate law, and who have some influence on the content of that law, can reasonably be expected to take some pride in that law.[32]

What is not at stake, ironically, is the economic self-interest of the lawyer, at least for lawyers outside of the state of Delaware.[33] A non-Delaware lawyer can just as easily form a corporation under Delaware law as under the law of his or her state. With fax and electronic filings, it does not matter where the office of the Secretary of State, where one typically files corporate documents, is located. Ironically, it is easier for most non-Delaware lawyers to form a Delaware corporation than it is for them to form a corporation under the laws of the state in which they live. This is because the Secretary of State of Delaware is quite customer-friendly—for instance, boasting a "two-hour" processing time.[34]

By contrast, Delaware lawyers do have an interest in making their law attractive to corporate managers, because the

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32. The author served as a member of the Colorado Bar Association committee that recommended the adoption of the Revised Model Business Corporation Act (with a number of modifications) to the state legislature in 1993. While broad competitive arguments were made to the legislature, many of the lawyers on the committee were motivated to work on the legislation and support its adoption so that Colorado would have a modern law, without regard to its fiscal consequences. There were no indications that Colorado businesses were choosing to incorporate, much less do business, elsewhere because of concerns over the Colorado corporate code.

33. Delaware lawyers benefit from the large number of incorporations in the state and thus may have an economic motivation to influence the content of the Delaware corporate code. *See* Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987) (explaining the content of Delaware law partially on the basis of the interests of the Delaware corporate bar).

34. *See* Delaware Division of Corporations, *Frequently Asked Questions* (last modified Jan. 1, 1999) <http://www.state.de.us/corp/q&a.htm#expedite>.

lawyers stand to benefit from additional incorporations in Delaware. Non-Delaware lawyers can and do have occasion to retain Delaware attorneys for counsel on the interpretation of Delaware law, and many corporate lawsuits are filed in Delaware to take advantage of the expertise and efficiency of the Delaware judiciary.

If non-Delaware attorneys wanted to compete with Delaware's dominance in the corporate chartering business, we might expect two things to occur. First, these attorneys should be lobbying their state legislatures to develop specialized business courts to compete with Delaware's. Regardless of the provisions of the corporate code, Delaware's superior judiciary would persist and provide a good reason to incorporate in Delaware. The Delaware Chancery Court, the state's forum for corporate litigation, hears approximately 500 business-related cases a year.[35] The Chancery Court resolves those cases promptly, and its decisions are rarely appealed. Only five percent of its decisions are appealed to the state Supreme Court—Delaware has no intermediate appellate court—and in those appeals the Supreme Court upholds the Chancery Court in seventy-five percent of the cases.[36] If a case is appealed to the Supreme Court, that court generally renders a decision in about thirty days from submission.[37] Thus, litigants know that Delaware will provide a prompt resolution of their dispute, and corporate managers might well value this in deciding where to incorporate. Providing a local business court, with specialized expertise and expedited procedures, might encourage business litigants to stay at home with their cases or, better yet, incorporate in the jurisdiction with an efficient judicial system. In reality, however, this has not happened. New York is experimenting with a specialized business court, and the idea is under consideration or in the experimental stages in a few other states, but Delaware remains essentially unchallenged.[38]

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35. This statistic and the ones that follow in this paragraph were the product of a formal study by the Chief Justice of the Delaware Supreme Court, E. Norman Veasey, and were reported by Justice Veasey in a speech to the Tulane Corporate Law Institute on March 4, 1999. *See* Celia Cohen, *The Appeal of the Chancery Court*, DEL. L. WKLY. (Mar. 16, 1999).

36. *See id.*

37. *See id.*

38. *See* Report of the Ad Hoc Committee on Business Courts, *Business Courts: Towards a More Efficient Judiciary*, 52 BUS. LAW. 947 (1997).

Second, non-Delaware attorneys might lobby for federal incorporation to supplant Delaware. Something akin to this is occurring in the bankruptcy field. Lawyers outside of Delaware are seeking to diminish the dominance of the Delaware bankruptcy court, which has become the preeminent bankruptcy court in the nation for reorganizations of large publicly-held corporations.[39] Venue provisions in bankruptcy laws allow the debtor to choose the state of its incorporation, among other possible venues, as the place to file for bankruptcy.[40] Bankruptcy lawyers outside of Delaware, seeking to eliminate Delaware's dominance and capture some legal business, are proposing a change in the bankruptcy law to require that a jurisdiction have a greater connection to the debtor than just being its state of incorporation.[41] Drawing on the efforts of their counterparts in the bankruptcy bar, if non-Delaware corporate lawyers wanted to eliminate the preference that litigants have for the Delaware courts in corporate matters, the easiest strategy would be to federalize corporate law by adopting a national corporate code and providing for federal incorporations. Then Delaware courts would not have jurisdiction over disputes unless there was some other nexus to the dispute. Again, there is no such movement afoot.

In response to this analysis, advocates of the competition theory, whether believers of the race to the bottom or top, might argue that the New Jersey committee quoted by Cary and Winter, like any group seeking a change in corporate law, was appealing to the legislators' fiscal concerns, the fear of losing incorporation and franchise fees. In most states, however, these fees are an insignificant portion of revenue. In her 1993 book, *The Genius of American Corporate Law*, Professor Roberta Romano analyzed this data. As of 1990, the most recent year for which she presented data, the vast majority of states charged $100 or less, with some charging as little as $10.[42] The same was true for annual franchise taxes, which, again, were nominal, accounting for one-tenth of one percent,

39. *See generally* Robert K. Rasmussen & Randall S. Thomas, *Forum Shopping by Insolvent Corporations: Precommitment, Investment Incentives and the Race to the Top* (forthcoming, manuscript on file with author).

40. *See* 28 U.S.C. § 1408 (1994).

41. *See* NATIONAL BANKR. REVIEW COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS 770–87 (1997).

42. *See* ROMANO, *supra* note 29, at 10–11.

or less, of taxes collected in nineteen states and five-tenths of one percent, or less, in thirty-three states.[43] By contrast, franchise fees in Delaware can range up to $150,000 per year for a large corporation and are a significant portion of the state's tax revenues, typically accounting for fifteen to twenty percent of state revenues. In 1998, for instance, corporate franchise tax revenue collected in Delaware amounted to almost $400 million, or more than nineteen percent of all taxes collected in the state.[44] Its corporate income tax revenue that year was less than one-quarter of its franchise tax revenue.[45] By comparison, in states with a corporate income tax, that tax is a large multiple of corporate franchise tax revenue.[46] Delaware clearly has an economic interest in maintaining its position as a jurisdiction of choice for incorporations, but if it is competing for the revenue, it appears that only a handful of other jurisdictions are its competitors. In only five states—Alabama, Louisiana, Rhode Island, Tennessee and Texas—were 1990 franchise fees more than two percent of state tax revenues. None of these states is a significant jurisdiction of incorporation for publicly-held corporations, the bread and butter of Delaware's incorporation business.

Professor Romano devotes a full chapter of her book to the Cary/Winter debate, but only a single paragraph to whether, in fact, states compete for corporate charters. Her conclusion is that they do, because she observes that states adopt statutory innovations and the states most responsive to change are the best in attracting and retaining incorporations.[47] This may confuse cause with effect. Surely states adopt statutory innovations, but their motivations for doing so may be more complex than a desire to attract revenues. Romano also notes that the states most dependent on franchise fees are also the most responsive to change.[48] While this does suggest an economic motivation, it also suggests a far more limited competition than

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43. *See id.*

44. *See* State of Delaware Department of Finance, *1998 Delaware Fiscal Notebook* (last modified Jan. 9, 1999) <http://www.state.de.us/finance/publications/fiscalnotebook/FiscalNotebookPage.htm>.

45. *See id.*

46. *See* BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 1998 323 (1998). For instance, in 1997, Colorado corporate income tax was 64 *times* corporate license fees.

47. *See* ROMANO, *supra* note 29, at 16.

48. *See id.*

Cary and Winter assumed. As noted above, for only a few states is corporate franchise tax revenue important and, ironically, those states do not compete with Delaware for new incorporations or reincorportions. Romano, like Cary and Winter, simply assumes away other reasons that states amend their corporate laws. This promotes a somewhat cynical view of state legislators, who may act for other reasons, such as the sincere belief that, regardless of the revenue effect, a change in the statute is sensible and furthers good public policy. In other areas of the law, we like to think that such motives predominate, but in the corporate area we assume just the opposite.

While the assumption that a concern for corporate franchise fees influences the shape of Delaware statutory law seems warranted, given the importance of those fees to the state treasury, it is less obvious that the Delaware courts would abrogate their judicial independence by deciding cases with a view toward revenue maximization. Nevertheless, Cary believed that he had discovered such a bias, and thus added a powerful argument to his thesis.[49] A review of Delaware jurisprudence in the past twenty-five years casts doubt on Cary's conclusions regarding the movement of corporate law in the Delaware courts and, therefore, on his broader conclusion regarding Delaware's single-minded commitment to attracting incorporations. A review of legislative developments, both inside and outside of Delaware, similarly has not supported the broad arguments made by Cary and Winter. The next section considers this evidence.

