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THE QUIET TRANSFORMATION OF CORPORATE LAW

Mark J. Loewenstein*

I. INTRODUCTION

WITH the corporate scandals that swept the country in 2002, corporate law underwent a quiet transformation, the extent of which we are only now beginning to appreciate. This transformation was characterized by a significant and continuing shift of lawmaking prerogative from state legislatures to the federal government and national stock exchanges, and a judicial activism in limiting the discretion of corporate officers and directors. At the legislative level, the transformation marked the end, or at least the beginning of the end, of state supremacy in corporate governance regulation, and the re-imposition of substantive regulation on corporate actors whose conduct nominally affects only the corporate stakeholders.

At the stock exchanges, the transformation might be characterized as the acceleration of an evolution, in the sense that in recent years stock exchanges have been increasingly active in regulating corporate governance of companies listed with them.¹ But the number and scope of recent

¹ Since 1926, the New York Stock Exchange (the “Exchange”) has refused to list nonvoting common stock and will delist the voting common stock of a company that creates a class of nonvoting common stock, subject to certain limitations. Since 1956, the Exchange has required listed companies to have at least two outside directors on their boards. Prior to the changes wrought by the most recent round of corporate scandals (see Part III B. below), the Exchange Listed Company Manual (the “Manual”) also included, among others, the following corporate governance standards, most of which have been added or modified in recent years:

302.00 Requirement for an annual meeting of shareholders;
303.00 Requirement for a “qualified” audit committee (including standards on a formal charter, the composition/expertise requirement of committee members and the independence requirement);
304.00 Limitations on classified boards;
312.03 Requirement of shareholder approval for certain stock option or stock purchase plans and certain related party transactions involving the issuance of common stock; and
313.00 Voting rights of common stock

In addition, the Manual includes informal advice on corporate governance issues such as concentrated voting (305.00), related party transactions (307.00), defensive tactics in take-
rules suggest far more than an evolution. At the judicial level, it is clear that courts—particularly Delaware courts, but not exclusively Delaware courts—have been influenced by recent corporate scandals and have become more activist in considering challenges to the conduct of corporate actors. These changes, covering a broad range of initiatives, do share one common concept: an increased emphasis on the importance, indeed centrality, of independent directors to the corporate governance scheme.

This article explores the changes wrought by what I have called the "quiet transformation" in corporate law. On the legislative, or rulemaking front, I consider the sensibility of shifting away from state law. On the judicial front, I consider the significance of a few prominent cases—two from Delaware and one from the U.S. Court of Appeals for the Seventh Circuit construing Illinois law—and what implication these cases hold for the development of corporate governance. Finally, I consider the increased emphasis on the independent directors and the venerable business judgment rule that protects the conduct of such directors from judicial scrutiny. I start, however, with a bit of background to place this transformation in an historical context.

II. THE TRADITIONAL SUPREMACY OF STATE LAW

One of the cornerstones of U.S. corporate law is that the state law of a corporation's state of incorporation governs the internal affairs of the corporation,\(^2\) including, among other things, the relationship between the directors and shareholders.\(^3\) In contrast to a corporation's internal affairs, the relationship between the corporation and the capital markets, though a subject of state law, is heavily regulated by federal law\(^4\) and, for companies listed on stock exchanges, by those exchanges as well.\(^5\)

The scandals at the turn of the millennium were not, of course, the first time that corporate mischief made the news. Indeed, from time to time over contests (308.00), transactions in company stock by officers and directors (309.00), quorum for meetings of common and preferred shareholders (310.00), and shareholder democracy (312.00). New York Stock Exchange, Listed Company Manual (2003), available at http://www.nyse.com.

2. Edgar v. MITE Corp., 457 U.S. 624, 645-46 (1982); Restatement (Second) of Conflict of Laws §§ 302-309 (1971). In connection with Congress's adoption of the Securities Exchange Act of 1934, the House Conference Report noted the deletion of section 13(d) as unnecessary because it made explicit that the SEC could not "interfere with the management of the affairs of an issuer." See also H.R. Conf. Rep. No. 73-1838, at 35 (1934).