II. A CRITICAL LOOK AT THE CARY AND WINTER THESES

A. *Case Law Developments*

Cary's considerable emphasis on Delaware case law likely reflects a view that the judiciary bears the primary responsibility for defining the fiduciary duties of directors. Most corporate statutes, including Delaware's, provide little guidance on the content of the fiduciary duties owed by directors and others to corporate shareholders. Indeed, some commentators have suggested Delaware legislators intentionally left these duties

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49. *See* Cary, *supra* note 1, at 670.

indeterminate to enhance the role of its judiciary.[50] Thus, Cary probably believed he could not make the case that Delaware had the pro-management policy he hypothesized unless he could demonstrate that Delaware courts cooperated with the legislature in shaping Delaware law.

Cary's criticism of the judiciary focused on seven Delaware cases.[51] On the whole, the cases he selected might be characterized as "pro-management," but they hardly tell the whole story of Delaware case law, either then or now. A brief examination of Delaware case law, from the time of Cary's writing through the present day, tells a different story.

1. Unfair Dealings with Shareholders and Disclosure Obligations.

Cary devoted several paragraphs of his article to a 1957 case called *American Hardware Corp. v. Savage Arms Corp.*,[52] which arose out of an attempt by American Hardware to take over Savage Arms. Fearing a planned tender offer by American Hardware, Savage Arms proposed to acquire a company called Aircraft Armaments in exchange for Savage Arms stock. This transaction, if approved by the Savage Arms shareholders, would have placed a large block of Savage Arms stock in friendly hands, thwarting the proposed takeover by American Hardware. Naturally, American Hardware opposed this transaction, and it sought to enjoin the Savage Arms' shareholder meeting at which the transaction would be considered and voted upon.

Among other things, American Hardware complained that the meeting was called on only sixteen days notice, leaving insufficient time for it to solicit the Savage Arms shareholders to vote against the proposal.[53] In particular, American Hardware argued, the short notice made it impossible to contact share-

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50. *See* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998).

51. Winter did not analyze Delaware case law. Consistent with his overall thesis, Winter might have said that if the Delaware judiciary acted with the same motivations as its legislature—to attract incorporations—the courts would, in the long run, decide cases in a way that was in the best interests of shareholders. Alternatively, if attracting incorporations was not the basis of the Delaware courts' decisions, analysis of the cases is of little use.

52. 136 A.2d 690 (Del. 1957)

53. *See id.* at 692.

holders who held their stock in the name of a registered broker-dealer, as apparently one-third of the shareholders did. The court rejected this argument as a basis for an injunction because the Delaware statute and the Savage Arms bylaws each required only ten days notice.[54] The court acknowledged that shareholders who held their stock in street name might not receive a solicitation from American Hardware, but it held those shareholders knowingly assumed that risk.[55] The corporation was only required to follow the statute and its bylaws, and it had done so in this case.[56]

American Hardware also objected to what it characterized as misleading disclosures in the Savage Arms proxy statement.[57] The proxy statement identified one director who voted against the acquisition, but it did not disclose that an additional three of the company's eleven directors also voted against the transaction. The Delaware Supreme Court acknowledged that "it would have been preferable to state all of the facts,"[58] but it nevertheless held that this omission did not warrant an injunction of the meeting. The court noted that the SEC rules governing the solicitation of proxies technically did not require Savage Arms to disclose the three additional dissents because, at that time, Savage Arms was only required to disclose the names of any director who informed it *in writing* of his intent to oppose the action.[59] Only one director—the one that Savage Arms named—had given written notice. Moreover, the court noted that American Hardware itself had informed the shareholders of the other dissenting votes.[60]

Cary states the facts and holding of this case, and contrasts it with a federal proxy case decided by the Supreme Court in which a more exacting standard of disclosure guided the Court.[61] Cary implies the *American Hardware* story was an example of the Delaware court accommodating Savage Arms' evil incumbent directors, who were indifferent to the interests of the company's shareholders. As far as Cary was concerned,

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54. *See id.* at 692–93.
55. *See id.* at 692.
56. *See id.* at 693.
57. *See id.* at 693–94.
58. *Id.* at 694.
59. *See id.*
60. *See id.*
61. *See* Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970).

the Delaware court simply ignored the directors' dishonesty and sharp dealing.[62]

The *American Hardware* case stands in remarkable contrast to two post-1975 Delaware cases, one addressing sharp practices and the other misleading proxy statements. In *Blasius Industries, Inc. v. Atlas Corp.*,[63] a 1988 case, the Atlas board was under attack from Blasius, which was soliciting the Atlas shareholders to vote to amend Atlas's bylaws to increase the board from seven to fifteen members, and to fill the resulting eight vacancies with Blasius nominees. If successful, this would have given Blasius control of the Atlas board and permitted it to proceed with a proposed restructuring of the target company. In response to the Blasius plan, the Atlas board voted to increase its size to nine and fill the resulting two vacancies with more friendly directors. These defensive actions were consistent with the Delaware statute and Atlas's bylaws. Nonetheless, the Delaware court enjoined the action, opining that, although legal, the actions of the Atlas board unduly interfered with the shareholder voting process, and the board's action was therefore set aside.[64] Simply put, *Blasius Industries* illustrates that the Delaware courts will not countenance all sharp practices of incumbent management. Thus, *American Hardware* is clearly not the last word on the role of the Delaware courts in matters of shareholder voting.

One can level similar criticism toward Cary's analysis of the proxy phase of the *American Hardware* case; Delaware courts do police against dishonesty. In *Lynch v. Vickers Energy Corp.*,[65] a 1977 case with a follow-up decision in 1981,[66] the Delaware Supreme Court held directors to a remarkably high standard of candor when communicating with their shareholders. These cases arose out of an attempt by Vickers Energy Corp., which owned a majority of the stock of TransOcean Oil, Inc., to acquire the remaining minority interest in TransOcean. Vickers sent a tender offer to TransOcean's minority shareholders offering to buy their stock at $12 per share. Allegedly, Vickers failed to disclose two facts: first, that a member of TransOcean's management had calculated a potentially higher

62. *See* Cary, *supra* note 1, at 675–77.
63. 564 A.2d 651 (Del. Ch. 1988).
64. *See id.* at 663.
65. 383 A.2d 278 (Del. 1977).
66. *See* 429 A.2d 497 (Del. 1981).

value for the company; and second, that Vickers' management had authorized open market purchases of TransOcean stock for up to $15 per share prior to the tender offer. The Delaware courts agreed that this lack of candor on the part of Vickers, which owed a fiduciary duty to the shareholders of TransOcean, was a violation of Delaware law, entitling the plaintiff-shareholders to money damages.[67]

The *Vickers* case announced and implemented a disclosure duty that appears more exacting than the federal case that Cary cited as an exemplary decision.[68] In Delaware, the court announced, fiduciary duties to shareholders include a duty of "complete candor," which, on its face at least, seems to go beyond the standard announced by the federal courts.[69] The Delaware court's opinion also reaffirmed the existence of a fiduciary duty from directors and officers to their corporation, to the stockholders as a whole, and to individual stockholders.[70] Cary had suggested that Delaware law was otherwise.[71] Finally, time has proven that the Delaware court's decision in *Vickers* was not merely a reaction to Cary's criticism, as some scholars have suggested.[72] In a recent decision, *Malone v. Brincat*,[73] for instance, the Delaware Supreme Court expanded liability for directors who allegedly misstate the truth, even if those misstatements are not made in connection with a call for shareholder action.

2. Duty of Care.

Cary was also critical of Delaware's decisions on a director's duty of care.[74] All state corporate codes recognize that di-

67. *See Vickers*, 383 A.2d at 281 ("Technically speaking, the language may be accurate; but that kind of generality is hardly a substitute for hard facts when the law requires complete candor.").

68. For a criticism that the Delaware Supreme Court went too far in the case, see Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087 (1996).

69. *See* Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970).

70. *See Vickers*, 429 A.2d at 503 & n.4.

71. *See* Cary, *supra* note 1, at 672.

72. *See, e.g.*, Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Law*, 76 NW. U. L. REV. 913, 914 (1982) (suggesting that one of the "effects" of Cary's criticism of the Delaware court was to cause the court to adopt a more pro-shareholder view in its cases).

73. 722 A.2d 5 (Del. 1998).

74. *See* Cary, *supra* note 1, at 683–84.

rectors have a duty to the shareholders to manage the business and affairs of the corporation with a requisite degree of care.[75] Many courts, including the Delaware courts, have struggled with defining just what that duty entails. Cary focused on a single 1963 Delaware case, *Graham v. Allis-Chalmers Manufacturing Co.*[76] The case arose after Allis-Chalmers, a manufacturer of electrical equipment, and four of its officers pled guilty to violations of the antitrust laws. Shareholders complained that, had the directors not been asleep at the switch, the antitrust laws would not have been violated and the corporation would not have suffered the losses that arose from its guilty plea. The Delaware Supreme Court rejected the claim, reasoning that the board had no obligation to "operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."[77] Cary suggested that the Delaware court set too low a standard for directors.[78]

Relatively few decisions nationwide had considered the duty of oversight when the Delaware court decided *Graham*, or since. Nevertheless, in a widely-reported decision of the Delaware Chancery Court in 1996, *In re Caremark International Inc. Derivative Litigation*,[79] the Delaware Chancellor announced that *Graham* no longer reflected Delaware law on the duty of oversight. Chancellor Allen, then a highly respected jurist in Delaware, articulated a proactive role for directors, in sharp contrast to the more passive role reflected in the *Graham* decision.[80] Allen ruled in *In re Caremark* that directors have a duty to install adequate information and reporting systems to enable the board to reach informed judgments concerning the corporation's compliance with law.[81] If this is an accurate statement of Delaware law, then one can describe Delaware as articulating a high standard of fiduciary duty for Delaware directors.

More striking than the *In re Caremark* decision was the Delaware Supreme Court's 1985 decision in *Smith v. Van*

75. *See, e.g.*, MODEL BUS. CORP. ACT § 8.30 (1998).
76. 188 A.2d 125 (Del. 1963).
77. *Id.* at 130.
78. *See* Cary, *supra* note 1, at 684.
79. 698 A.2d 959 (Del. Ch. 1996).
80. *See id.* at 969–70.
81. *See id.* at 970.

Gorkom.[82] While *In re Caremark* dealt with the directors' duty of oversight, *Van Gorkom* dealt directly with the duty of directors to exercise care in making business judgments and, more specifically, with judicial review of such business decisions. In *Van Gorkom*, a case that shocked the corporate bar, the Delaware Supreme Court held the directors of the Trans Union Corporation personally liable for damages because the court found, in essence, that they simply did not do enough homework before agreeing to a sale of the company.[83] This was despite the facts that the directors had no conflicts of interest in approving the transaction, were highly qualified and respected individuals, and the sale was for a considerable premium over market price.[84] The Delaware courts in these cases can hardly be said to be pandering to directors in order to attract management to incorporate in the state.

3. Takeover Cases

Another Delaware decision that Cary criticized was in the takeover area, then in its jurisprudential infancy. Arguably, the takeover cases might be characterized as the most important cases to a manager of a publicly-held corporation contemplating whether to incorporate elsewhere or to remain within a particular jurisdiction. Corporate management would generally favor a jurisdiction that gives it wide discretion in defeating a hostile takeover. Cary so characterized Delaware, citing *Cheff v. Mathes*,[85] a 1964 case that upheld a board's decision to buy out a potential purchaser of the company at a premium, an early greenmail case. The case has become the paradigm for an unwise business decision—the corporation failed soon after the takeover was killed—that may have been motivated by the incumbent board's desire to remain in office. To Cary, this case illustrated, once again, a judiciary with a "clear penchant in favor of management."[86]

However, *Cheff v. Mathes* has hardly been the last word on the duties of incumbent management when faced with a hostile takeover. While Delaware courts have accorded a measure of

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82. 488 A.2d 858 (Del. 1985).
83. *See id.* at 874.
84. *See id.* at 893–94 (McNeilly, J., dissenting).
85. 199 A.2d 548 (Del. 1964).
86. Cary, *supra* note 1, at 673.

deference to directors who resist a hostile takeover,[87] it is far too simplistic to dismiss this now rich jurisprudence as merely deferential to management.[88] Several decisions within the past year alone, for instance, demonstrate the balanced approach of the Delaware courts in this area.[89] In these cases, the Delaware courts invalidated an increasingly popular takeover defense known as a "dead hand provision." In short, a dead hand provision limits or eliminates the ability of newly-elected directors to dismantle antitakeover defenses, such as poison pills,[90] of the previous board. Many companies have adopted so-called poison pill defenses, or shareholder rights plans, that make a hostile takeover economically impracticable. A dead hand provision makes it impossible for a hostile suitor to elect a slate of directors and remove the poison pill. The combination of a poison pill and a dead hand provision assures that a hostile bidder can achieve neither a successful tender offer nor a successful proxy fight to obtain control of a corporation.[91]

The Delaware courts invalidated the dead hand tactic because it unduly interferes with the right of elected directors to manage the corporation.[92] At least one other state had ruled otherwise on dead hand provisions,[93] suggesting there was precedent for a similar result by the Delaware courts, and that the result reached in Delaware was not inevitable. In this, and in many other instances, Delaware courts have demonstrated

87. *See, e.g.,* Paramount Comm., Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989).

88. For a more nuanced analysis of Delaware case law, see Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997).

89. *See, e.g.*, cases cited *infra* note 92.

90. For a description of the poison pill defense, see JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 903–05 (4th ed. 1995).

91. *See generally* Jeffrey N. Gordon, *"Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder Adopted Bylaws: An Essay for Warren Buffett,* 19 CARDOZO L. REV. 511 (1997).

92. *See* Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281 (Del. 1998) (invalidating a "delayed redemption provision"); Camody v. Toll Bros., Inc., 723 A.2d 1180 (Del. Ch. 1998) (invalidating a dead hand provision under Delaware law).

93. *See* Invacare Corp. v. Healthdyne Tech., Inc., 968 F. Supp. 1578 (N.D. Ga. 1997) (upholding a dead hand poison pill under Georgia law). An earlier New York case had reached a contrary conclusion under New York law. *See* Bank of New York Co. v. Irving Bank Corp., 528 N.Y.S.2d 482 (N.Y. Sup. Ct. 1988).

an admirable measure of independence from any supposed state policy of attracting incorporations.[94]

4. The Federal Comparison

Ironically, not only have the Delaware courts failed to follow the pro-management path that Cary predicted, but the federal courts have ceased to be the faithful guardian of shareholder rights that Cary extolled. A few years after Cary published his article, the Supreme Court announced that federal courts should not equate conduct amounting to a breach of fiduciary duty with securities fraud.[95] Thus, the trend that developed in the 1960s and 1970s, in which federal courts were becoming the venue of choice for claims relating to corporate misconduct,[96] came to an abrupt halt by the early 1980s. Moreover, in a series of decisions that followed soon after Cary published his article, the Court tightened the standards for what constitutes securities fraud, thus further limiting the involvement of the federal courts in corporate litigation.[97] Thus, false statements that might have given rise to a federal securi-

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94. *E.g.*, Emerald Partners v. Berlin, 726 A.2d 1215 (Del. 1999) (liberally construing pleading requirements in derivative action raising entire fairness claim).

95. *See* Santa Fe Indus. v. Green, 430 U.S. 462 (1977).

96. *See, e.g.*, Marshel v. AFW Fabric Corp., 533 F.2d 1277 (2d Cir. 1976) (freeze-out merger without business purpose is fraudulent under Rule 10b-5); Dranchman v. Harvey, 453 F.2d 722 (2d Cir. 1971) (self-dealing may be fraudulent under Rule 10b-5); Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) (unfair purchase by insider of stock from the corporation actionable under Rule 10b-5 even in the absence of deception); *see also* Ralph Ferrara & Marc Steinberg, *A Reappraisal of* Santa Fe: *Rule 10b-5 and the New Federalism*, 129 U. PA. L. REV. 263 (1980) (discussing the relationship between federal and state law after *Santa Fe*). *See generally* 3D HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW 22-1 to 22-195 (2d ed. 1998).

97. *See, e.g.*, Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994) (denying aider and abetter liability under Rule 10b-5); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (maintaining a private damage action under Rule 10b-5 requires that the plaintiff must prove the defendant acted with scienter); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (holding that plaintiff must be a purchaser or seller of securities to have standing to maintain a private cause of action for damages under Rule 10b-5). *But see* Herman & Maclean v. Huddleston, 459 U.S. 357 (1983) (allowing an action to be maintained under Rule 10b-5 even if a remedy under section 11 of the Securities Act of 1933 is available and holding that plaintiff need only prove the well-pleaded allegations of his complaint by a preponderance of the evidence, not a higher clear and convincing standard).

ties claim in 1975 would not today,[98] while false statements that Cary thought would not violate Delaware law do today.[99]

The cases that Cary chose to cite and discuss give an impression that, at least up to that time, managers always won and shareholders always lost in the Delaware courts. That impression is surely misleading; Delaware courts had a more balanced view of the law even at the time Cary was writing his article.[100] Thus, it is not the case that a sea change has occurred in Delaware in the intervening twenty-five years. Rather, Cary simply overstated the case in 1974. Moreover, Cary was wrong to suggest that shareholders were disadvantaged in the Delaware courts, as this cursory review of post-1974 Delaware judicial decisions makes abundantly clear. It neither was, nor is, the case that Delaware judges decide cases solely to further the interests of corporate managers. What underlying philosophy, if any, they do employ, however, is beyond the scope of this paper.[101] In any event, an important support for Cary's thesis is weak, at best. A review of legislative changes in Delaware and elsewhere provides somewhat more support for the notion that Delaware acts to protect corporate managers, and that other states follow. However, as the next section demonstrates, the evidence is less than overwhelming.

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98. In 1976, the Supreme Court decided that negligence would not support a cause of action under Rule 10b-5, overruling some lower federal courts that had ruled otherwise. *See Ernst & Ernst*, 425 U.S. at 187. In *Central Bank of Denver*, 511 U.S. at 167, the Court upset settled precedent in the lower federal courts when it held that a claim for aiding and abetting liability could not be maintained under Rule 10b-5.

99. Cary surely would have been surprised at the Delaware Supreme Court's decision in *Malone v. Brincat*, 722 A.2d 5 (Del. 1998), holding that directors may be liable for false statements even if not made in connection with a solicitation for shareholder action. By comparison, under federal law, a plaintiff alleging a false statement in a proxy solicitation must demonstrate that the proxy solicitation was an "essential link" in the transaction. *See* Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991).