3. State corporate law delineates the rights of shareholders, the obligations of directors, and the rules governing fundamental corporate changes (amendment to articles of incorporation, mergers, dissolution, and sale of substantially all of the corporation's assets), among other things. Some commentators have characterized the corporation as a nexus of contracts among the various parties who have an interest in the corporation, such as shareholders, directors, officers, creditors and employees. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 Colum. L. Rev. 1416-26 (1989).


5. Stock exchanges regulate listed companies through listing standards. See supra note 1.
scholars have expressed frustration with the lack of governmental oversight of large corporations and, as a solution, proposed federal incorporation or, at least, federal “minimum standards.” Serious proposals for federal chartering have been before Congress on several occasions. In the early part of the twentieth century, Presidents Roosevelt, Taft and Wilson each proposed that corporations be federally chartered. The idea emerged again in the 1930s, as regulators sought a response to the failures that led to the Great Depression. Federal incorporation was considered in the New Deal, and though seriously considered, was ultimately rejected. The final serious attempt occurred in the 1970s, following the publication of an influential law review article by a former chairman of the SEC. Congress again declined to adopt federal minimum standards for corporations.

Congress’s reluctance to federalize corporate law had its analog in the courts. In *Santa Fe Industries, Inc. v. Green,* for instance, the U.S. Supreme Court halted the federalization of the law of fiduciary duty that was then developing in the Second Circuit Court of Appeals. *Santa Fe* presented a case in which the minority shareholders of Kirby Lumber Corp. used Rule 10b-5 to challenge a freeze-out merger engineered by Kirby’s 95% stockholder, Santa Fe. The plaintiffs complained that Santa Fe breached its fiduciary duty to the minority shareholders by failing to pay a fair price for their shares. Reversing the appellate court, the Supreme Court limited the reach of Rule 10b-5 to manipulations and deceptions, holding that breaches of fiduciary duty not involving a

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9. See Roe, *supra* note 7, at 602-03. The view of the New Deal was summarized by Joel Seligman, *The Transformation of Wall Street* 42:

Roosevelt committed himself to the long-held populist and progressive goal of supersed ing lax state corporation laws with more stringent federal standards. His securities [law] policy was an attempt to remedy the weaknesses in the . . . state and private rules then in effect, which cumulatively failed to minimize fraud or unfairness in the initial sale of corporate securities.

Most fundamental of the rules Roosevelt sought to supersede were the state corporation laws. . . . Originally the state corporate statutes had been restrictive, limiting, among other things, the amount of capital a firm could raise. But. . . . [b]y the turn of the twentieth century, “charter-mongering” states like New Jersey, Delaware, and Nevada had stimulated a “race to the bottom” [making their statutes more and more lax].


manipulation or deception are matters of state law, not federal law.\textsuperscript{14} Similarly, the courts have not allowed the Securities and Exchange Commission ("SEC"), through rulemaking, to encroach on internal corporate governance. In response to the use of dual classes of stock as an anti-takeover tactic in the 1980s, the SEC adopted Rule 19c-4, which prohibited the stock exchanges and NASDAQ from listing securities of any company that "issues any class of security, or takes other corporate action, with the effect of nullifying, restricting or disparately reducing the per share voting rights of holders of an outstanding class or classes of common stock."\textsuperscript{15} Enforcement of this rule was enjoined by the D.C. Circuit Court of Appeals in \textit{The Business Roundtable v. SEC},\textsuperscript{16} with the court holding that the SEC had exceeded its statutory authority because the rule regulated corporate governance.\textsuperscript{17} The court was emphatic in limiting the SEC's authority: "[State law] regulates the distribution of powers among the various players in the process of corporate governance, and the Commission's present leap beyond disclosure is just that sort of regulation."\textsuperscript{18}

At the same time that corporate takeovers were hot news, lavish executive compensation was also making headlines.\textsuperscript{19} Heeding the lessons from the Second Circuit, the SEC was more circumspect when responding to this crisis of corporate governance. The Commission promulgated a set of rules that dramatically increased the amount of disclosure regarding executive compensation in an issuer’s annual proxy statement,\textsuperscript{20} but sought no change in corporate governance. Interestingly, Congress adopted a mild intervention, amending the tax code to limit the deductibility of executive compensation in excess of $1 million unless the compensation was performance based.\textsuperscript{21} Neither disclosure nor tax code provisions addressed what was widely perceived to be the cause of the problem: the absence of independent decisionmakers on the question of executive compensation.\textsuperscript{22} Whether or not that was actually the cause of