100. *See, e.g.*, Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971) (holding that Delaware directors breached their duty to shareholders by taking action that, although permitted under the Delaware corporate code and the company's bylaws, was inequitable and interfered with corporate democracy); Bennett v. Propp, 187 A.2d 405, 409 (1962) (requiring directors to demonstrate that the repurchase of shares from a potential acquirer was "primarily in the corporate interest").

101. *See generally* Rock, *supra* note 88.

B. Statutory Developments

A review of changes in the Delaware General Corporation Law is more complex. Delaware frequently amends its corporate statute, nearly annually, in fact. Interestingly, few other states amend their corporate laws with such frequency. This suggests, again, that states do not compete with one another for incorporations. It is as though Sony alone improved the features of its CD players each year, while JVC, Magnovox, and other manufacturers updated theirs only every five to ten years. Under such circumstances, it would not appear that JVC and Magnovox were competing with Sony. In any event, Delaware's statutory changes often respond to judicial decisions that either illuminate an ambiguity in the statute,[102] or create some controversy.[103] In either case, the resulting statutory changes seem to be those that corporate management would favor.[104] This observation would tend to support Cary's thesis; Cary would say that he expected nothing less. Judge Winter might respond, however, that one cannot characterize a change as favoring management or shareholders because, in the end, a statute that does not serve the interests of shareholders cannot survive. There is reason to doubt both propositions.

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102. In 1998, the legislature amended section 251(c) of the Delaware General Corporation Law to make clear that a board of directors can submit to a shareholder vote a merger agreement that the board no longer supports. This amendment addressed a problem in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), and subsequent merger cases. *See* Edward P. Welch & James L. Love, *Recent Developments in Delaware Corporate Law*, 1 DEL. L. REV. 267, 269 (1998). In 1997, the legislature amended section 211 to allow shareholders to elect directors by written consent in lieu of holding an annual meeting. The Chancery Court decision in *Hochett v. TSI Int'l Software, Ltd.*, 683 A.2d 43 (Del. Ch. 1996), had held that the election of directors by written consent of stockholders in lieu of a meeting does not satisfy the statutory requirement in section 228 that the corporation hold an annual meeting.

103. The most prominent example of this is the amendment to section 102(b) of the statute to allow a corporation to limit the liability of its directors for breaches of the duty of care following the Delaware Supreme Court's decision in *Van Gorkom*, 488 A.2d at 858.

104. *See id.* See also the 1995 amendment to section 145, which provides for indemnification of directors. This amendment simplified the process for obtaining indemnification. 69 Del. Laws 522 (1994); *see also* Brenda G. Houck, *Statutory Amendments to the Delaware General Corporation Law*, 20 DEL. J. CORP. L. 477, 487–91 (1995).

1. Refuting Cary

Doubt is cast on Cary's thesis if the Delaware legislature amends its statute in a way that clearly advantages shareholders vis-a-vis management, or if the legislature fails to adopt a pro-management provision that appears in other state codes. Doubt is also cast if other states fail to adopt promptly an important Delaware statutory innovation. A review of corporate codes discloses examples of all three of these doubt-casting phenomena. While Delaware has not frequently amended its law to favor shareholders or passed on the opportunity to adopt innovations in other state laws, these things occur. More telling, many states are slow to amend their codes to adopt the latest Delaware corporate innovation.

An example of what Cary might have characterized as a "pro-shareholder" Delaware provision can be found in the 1998 amendments to the Delaware code. Last year, the Delaware legislature adopted a provision that requires directors to declare the advisability of a merger agreement before submitting it to the shareholders.[105] Before this statutory change, directors merely had to approve a merger agreement before submitting it to a vote of the shareholders.[106] After the amendment, the directors have the additional obligation and the shareholders have an additional, albeit small, statutory protection, which insures that the directors are acting in their interests.[107] Although the change is uncontroversial, and conforms this section of Delaware law to other sections,[108] it is also clearly not a dilution of the rights of shareholders vis-à-vis management. To the contrary, it enhances shareholder rights.

Examples of Delaware's failure to adopt a pro-management provision from other state codes or the failure of other states to adopt Delaware innovations are abundant. For instance, many states allow corporations to limit the liability of officers for

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105. *See* DEL. CODE ANN. tit. 8, § 251(b) (Supp. 1998). *See also* Welch & Love, *supra* note 102, at 267.

106. *See* title 8, § 251(b).

107. *See id.* The section now provides, in part, that if the corporation has capital stock, its board of directors "shall adopt a resolution setting forth the amendment proposed, *declaring its advisability.*" *Id.* (emphasis added). The italicized words were added by the amendment.

108. Title 8, section 242(b)(1) of the Delaware Code requires that the board of directors declare that a charter amendment is "advisable" before submitting it to a vote of the shareholders. *See id.*

negligent conduct.[109] The Delaware code does not, providing only that the liability of directors, and not that of officers, may be limited.[110] More importantly, in Delaware it is harder for the directors to get a court to dismiss a derivative action filed against them than it is in other states. In Delaware, as compared to, say, New York, the courts will scrutinize the decision of a director-created special litigation committee to dismiss a derivative action against corporate management.[111] Some commentators have suggested that the Delaware legislature has rejected the New York approach because of resistance of the Delaware bar. Presumably, both defendants' and plaintiffs' bars desire to preserve this lucrative area of practice, and they oppose statutory reform that makes it too easy for defendants to dispose of the litigation.[112] This explanation of Delaware's reluctance to protect officers and directors is questionable. Evidence of such a conspiracy is lacking, and the explanation is hard to square with other actions of the Delaware legislature that have the effect of limiting shareholder litigation. The prime example of this is the Delaware legislature's reaction to *Smith v. Van Gorkom*, discussed above.[113] The legislature

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109. *Compare id.* § 102(b)(7) ("the certificate of incorporation may . . . contain . . . [a] provision eliminating or limiting the personal liability of a director") *with* MD. CODE ANN., CORPS. & ASS'NS § 2-405.2 (Supp. 1998) ("[t]he charter of the corporation may include any provision expanding or limiting the liability of its directors and officers to the corporation or its stockholders"), VA. CODE ANN. § 13.1-692.1(A)(2) (Michie 1999) (limiting the liability of officers and directors), *and* N.J. STAT. ANN. § 14A:2-7(3) (West Supp. 1999) ("[t]he certificate of incorporation may provide that a director or officer shall not be personally liable, or shall be liable only to the extent therein provided").

110. *See* title 8, § 102(b)(6).

111. *Compare, e.g.,* Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979) (holding that if the corporation's special litigation committee was independent and disinterested, and employed adequate and appropriate investigative procedures and methodologies, its decision to dismiss derivative litigation is entitled to the protections of the business judgment rule), *with* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (finding that if the special litigation committee was independent and demonstrated reasonable bases for good faith findings and recommendations, the Chancery Court should determine, applying its own business judgment, whether the committee's recommendation to dismiss the litigation should be granted).

112. This arguably explains why Delaware does not have a statute requiring plaintiffs with small shareholdings who file derivative actions to post security for expenses. *See Law for Sale, supra* note 7, at 888. Statutes requiring derivative plaintiffs to post security for expenses, although popular several years ago, are only retained in eight states today. *See* MODEL BUS. CORP. ACT ANN. § 7.40, at 7–260 (Supp. 1997).

113. *See supra* text accompanying notes 77–79.

amended its corporate code to allow corporations to limit the liability of directors for breach of the duty of care, potentially cutting off a substantial amount of litigation. Why did the defendants' and plaintiffs' bars not join to resist this statutory change? In fact, anecdotal evidence suggests that the defendants' bar *initiated* this change.

Finally, there are many instances in which states have failed to follow Delaware's lead in statutory innovation. For instance, in 1995, Delaware adopted a new provision permitting a Delaware corporation to reorganize as a holding company, subject to certain limitations, without shareholder approval.[114] Transactions contemplated by this new section would have required shareholder approval under prior law.[115] Only a few states have adopted this innovation.[116]

2. Refuting Winter

Winter, though, is less easy to refute, at least if one accepts his assumptions. Winter starts from the premise that the states compete to provide an economically efficient corporate code.[117] If a corporate code is inefficient, the state will not be able to "sell" it to promoters and corporate managers choosing a jurisdiction in which to incorporate. According to this logic, in the long term, the Delaware corporate law simply cannot be economically inefficient, and it is folly to seek to characterize a provision or amendment as favoring management or shareholders. The Delaware antitakeover statute, however, presents a problem in this analysis.[118] As a matter of theory, supported by some empirical research,[119] antitakeover statutes are inefficient because they impede the market for corporate control, leaving corporations in the hands of ineffective managers.

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114. *See* title 8, §251(g). For a description of this provision, see C. Stephen Bigler, *1995 Amendments to the Delaware General Corporation Law*, INSIGHTS, Aug. 1995, at 21.

115. See title 8, § 251(c).

116. A computer search in March 1999 found that only three states had adopted provisions similar to Delaware's section 251(g). *See, e.g.*, FLA. STAT. ANN. §607.11045(3) (West Supp. 1999); MO. ANN. STAT. §351.448(1) (West Supp. 1999); TEX. BUS. CORP. ACT ANN. art. §5.03(H) (West Supp. 1999).

117. *See* Winter, *supra* note 18, at 254.

118. *See* title 8, § 203.

119. *See* Gregg A. Jarrell & Michael Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J.L. & ECON. 371 (1980).

An unfettered market for corporate control assures that corporate assets will move to those investors placing the highest value on those assets, furthering economic efficiency. If the market for corporate control is distorted, inefficient corporate laws can continue to exist, as entrepreneurs will be discouraged in their attempt to take over a corporation and reincorporate it in a jurisdiction with a more efficient law. Winter's thesis, therefore, depends on the absence of an antitakeover statute in the same way that the rules of basketball depend on a fixed time for the length of the game. If the game had no endpoint, the other rules simply would not matter. In the context of Winter's thesis, an antitakeover statute may be the only corporate law one can identify *ex ante* as being economically inefficient. Indeed, Winter and other proponents of the view that states compete to offer the most efficient corporate law are strong advocates of the view that state antitakeover statutes are economically inefficient.[120] Not surprisingly, they have had a difficult time explaining how such statutes can persist in the competitive environment that they postulate.[121]

While Delaware joins many other states that have adopted various measures to strengthen the position of corporate managers in defeating hostile takeovers,[122] roughly one-third of the states have not done so.[123] This state of affairs says a great deal about the race debate. On one hand, we can explain Delaware's law as an example of Cary's race to the bottom. According to this argument, Delaware enacted its law because other states had provided protection to incumbent manage-

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120. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1188 (1981); Winter, *supra* note 18, at 288.

121. For a review of these efforts, see Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Takeover Law; The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999).

122. For a recent summary of the various state antitakeover statutes, see *From the Hustings: The Roll of States With Takeover Control Laws*, MERGERS & ACQUISITIONS Sept.–Oct. 1997, at 55, 55–56, indicating that, as of mid-1997, 41 states had adopted some type of statutory takeover controls. This number includes states with so-called "other constituency" statutes, which permit directors to consider constituencies other than shareholders when considering corporate action, including defenses to hostile takeovers. Not all commentators would characterize such statutes (which 30 states had adopted) as antitakeover statutes.

123. *See id.* at 55. States without such statutes include Alabama, Alaska, Arkansas, California, Colorado, the District of Columbia, Illinois, Iowa, Montana, New Hampshire, New Mexico, North Dakota, Rhode Island, Texas, Vermont, West Virginia, and Wyoming. *See id.*

ment, and Delaware had to follow suit to avoid losing corporations.[124] Delaware could not, and did not, cite the justification that other states relied upon in enacting their antitakeover statutes: that a change in corporate control results in a loss of jobs in the state and in harm to communities within the state.[125] Very few of Delaware's corporations have operations in the state, so Delaware rarely suffers the sorts of losses that other states incur when a change of control occurs in a Delaware corporation. Delaware was simply protecting its incorporation business.[126]

On the other hand, Delaware's statute does allow corporations to opt out of its protective provisions, and some corporations have done so. The statute is also less of an impediment to a takeover than other statutes; it merely limits the ability of a hostile acquirer to enter into a business combination with the target for a three-year period following the takeover. This would tend to support Winter's thesis: Delaware's restraint, he might say, reflects its appreciation for the economic realities of corporate statutes.

The truth, again, lies somewhere between Cary and Winter. Delaware does react to the interests of corporate management, in the same way that major airlines design their fre-

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124. *See generally* Alan E. Garfield, *State Competence to Regulate Corporate Takeovers: Lessons From State Takeover Statutes*, 17 HOFSTRA L. REV. 535 (1989) (reviewing the legislative history of the Delaware statute and concluding that the Delaware legislature acted to protect its position as a jurisdiction of choice for corporate charters and responded to promote managerial interests).

125. *See id.* at 583.

126. In theory, the fact that Delaware's antitakeover statute helped it maintain its desirability as a jurisdiction of choice for incorporation does not suggest the legislature's motive in enacting the law. It seems clear, however, that Delaware was concerned with appealing to corporate managers by providing a law that deterred hostile takeovers. Shareholders might favor an antitakeover law that protected them against coercive tender offers, i.e., bids structured to encourage shareholders to tender even when they feel the price is inadequate. But the Delaware statute goes well beyond that, limiting the ability of an acquirer to effectuate a business combination with the target unless the target board consents. *See* DEL. CODE ANN. tit. 8, § 203 (1991 & Supp. 1998). This provides no shareholder protection, but does deter some offers. Similarly, with a view to shareholder preferences, the Delaware legislature could have made the protections of the Delaware antitakeover statute subject to shareholder approval on an opt-in basis, as they did some years ago with a provision allowing corporations to limit the liability of corporate directors. *See id.* § 102(b)(7). In the antitakeover context, however, corporate managers may elect to opt out. *See id.* § 203(b). This, too, demonstrates the motivations of the Delaware legislature. For a fuller development of this point, see Bebchuk & Ferrell, *supra* note 121.

quent flier programs for the corporate travelers who buy airline tickets. But neither Delaware nor the airlines can act without restraint. Delaware probably is restrained by the economic principles that Winter identified, but only to an extent. The Delaware legislature, and the corporate law committee that advises it, likely consider multiple factors, including the interests of both management and shareholders, as well as a crude assessment of economic efficiency.[127]

C. *Convergence of State Law and the Effect of the Stock Exchange Rules*

As both Cary and Winter accepted the premise that state legislatures consciously compete with one another to provide attractive corporate codes, each might have reasonably anticipated a convergence of statutory law. The differences among corporate statutes, particularly in reference to provisions of critical importance to corporate management, should decline. In reality, however, a great deal of diversity persists in corporate law.[128] These differences may persist because legislators responsible for enacting those laws may not be motivated—or at least are not only motivated—to attract incorporations. While legislators are concerned with providing a modern, efficient corporate statute, that is not their only consideration. Fairness to shareholders and other constituents, at least as perceived by the state legislature and the members of the state's corporate bar who often advise them, is also a consideration.[129] A nice example of this balance of interests emerges from the American Bar Association's Model Business Corporation Act. The Model Act is the product of the Bar's section on corporate, banking, and business law. The mere existence of this work, and the large number of adoptions it has garnered, suggests the presence of diversity in corporate law. There

127. *See* S. Samuel Arsht, *A History of Delaware Corporation Law*, 1 DEL. J. CORP. L. 1, 20 (1976) (arguing, possibly somewhat self-servingly, that the corporate law revision committee, of which the author was a member, adopted "pro-shareholder" provisions it considered appropriate, and was influenced by factors other than managerial interests).

128. *See infra* notes 142–49 and accompanying text.

129. *See* Renee L. Crean, *Recent Developments in New York Law*, 72 ST. JOHN'S L. REV. 695 (1998) (explaining how various political factors affected the actions of the New York legislature in its recent amendments to its corporate code).

would be little point to the Bar's scholarly drafting and commentary if the Model Act simply mirrored Delaware's law. At the end of the day, states would simply be inclined to follow Delaware's lead.

The Model Act contains provisions not found in Delaware's code that might be characterized as pro-shareholder and economically inefficient. For instance, the Model Act and Delaware law have long differed on whether shareholders who vote against a proposal to sell all of the corporation's assets have dissenters' rights.[130] The Model Act and the laws of almost all states provide that such shareholders may require the corporation to repurchase their shares at fair value.[131] Delaware does not.

In the extensive 1984 revision to the Model Act, the drafters included a new provision that allowed shareholders to dissent from certain amendments to the articles of incorporation and receive the fair value of their shares from the corporation.[132] While Delaware does not have a comparable provision, as of 1997 thirty-seven states had adopted the Model Act provision.[133] Similarly, the Model Act protects the rights of the holders of a class of shares to vote as a class on amendments to the articles of incorporation that create a new class of shares with superior rights on dissolution.[134] In such circumstances, the Delaware corporate code does not require class voting.[135]

Expansive dissenters' rights and class voting appeal to a sense of fairness, even if they are inefficient. How do we explain these and other important differences between Delaware and other states?[136] Are these simply anomalies, or do such

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130. *Compare* MODEL BUS. CORP. ACT § 13.02(a)(3) (Supp. 1997) *with* DEL. CODE ANN. tit. 8, § 262(a) (Supp. 1998).

131. *See* 1 JONATHAN R. MACEY, MACEY ON CORPORATION LAWS § 14.02[B] (1999).

132. *See* MODEL BUS. CORP. ACT § 13.02(a)(4) (1984).

133. *See* MODEL BUS. CORP. ACT ANN. § 13.02(a)(4) annot. at 13–22 (Supp. 1997).

134. *See* MODEL BUS. CORP. ACT § 10.04(a)(6) (Supp. 1997), *as set forth in Changes in the Model Business Corporation Act—Fundamental Changes*, 54 BUS. LAW. 685, 720 (1999).

135. *See* title 8, § 242.

136. For instance, the Model Act provides that, unless the articles of incorporation reserve the power to amend bylaws exclusively to the shareholders, directors may amend the bylaws. *See* MODEL BUS. CORP. ACT § 10.20(a) (Supp. 1998). Delaware reverses this: unless the articles expressly authorize the directors to amend the bylaws, that power rests exclusively with the shareholders. *See*

provisions reflect some deeper truth about corporate law? Multiple factors likely account for corporate law. Economic efficiency is but one factor.