\textsuperscript{14} Santa Fe Indus., 430 U.S. at 478-80.
\textsuperscript{15} 17 C.F.R. § 240.19c-4 (1988).
\textsuperscript{16} 905 F.2d 406, 417 (D.C. Cir. 1990).
\textsuperscript{17} Business Roundtable, 905 F.2d at 417. The SEC's rulemaking authority was based on its authority to regulate proxy voting. (Note that following the SEC's failed attempt, the exchanges "voluntarily adopted similar listing requirements." \textit{See} Exchange Act Release No. 28,517, 47 S.E.C. Dock. 377 (Oct. 5, 1990) (approving NASD rule)).
\textsuperscript{18} Id. at 412.
\textsuperscript{19} \textit{See} Mark J. Loewenstein, \textit{Reflections on Executive Compensation and a Modest Proposal for (Further) Reform}, 50 SMU L. REV. 201 (1996).
\textsuperscript{21} Among other things, the new rules mandated that issuers include in the proxy statement a table covering a three-year period of the compensation of the CEO and other highly-paid executives; a table detailing option grants, holdings, and exercises, including values of the options granted; a chart comparing the company's performance to a peer group; and a narrative report of the company's compensation committee. \textit{See generally} Loewenstein, \textit{supra} note 19, at 215-17.
\textsuperscript{23} \textit{See}, e.g., Charles M. Elson, \textit{Executive Compensation—A Board-Based Solution}, 34 B.C. L. REV. 937, 945-49 (arguing that directors are beholden to the CEO and therefore
the pay problem, the measures adopted by the SEC and Congress in the early 1990s have not resulted in a decline in executive compensation.

Looking at this brief history as a whole, it seems that the federal government and the states reached an unwritten compromise on corporate law. The federal government would regulate the external aspects of corporate behavior—the interaction between the corporation and the capital markets—through a disclosure regime. On the other hand, the states would regulate the internal affairs—the relationship between managers and shareholders. This compromise was tested several times in the twentieth century, but, with some notable exceptions, seemed to be intact at century's end. Enron changed that, as the next section describes.

23. Another example is in the going-private area. Though clearly dissatisfied with state law that permitted a public company to squeeze out public shareholders on unfavorable terms, the SEC limited its rule to disclosure. 17 C.F.R. § 240.13e-3 (2003), See Going Private Transactions by Public Companies or Their Affiliates, Exchange Act Release No. 14,185, 42 Fed. Reg. 60,090, 60,091 (Nov. 13, 1977) (proposing Rule 13e-3).

24. This may be a bit of an overstatement, as disclosure rules can affect internal governance. Requiring disclosure, for instance, of management’s background can discourage the hiring of certain individuals. See Donald C. Langevoort, Seeking Sunlight in Santa Fe’s Shadow: The SEC’s Pursuit of Managerial Accountability, 79 WASH. U. L.Q. 449, 459 (2001) (commenting on the relationship between substantive breach of fiduciary duty and disclosure requirements). An SEC rule that predates the Business Roundtable decision, the all-holders rule, is put into doubt by that decision. SEC Rule 13e-4, 17 C.F.R. § 240.13e-4; SEC Rule 14d-10. 17 C.F.R. § 240.14d-10 (2003). This rule requires a tender offeror to extend the offer to all the target’s shareholders, thus precluding the sort of discriminatory tender offer in the landmark case of Unocal v. Mesa Petroleum Co., 493 A.2d 946, 956-57 (Del. 1985). Arguably, this rule goes beyond disclosure to substantive regulation, a matter within the states’ prerogative.