Earlier this year, the drafters of the Model Act promulgated a number of provisions that, in effect, require shareholder approval of corporate transactions in instances in which prior law did not.[137] Such provisions obviously limit the discretion of management by empowering shareholders to act. The drafters recommended these provisions to conform the Model Act to the requirements that are now imposed on companies listed or traded on the New York Stock Exchange,[138] the American Stock Exchange,[139] and the National Association of Securities Dealers Automated Quotation System (NASDAQ).[140] The drafters, however, did not limit the applicability of the provisions to publicly-traded corporations. To have done so would have been to amend the Model Act to conform with the effective limitation on similar Delaware corporations, which are subject to the stock exchange listing requirements, even if those requirements are in conflict with Delaware law. The drafters thus went beyond Delaware law.

While it might be argued that, as a practical matter, these changes only affect publicly-traded companies and, therefore, the Model Act is not more shareholder-friendly than the Delaware statute, a more conservative approach would have been to leave the law unchanged, as the stock exchanges may, at some point, amend their rules. The failure to adopt this more con-

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title 8, § 109(a). Twenty-three jurisdictions have adopted the Model Act approach, two jurisdictions have followed the Delaware provision and 26 jurisdictions have drafted their own provisions. *See* 2 MACEY, *supra* note 131, at 7–66. The power of shareholders to call a special meeting of shareholders is another instance of a sharp demarcation between the Delaware Code and the Model Act. The Model Act requires the board to call a special meeting of shareholders if shareholders holding ten percent of the stock so demand (the articles of incorporation can raise this number to no more than twenty-five percent). *See* MODEL BUS. CORP. ACT § 37.02(a)(2) (Supp. 1998). Delaware is the opposite: unless the articles empower shareholders to call a special meeting, they have no power to do so. *See* title 8, § 211(b). Most states follow the Model Act approach, which puts those states in a competitive disadvantage in relation to Delaware. Typically, management of a publicly held corporation would prefer that shareholders have no ability to call a special meeting and possibly replace the board.

137. *See* Committee on Corporate Laws, *Changes in the Model Business Corporation Act—Fundamental Changes*, 54 BUS. LAW. 685 (1999).

138. *See* N.Y.S.E. Listed Co. Man. § 7 (N.Y.S.E., Inc.) (1983).

139. *See* 2 Am. Stock Ex. Guide, Rules 701-26 ¶¶ 9556-9564B (CCH) (1991).

140. *See* NASD Man. (CCH) (1999).

servative approach may reflect the drafters' belief that the stock exchange rules are good ones, and ought to be reflected in state law, even if the stock exchanges subsequently amend their rules.

More importantly, the action of the drafters reflects an additional phenomenon—that stock exchanges play an important role in the evolution of corporate law[141]—a development that neither Cary nor Winter anticipated. In addition to specifying a number of transactions that require shareholder approval, the stock exchange rules delve into other aspects of corporate governance. For instance, the rules limit the ability of listed companies to "disparately reduce[] or restrict[]" the voting rights of existing shareholders,[142] and require that a listed company have at least two independent directors on its board[143] and maintain an audit committee, a majority of the members of which must be independent directors.[144]

These corporate governance requirements are particularly noteworthy because stock exchanges do compete for the privilege of listing corporations, deriving fees from them both when a corporation is listed on the exchange and when its shares are traded. Like the drafters of corporate codes, stock exchanges must provide rules that are attractive to corporate managers, who decide where to list, and to investors, who could choose not to invest in an exchange-listed security on the basis of its rules. The exchanges have adopted rules of corporate governance that Delaware has not adopted, suggesting that, in deciding between shareholder protection and management flexibility in a competitive environment, reasonable minds can differ.

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141. For a thoughtful development of this ideal, see John E. Coffee, Jr., *The Future as History: The Prospect for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641 (1999).

142. *E.g.*, NASD Man., Rule 4310(21) (CCH) (1999).

> Voting rights of existing shareholders of publicly traded common stock registered under Section 12 of the Act cannot be disparately reduced or restricted through any corporate action or issuance. Examples of such corporate action or issuance include, but are not limited to, the adoption of time-phased voting plans, the adoption of capped voting rights plans, the issuance of super-voting stock, or the issuance of stock with voting rights less than the per share voting rights of the existing common stock through an exchange offer.

Id.

143. *See, e.g.*, *id.*, Rule 4310(25)(B).

144. *See, e.g.*, *id.*, Rule 4310(25)(C). *See generally* 4 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 1826–54 (3d ed. 1990).

Even among states that have adopted the Model Act, one finds an interesting diversity in the law. In a recent article, Professor William Carney concluded that state adoptions of the Model Act demonstrated that state corporate statutes are in fact highly uniform.[145] He noted, for instance, that as of 1996, 142 provisions of the Model Act had been adopted by an average of about thirty-seven states, or seventy-four percent of the states.[146] A closer look at these data, however, supports the opposite conclusion. The fact that a quarter of the states, on average, do not adopt any given provision itself suggests a material degree of diversity among the states. More importantly, while many provisions are adopted by a large majority of the states, and others are rejected by a large majority of states, the individual states adopting or rejecting any given provision vary considerably.

Looking at just two important Model Act provisions, one relating to the removal of directors[147] and the other relating to the right of shareholders to dissent from amendments to the articles of incorporation,[148] illustrates the point. Section 8.08(d) of the Model Act provides that a director can only be removed at a meeting of shareholders called expressly for the purpose of removing the director, and the notice of the meeting must state that the purpose of the meeting is to remove the director. As of 1996, thirty-three states had adopted this provision, which represents a limitation on the ability of shareholders to remove a director.[149] Surprisingly, the Delaware code does not include this limitation.[150]

Section 13.02(a)(4) of the Model Act grants to shareholders the right to dissent from certain amendments to the articles of incorporation, a provision that represents an expansion of shareholder rights. As of 1996, thirty-seven states had adopted this provision.[151] Not surprisingly, Delaware does not grant

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145. *See* William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 755 (1998).

146. *See id.* at 731.

147. *See* MODEL BUS. CORP. ACT § 8.08(d) (1998).

148. *See id.* § 13.02(a)(4).

149. *See* Carney, *supra* note 145, at 769.

150. Incumbent management would favor any provision that makes its removal more difficult. Delaware's law thus allows insurgents to remove directors through a consent solicitation, which would not be possible in a Model Act state that adopts section 8.08(d).

151. *See* Carney, *supra* note 145, at 770.

this right to shareholders. Ignoring Delaware, Professor Carney might have cited this data as support for the uniformity of corporate law. However, based on Carney's tables, of the thirty-seven states that adopted section 13.02(a)(4), only twenty-seven also adopted section 8.08(d).[152] As additional provisions are considered, the number of states that have adopted all provisions continues to decline. Note, too, how an analysis of just these two provisions demonstrates the willingness of states to deviate from Delaware law. States must understand that even if they were to copy Delaware's statute wholesale, they could not attract significant incorporation business away from Delaware. Delaware's other advantages, noted above,[153] give it a nearly insurmountable advantage in attracting incorporation business.[154] If a state legislature accurately assesses its competitive position—assuming it was otherwise inclined to compete for incorporation business—it might well conclude that considerations other than attracting incorporation business should motivate its legislative action.

In addition to a continued diversity in state law, which we would not expect were there a high degree of competition, inefficient corporate laws persist and, indeed, have been added to the statute books in recent years. The next section discusses the "Achilles' heel" of the Winter thesis, the persistence of inefficient corporate laws.

D. The Persistence of Economically Inefficient Laws and the Market for Corporate Control

According to conventional economic theory, which is reflected in Winter's article, competition among the states for the corporate chartering business will motivate states to eschew inefficient statutory provisions. As noted above, many states, including Delaware, have antitakeover statutes.[155] However,

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152. *See id.* at 769–70.

153. *See* discussion *supra* Part I.

154. As Professor Macey has noted: "At various times, several states (including Maine and Nevada) have attempted to attract incorporation business (and the accompanying tax revenues and fees) by enacting more permissive statutes that include incentives to incorporation. These states have had little success in seizing Delaware's place at the forefront of the rechartering business." 1 JONATHAN R. MACEY, MACEY ON CORPORATION LAWS xxxix (1998).

155. *See supra* note 122.

these statutes are not the only corporate law provisions that are inefficient. Among other provisions, the sections of the Model Act that grant shareholders dissenters' rights might be characterized as inefficient.[156] By allowing shareholders to insist on a buy-out, the cost to the corporation of selling its assets or amending its charter is increased. More fundamentally, *any* mandatory provision in the corporate law is arguably inefficient. The relationship between shareholders and the corporation is essentially one of contract, the terms of which are set forth in the articles of incorporation and the state corporate codes.[157] Presumably, mandating terms in the corporate code is unnecessary and inefficient, as the shareholders can bargain for such terms as they prefer. If the state mandates a term, and it is not a term that would have resulted from bargaining between the corporation and the shareholders, then the state's mandated term is inefficient. The persuasiveness of this argument is examined in the Conclusion below. In any case, however, the continuation of mandatory terms in the Model Act, Delaware corporate law, and the corporate codes of all states amply demonstrates that inefficient corporate laws not only exist, but in some instances are on the increase.[158]

Finally, even if Winter is correct that markets accurately price corporate law, he overestimates the importance of the market for corporate control. A key element of Winter's theory is that corporations that choose an inefficient law will be subject to increased takeover risks. To avoid that eventuality, corporate managers will choose an efficient law.[159] This theory thus assumes an active, unencumbered market for takeovers, an assumption that is simply counterfactual. Aside from the effect of antitakeover laws, hostile takeovers are problematic.

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156. *See, e.g.*, MODEL BUS. CORP. ACT § 13.02 (1998).

157. For further development of this point, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1–39 (1991).

158. Among the mandatory provisions in the Model Business Corporation Act are: only shares can vote (section 7.21); a quorum of directors must be at least one-third (section 8.24(b)); shareholder action without a meeting must be by unanimous consent (section 7.04); and, a staggered board must consist of at least nine directors (section 8.06). *See generally* Carney, *supra* note 145, at 768–73 (setting forth a table showing mandatory provisions in the Model Business Corporation Act and the number of states adopting such provisions). Professor Carney catalogued 30 mandatory rules and another 29 mandatory constraints on enabling rules.

159. *See* Winter, *supra* note 18, at 289–90.

The otherwise inefficient corporate statute must have a dramatic effect on the stock price, as the typical hostile takeover is at a premium of twenty-five to thirty-five percent over market.[160] Not surprisingly, Winter did not cite, and I was unable to find, a single instance of a corporation reincorporating in a more shareholder-friendly state after a takeover—the scenario that Winter so forcefully predicted.

Winter might respond that the differences among state laws are not sufficiently great to warrant reincorporation. But there are significant differences among the states. An alternative explanation is that even significant differences in law do not translate into material differences in market effects. If this is true, however, then two conclusions emerge. First, the public policy that supports corporate law can be broader than economic efficiency. If a statute that for other reasons seems appropriate, such as a statute that grants dissenters' rights, does not materially affect a corporation's market value, then legislatures should adopt such a statute.[161] Second, if Delaware's dominance is secure, and the states are not engaged in a "race to the top," then we might wonder, as Cary did, whether corporate law adequately protects shareholder interests. This is the subject of Part III, below.

III. THE ROLE OF CORPORATE DEMOCRACY

The answer to this question—the one that so concerned Cary—is not in federal regulation, as Cary believed, nor in the market for corporate control, as Winter has argued. Rather, the solution may be more direct: to increase shareholder democracy. To the extent that shareholders are disadvantaged by provisions of state corporate law, their corporate charter or by-laws, or, most importantly, by the unilateral action of their board of directors,[162] they should be afforded the means by which they can make changes. This, it turns out, is a matter

160. *See* Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Capital: The Scientific Evidence*, 11 J. FIN. ECON. 5, 7 (1983).

161. *See infra* Conclusion for a more detailed development of this idea.

162. Unilateral actions might include the adoption of shareholder rights plans, or poison pills, or the adoption of plans that create disparate voting rights. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (upholding a director-created "flip-over poison pill").

implicating both federal and state law, but one not much noticed by those so earnestly engaged in the race debate.

Part of the reason that shareholder democracy is not more warmly embraced is that, like citizen ballot initiatives, it is often abused. Many shareholder proposals relate to the pet projects or political agendas of various shareholders with small stakes in the corporation. Quite often, shareholders propose matters relating to political contributions, human rights, and other social policies that are better left to the political arena. Of equal importance, these measures never pass, because most shareholders believe that they are not proper matters for shareholder democracy.[163]

At the same time, we are witnessing a quiet revolution regarding shareholder proposals that relate to corporate governance. Over the past several years, shareholders have been increasingly active in making proposals to their fellow shareholders and increasingly successful in achieving corporate governance reform through such initiatives. For instance, in 1997 there were eighteen shareholder proposals recommending to the board of directors that it redeem or allow shareholders to vote on implementing or continuing poison pills. The average vote in favor of these proposals was fifty-five percent.[164] In 1998, the number of such proposals had increased to twenty, and the average affirmative vote increased to fifty-seven percent.[165] By comparison, in 1992 there were about the same number of proposals, but the affirmative vote was only forty-

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163. For instance, of the 737 shareholder proposals tracked by the Investor Responsibility Research Center (IRRC) in 1998, 261, or thirty-five percent, dealt with social issues, 429 dealt with corporate governance proposals, and 47 were classified as "overlapping proposals." The social issues included topics related to equal employment, charitable contributions, and Northern Ireland, among others. None passed and the average vote in favor of these proposals was about nine percent. By comparison, corporate governance proposals received, on average, a twenty-four percent favorable vote. *See* 15 CORP. GOVERNANCE BULL. (Feb. 3, 1999).

164. *See* Kenneth A. Bertsch et al., *SEC Release on Shareholder Proposal Rule Reform Sparks Much Controversy*, 14 CORP. GOVERNANCE BULL. 7, 10 (1998).

165. *See Summary of 1998 U.S. Shareholder Resolutions*, 15 CORP. GOVERNANCE BULL. SUPP. (Feb. 3, 1999).

three percent.[166] Similar trends are apparent in other matters of corporate governance of interest to shareholders.[167]

Federal law has a role to play here, because the SEC oversees the proposal process, advising companies whether SEC rules allow the company to omit a particular proposal from its proxy statement.[168] Under Rule 14a-8 (adopted under section 14 of the Securities Exchange Act of 1934), a public company must include shareholder proposals in its proxy statement unless the rules provide a specific exemption.[169] For instance, under Rule 14a-8, a company need not include a proposal that relates to the ordinary business of the company,[170] nor one that is not relevant to the company's business[171] or is improper under state law.[172] If the SEC rules that a company must include a particular shareholder proposal in its proxy statement, the company may appeal the ruling to the federal courts, but it is at a clear disadvantage, as the court will generally defer to the SEC's expertise.[173]

The latest development in this area has been the use by shareholders of Rule 14a-8 to amend the corporation's bylaws, thereby exercising a power that they generally share with directors under most corporate codes.[174] Unlike the earlier initiatives that merely *requested* the board to act, a bylaw amendment, if approved by the shareholders, would be self-executing and binding on the board.[175] The staff of the Commission has ruled that it would treat shareholder proposals to amend the

166. *See Shareholder Activism Continues to Thrive*, 10 CORP. GOVERNANCE BULL. 8 (May/June 1993).

167. For instance, the number of proposals to repeal classified boards had increased from 35 in 1992 to 49 in 1998, while the vote in favor of the proposal had increased from 32% in 1992 to 47% in 1998. *Compare id. with Summary of 1998 U.S. Shareholder Resolutions, supra* note 167.

168. *See* Peter J. Romeo and Richard I. Parrino, *Reforming the Shareholder Proposal Process,* 1023 PLI/CORP. 239, 245–46 (1997).

169. *See* 17 C.F.R. § 240.14a-8(i) (1999).

170. *See id.* § 240.14a-8(i)(7).

171. *See id.* § 240.14a-8(i)(5).

172. *See id.* § 240.14a-8(i)(1).

173. *See* New York City Employees' Retirement Sys. v. Dole Food Co., 795 F. Supp. 95, 100 (S.D.N.Y. 1992), *appeal dismissed as moot and order vacated,* 969 F.2d 1430 (2d Cir. 1992).

174. *See* MODEL BUS. CORP. ACT § 10.20(a) (Supp. 1997).

175. *See, e.g.*, Burr v. Burr Corp., 291 A.2d 409 (Del. Ch. 1972) (enforcing stockholder-approved amendment to the bylaws authorizing holders of a majority of the stock to fill newly created directorships at a time other than the annual meeting).

corporation's bylaws like any other shareholder proposals; companies must include the proposals in their proxy statements unless the proposal falls within one of the exemptions.[176]

One of those exemptions is whether the proposal is a proper matter of action for shareholders.[177] This exemption was at the heart of a closely watched Oklahoma case, *International Brotherhood of Teamsters General Fund v. Fleming Cos.*,[178] where a shareholder proposed that the corporation include in its proxy statement a bylaw amendment that would have repealed the corporation's poison pill and eliminated management's ability to implement a similar provision in the future without prior shareholder approval. Management refused to include this proposal in the proxy statement, arguing that the decision of whether or not to institute or repeal a poison pill is a purely management decision. Shareholders, they argued, have no authority under state law to interfere with this aspect of corporate governance. The federal district court in Oklahoma, in a 1997 ruling from the bench, ordered Fleming to include the proposal. Fleming appealed the ruling to the Tenth Circuit, which certified the matter to the Oklahoma Supreme Court, asking whether, under Oklahoma state law, (a) the board of directors has exclusive authority to create and implement poison pill plans, and (b) whether a shareholder proposal may require that poison pill plans be submitted to a vote of shareholders. In a decision handed down in January of 1999, the Oklahoma Supreme Court ruled in favor of the shareholders, deciding that the board's authority was not exclusive and the shareholder proposal was a proper avenue for shareholders to seek amendments to the corporate bylaws.[179]

This decision strikes at the very heart of the relationship between shareholders and directors and at the race debate. Fleming argued that the corporate code empowered the board, not shareholders, to implement and redeem poison pills.[180] It thus argued, in effect, that the corporate code empowered the

176. *See, e.g.*, Letter from General DataComm Industries, Inc. to the Securities and Exchange Commission (Oct. 27, 1998) (*available in* 1998 WL 883796 (SEC)) (regarding the SEC's no-action letter).