25. The SEC has the authority to regulate proxy solicitation, which obviously does affect internal governance. As Professor Roe has stated:

The wide SEC regulation of proxies determines what goes into the proxy request to shareholders, what gets onto the ballot, who gets access to shareholder lists, and how a proxy fight (what could be more basic and internal?) is waged. This is not a small point. Voting is probably the single most important internal corporate affair.

Roe, supra note 7, at 611. However, the extent to which the SEC’s proxy rules exceed its rulemaking authority, because they shade over from disclosure to substantive regulation, remains somewhat of an open question. See note 147, infra, discussing the SEC’s proxy rules.

Another regulation of internal affairs is the so-called “all holders rule.” SEC Rule 13e-4, 17 C.F.R. § 240.13e-4 (2003) and SEC Rule 14d-10, 17 C.F.R. § 240.14d-10 (2003). This rule was adopted in reaction to the Delaware Supreme Court decision in Unocal, 493 A.2d at 958-59 (Del. 1985), where the Delaware Court upheld a defensive self-tender by Unocal (the target) that excluded Mesa, the hostile bidder. In adopting the all-holders rule, the SEC effectively overruled state law to the contrary. See Roe, supra note 7, at 619. Again, the validity of this rule has not been tested before the U.S. Supreme Court.
III. SARBANES-OXLEY, THE STOCK EXCHANGES AND THE SEC.

A. SARBANES-OXLEY

In passing The Sarbanes-Oxley Act of 2002, Congress adopted a wide-ranging approach to the perceived causes of the financial crises typified by Enron and WorldCom. To the extent that these crises reflected a weakness in the regulation of the accounting profession, for instance, Sarbanes-Oxley created an accounting oversight board. Similarly, perceived weaknesses in the independence of the company's auditors were addressed with new rules to limit non-audit services, to require audit partner rotation, etc. The law also addressed corporate governance directly in what might be characterized as two separate sets of initiatives. The first set consists of changes in aspects of corporate governance that were already "federalized." Examples include a new requirement that the company's chief executive officer and chief financial officer certify the company's periodic filings with the SEC. This requirement does alter the rules of corporate governance, as the functions and responsibilities of corporate officers are typically matters of state law. However, the federal securities laws have always specified who signs documents to be filed with the SEC, so requiring officer certification to periodic reports did not reflect a significant change in the federal-state relationship.


28. Id. §§ 201, 116 Stat. at 771-75.

29. Id. §§ 302, 116 Stat. at 777-78.

30. See, e.g., § 6 of the Securities Act of 1933, 15 U.S.C. § 77f, provides that registration statements filed under the Act "shall be signed by each issuer, its principal executive officer or officers, its principal financial officer, its comptroller or principal accounting officer, and the majority of its board of directors...." Form 10-K, the annual report required to be filed by companies registered under the Securities Exchange Act of 1934, must be signed by a majority of the board of directors, in addition to the principal executive officer, principal financial officer and controller. See Instruction D to Form 10-K, S.E.C. Fed. Corp. § 29.7.

31. Other examples include:
§ 305, which empowers the SEC to bar persons from serving as officers or directors of a public company if they committed violations of the federal securities laws and are unfit to serve as an officer or director. Under prior law, a federal court had that authority;
§ 303, which makes it unlawful for an officer or director to interfere with an audit. While prior law had no analog, neither did state law. Moreover, the requirement of audited financial statements is, for the most part, limited to public companies and relates to the capital markets; and
§ 306, which limits the ability of directors and executive officers to trade in their company's stock during so-called "blackout" periods, i.e., times when participants in a retirement plan are prohibited from selling company stock. Federal law has governed retirement plans for many years and this provision is consistent with that regulation.
The second set of initiatives, of greater importance here, are forays into what had been the province of the states. These include forfeiture of certain bonuses and profits, and a bar on loans to officers and directors. Each of these provisions addressed abuses at Enron and other companies, where officers realized substantial bonuses on the basis of fraudulent financial statements and benefited from large loans from the company.

The forfeiture provision is triggered by an accounting restatement due to misconduct and requires the chief executive officer and chief financial officer to reimburse the company for any incentive-based compensation during the twelve-month period following the filing of the original statement and any profits realized in the sale of company securities during that period. Such a forfeiture has no analog in prior federal law, but

32. Sarbanes-Oxley, § 304, codified at 15 U.S.C. § 7243. This section provides, in pertinent part:

If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for—

(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and

(2) any profits realized from the sale of securities of the issuer during that 12-month period.

33. Id. § 402, codified at 15 U.S.C. § 78m(k). This section provides, in pertinent part:

(k) Prohibition on personal loans to executives

(1) In general

It shall be unlawful for any issuer . . ., directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer. An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions of this subsection, provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date of enactment.

(2) Limitation

[sets forth certain exemptions from the probation of (1) for loans such as home improvement and manufactured home loans, consumer credit, and certain extensions of credit by registered brokers or dealers that are]

(A) made or provided in the ordinary course of the consumer credit business of such issuer;

(B) of a type that is generally made available by such issuer to the public; and

(C) made by such issuer on market terms, or terms that are no more favorable than those offered by the issuer to the general public for such extensions of credit.

34. One might identify a third initiative, increased federal regulation of the corporation's "gatekeepers." For instance, under Sarbanes-Oxley, lawyers have to report wrongdoing up the corporate hierarchy, including, ultimately, the corporation's board of directors. Sabaness-Oxley, § 307. See, Roe, supra note 7, at 622-23 (discussing the federalization of laws relating to gatekeepers).

35. But note that the SEC has the authority under § 20(d) of the Securities Act of 1933 and § 21(d)(3) the Securities Exchange Act of 1934 to obtain disgorgement orders against those who violate the provisions or regulations under those laws. See James D. Cox, Robert W. Hillman & Donald C. Langevoort, Securities Regulation at 872 (3d
does in state law. If a person receives compensation on the basis of fraudulent financial statements, the payer may well have a claim under state law for restitution based on mistake, unjust enrichment, or fraud.36 Similarly, if an officer realizes a profit on a stock transaction made possible by fraudulent financial statements, the company may have a claim against the officer for breach of fiduciary duty and may recover the ill-gotten gains as damages.37

While Sarbanes-Oxley does not expressly preclude these state causes of action,38 the law may arrest the development of such claims in the same way that Rule 10b-5 ended the development of state law claims based on insider trading.39 Of equal importance, Sarbanes-Oxley, by limiting the recovery to gains of the chief executive officer and chief financial officer, 36. See, e.g., In re HealthSouth Corp. S'holders Litig., No. 19896, 2003 WL 22769045 at *7 (Del. Ch. Nov. 24, 2003), where the court recognized an action to rescind a loan repayment made by the company's CEO using shares of stock that were overvalued as a result of fraudulent financial statements. The court held that the repayment may be rescinded on the basis of either unjust enrichment or negligent misrepresentation. The court identified the elements of unjust enrichment, quoting from an earlier Delaware Supreme Court opinion, as:

the unjust retention of a benefit to the loss of another, or the retention of money or property of another against the fundamental principles of justice or equity and good conscience. To obtain restitution, the plaintiffs were required to show that the defendants were unjustly enriched, that the defendants secured a benefit, and that it would be unconscionable to allow them to retain that benefit. Restitution is permitted even when the defendant retaining the benefit is not a wrongdoer. Restitution serves to deprive the defendant of benefits that in equity and good conscience he ought not to keep, even though he may have received those benefits honestly in the first instance, and even though the plaintiff may have suffered no demonstrable losses. (Taken by the court from the Delaware Supreme Court decision in Schock v. Nash, 732 A.2d 217, 232-33 (Del. 1999), with internal quotation marks and footnotes omitted, and emphasis added by the Chancery Court)). Id. at *7.

The court also identified the elements of negligent or innocent misrepresentation:

To make out their claim of innocent misrepresentation, the plaintiffs must show: 1) a false statement by [defendant CEO] Scrushy; 2) made with the intent to induce HealthSouth to act; 3) upon which HealthSouth justifiably relied in acting; and 4) injury. Equity "provide[s] a remedy for negligent or innocent misrepresentations: the defendant did not have to know or believe that his statement was false or to have proceeded in reckless disregard of the truth." (Quoting from Stephenson v. Capano Dev., Inc., 462 A.2d 1069, 1074 (Del. 1983) (footnote omitted)).