177. *See* § 240.14a-8(i)(1).

178. 975 P.2d 907 (Okla. 1999).

179. *See id.* at 913.

180. *See id.* at 910.

board, not the shareholders, to manage the business and affairs of the corporation. The Oklahoma court was unconvinced.

Some critics of the *Fleming* decision have questioned whether Delaware would follow it,[181] citing *Quickturn Design Systems, Inc. v. Mentor Graphics, Inc.*[182] In that 1999 decision, the Delaware Supreme Court held that a board of directors could not adopt a poison pill plan that limited the ability of future boards to repeal the plan, thereby setting aside a so-called "delayed redemption" provision.[183] The court reasoned that an elected board of directors must have full power to manage and direct the business and affairs of the corporation.[184] Arguably, the bylaw provision approved in *Fleming* infringes upon this authority, but the context is so different that citing *Quickturn* as inconsistent with *Fleming* borders on cynicism. In *Quickturn*, the court overturned the attempt by the board of directors to affect the authority of future boards, thereby limiting a draconian antitakeover measure. In *Fleming*, the Oklahoma court upheld the action of the *shareholders* to limit the authority of the board of directors. It is a decision that limits the likelihood of a draconian antitakeover measure. The decisions are perfectly consistent with one another to the extent that they both support the removal of barriers in the market for corporate control.

If a Delaware court were to reject *Fleming*, then, at least on one level, it would be saying that shareholders are incapable of acting in their own best interests, a proposition that is at odds with the philosophy underlying *Quickturn* and the Delaware corporate code itself. Under the corporate code, only directors are limited in the ability to adopt, amend, or repeal bylaws. Once the corporation issues shares, the power to adopt, amend, or repeal bylaws rests exclusively with shareholders, unless the articles also give this power to directors.[185] Even if

181. *See, e.g.*, Michael D. Goldman, Fleming *Must Be Read Narrowly*, 21 BANK AND CORP. GOVERNANCE L. REP. 1102 (1999) (providing a symposium on this issue); Jonathan R. Macey, *The Legality and Utility of the Shareholder Rights Bylaw*, 26 HOFSTRA L. REV. 835 (1998) (arguing for the enforceability of such bylaw amendments); Charles F. Richards, Jr. & Robert J. Stearn, Jr., *Shareholder By-Laws Requiring Boards of Directors to Dismantle Rights Plans Are Unlikely to Survive Scrutiny Under Delaware Law*, 54 BUS. LAW. 607 (1999).

182. 721 A.2d 1281 (Del. 1998).

183. *See id.* at 1291.

184. *See id.*

185. *See* DEL. CODE ANN. tit. 8, § 109(a) (1998).

the articles confer upon directors the power to adopt, amend or repeal bylaws, however, the shareholders continue to have the power undiminished.[186] The Delaware code thus expresses a preference for shareholder rulemaking in the corporate area.

Finally, *Fleming* is a decision that is consistent with economic efficiency, a goal that Justice Veasey, the Chief Justice of the Delaware Supreme Court, has extolled in speeches and articles.[187] Just as investors value corporate governance features in assessing a company's value, they would only vote for corporate governance proposals that enhance the value of their investment. If one is willing to trust shareholders on the investment side, then one must trust them even more so on the voting side. An investor may purchase shares despite dissatisfaction with one or more terms of governance, but a rational investor will not vote for a discrete proposal that disadvantages his or her investment.

In any event, shareholder democracy holds the key to the future of corporate law. So long as shareholders can undo value-decreasing corporate governance structures, or implement value-enhancing provisions, they can minimize the impact of statutory law. Corporate law simply will matter far less if investors directly influence corporate law at the corporate ballot box and not just indirectly with their investment preferences. State legislators who truly wish to enact an efficient law should protect shareholder democracy.

CONCLUSION: THE ROLE OF THE STATE LEGISLATURES.

Beyond protecting shareholder democracy, however, is there any role for state legislators? This question provides another way to characterize the Winter/Cary debate. When Winter and others argue that investors can price the terms of corporate governance,[188] they are also saying that corporate codes should be enabling, not mandatory. That is, corporate codes should not mandate anything in the relationship between shareholders and corporate managers; what investors and managers decide upon on their own is likely to be more efficient

186. *See id.*

187. *See, e.g.*, E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 BUS. LAW. 681 (1998).

188. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 157, at 1431 ("The [stock] price reflects the effects, good or bad, of corporate law.").

than anything that state bureaucrats can devise. After all, the argument goes, investors will do a better job than bureaucrats because investors are putting their own funds at risk, while the bureaucrats are not.[189]

This sounds very nice. Why not let private parties order their affairs in any way that they see fit? After all, is there any real public interest involved here? If the shareholders of, say, XYZ, Inc., suffer a loss because their managers diverted corporate opportunities to themselves, and their corporate charter permitted such conduct, that is a problem for the XYZ shareholders, who assumed that risk when they made the investment, but it is not a problem for anyone else. Perhaps the shareholders received some other concession, such as a charter provision that limited executive compensation in some novel way. If that was the deal the XYZ shareholders made, then we ought to respect their freedom to contract in any way they see fit.[190]

This view is very popular in law and economic circles. In fact, it is a Holy Grail among its adherents.[191] Like other neat theories, however, this one has its problems. For starters, it rests on an assumption about the world that does not square with common observations. As a society, we recognize that people sometimes take advantage of other people and that, in egregious cases, it is proper to provide a means to redress such wrongs. The common law simply could not live with an unfettered freedom of contract because of the abuses that might occur. As a result, the law either provides relief *ex post* or prohibits the offending conduct *ex ante*. As it is probably more efficient to establish minimum standards *ex ante* than make ad hoc judgments *ex post*, corporate law has opted for at least some protective provisions. Therefore, corporate law provides that directors owe a fiduciary duty of loyalty to their corporation and cannot contract out of this duty.

Second, the "Holy Grail" economic efficiency analysis assumes that markets can accurately price the value of all terms

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189. *See id.*

190. *See* J. Dennis Hynes, *Freedom of Contract, Fiduciary Duties, and Partnerships: The Bargain Principle and the Law of Agency*, 54 WASH. & LEE L. REV. 439 (1997) (arguing that, in the partnership context, parties ought to be able to waive all fiduciary duties).

191. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989).

of corporate governance, but there is evidence that markets do not do a particularly good job of valuing even significant terms of corporate governance.[192] Imagine, then, how fanciful it is to think that the market is valuing the most obscure risks. For instance, until recent amendments to the Colorado corporate code, the directors of a Colorado corporation could, in theory, eliminate minority shareholders without compensation for their shares through a reverse stock split. Several years ago, a Colorado corporation apparently did just that.[193] The shareholders approved a reorganization in which each 10,000 shares that a shareholder held would be converted into one share. No fractional shares were to be issued. If a shareholder held less than 10,000 shares, he would receive scrip entitling him to a share if he could assemble scrip for 10,000 shares. If he failed to do so by a specified date, the scrip became void. The large shareholders approved the split and consolidated their ownership of the company, while the small shareholders were left holding scrip of questionable value. The Colorado code neither prohibited this transaction nor required compensation for the adversely affected shareholders. While that transaction may have represented a breach of fiduciary duty by the directors, the minority shareholders would have to litigate to establish their right to relief.[194]

In 1994, the Colorado legislature amended the code to provide that in this situation shareholders holding scrip are entitled to be paid the fair value for the fractional interest represented by the scrip.[195] We might ask whether, when this corporation first issued stock to the public, the markets priced the possibility of an investor being squeezed out of the corporation without compensation. There may be no way to test this hypothesis, but is it really necessary to do so? Is not the legislative solution of requiring fair compensation a better solution than litigation on the question of breach of fiduciary duty? It is

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192. *See* Elliot J. Weiss & Lawrence J. White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to 'Changes' in Corporate Law*, 75 CAL. L. REV. 551 (1987) (finding no statistically significant market reaction to any of seven significant Delaware cases related to corporate governance).

193. The author learned of the reverse split after shareholders who were adversely impacted by it contacted him for an opinion on whether it conformed with Colorado's corporate law. To his knowledge, the action was never litigated.

194. *C.f.* Goldman v. Union Bank & Trust, 765 P.2d 638 (Colo. App. 1988) (breach of fiduciary duty not established).

195. *See* COLO. BUS. CORP. ACT, § 7-113-102(2.5) (1999).

fairer and cleaner than the messy uncertainty of litigation, and a legitimate action for a legislature to take.

Needless to say, the corporation codes contain other instances of reasonable legislative responses to perceived injustices.[196] This is the role that we expect of legislatures, and the corporate law should be no exception. In areas of potential abuse of minority shareholders, legislatures should continue to consider and enact reasonable protective provisions. Legislatures might regard the relationship between shareholders and directors as indeed one of contract, but like other contracts, one in which unconscionable bargains are not enforceable. Mandatory terms of corporate codes are best understood in that light: they ought to mandate terms which, if not present in the "contract," might give rise to an unconscionable result, as in the Colorado case discussed above. This test suggests that many, if not most, mandatory terms are unnecessary. On the other hand, this test leaves an important role for legislatures to play in what might otherwise be thought to be a matter of private contracting, to express the conscience of the community.

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196. This instinct provides an explanation for dissenters' rights, among other provisions.