Id. at *8.

37. See, e.g., Demoulas v. Demoulas Super Mktts., Inc., No. 90-2927(B), 1995 WL 476772 (Mass. Super. Aug. 2, 1995) (finding the appropriate remedy for breaches of fiduciary duty by directors which result in a profit to those directors to be disgorgement of the profits). If an officer is responsible for false financial statements, and bonuses paid on the basis of such statements, the officer would be guilty of constructive fraud, even in the absence of scienter. See In re RSL Com Primecall, Inc. v. Beckoff, No. 01-11457, 2003 WL 22989669, at *3 (Bankr. S.D.N.Y. Dec. 11, 2003) (defining constructive fraud).

38. Indeed, Sarbanes-Oxley does not provide for a private cause of action.

will make it more difficult for state common law remedies to reach other corporate actors, including directors and members of the audit committee, who might bear responsibility for the inaccurate financial statement.

Similarly, the prohibition on loans to any director or executive officer treads on ground previously plowed by state corporate codes.\footnote{Delaware's code allows a loan to an officer "whenever in the judgment of the directors such loan . . . may reasonably be expected to benefit the corporation." \textit{Del. Code Ann. tit. 8, § 143 (2002)}. Presumably, Sarbanes-Oxley will preempt this provision of Delaware law.} Earlier versions of the Model Business Corporation Act contained limitations on loans to officers and directors, sometimes requiring disclosure to the shareholders. Moreover, this outright prohibition deals with a fundamental prerogative of a board of directors, to decide upon compensation of officers, and a fundamental aspect of state corporate codes, the authority of a board of directors. Ironically, the justification for the federal provision is that loans can constitute a form of "hidden" compensation and, therefore, should be banned.\footnote{See Cong. Rec., S6762 (2002) (Statement of Sen. Feinstein).} The irony rests in the fact that Congress could have simply required disclosure (or directed the SEC to do so) and would have been acting within traditional federal jurisdiction.\footnote{Indeed, the original Senate Bill (S. 2673) did not include a forfeiture provision, but did require disclosure (§ 402). \textit{See Report of the Committee on Banking, Housing, and Urban Affairs of the United States Senate to accompany S. 2673 (July 8, 2002).}} Another irony is that state corporate codes had required disclosure, so that now both the states and the federal government have abandoned disclosure requirements in favor of a federal substantive regulation of internal corporate governance.

The federal ban on loans to officers and directors represents the first direct federal intervention into executive compensation, and an awkward one at that. In response to political pressure to address the growing disparity between executive compensation and the compensation of ordinary workers,\footnote{CEOs of America's largest companies earn more than 400 times the compensation of the average worker in their labor forces. \textit{See Loewenstein, supra} note 22, at note 9.} Congress amended the tax code to limit the deductibility of some forms of executive compensation\footnote{Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13, 211, 107 Stat. 312, 449 (1993) adding § 162(m) to the Internal Revenue Code. In addition, the Code includes limitations on the deductibility of "golden parachute" compensation. \textit{See Edward A. Zelinsky, Greenmail, golden parachutes and the Internal Revenue Code: a tax policy critique of Sections 280G, 4999 and 5881, 35 Vill. L. Rev. 131, 141-44 (1990)}.} and the SEC has increased the amount of required disclosure,\footnote{57 Fed. Reg. 48,126 (Oct. 21, 1992).} but Sarbanes-Oxley represents an attempt to limit (or, in this case prohibit) a form of compensation. Whether loans were the most abused form of compensation, and thus a logical place for Congress to start, is questionable. Whether Congress will become further embroiled in the issue is certainly a fair question in light of Sarbanes-Oxley. In any case, this legislation will likely stifle any attempt by the states to address the issue of executive compensation.
Perhaps the implicit preemption by Congress is a good thing. After all, the states have done little to address these problems, and indeed seemed to be moving in the opposite direction. The original 1946 version of the Model Business Corporation Act prohibited loans to officers and directors, a provision deleted in § 47 of the 1969 version.46 While state common law may provide a remedy for recovery of "fraudulent" bonuses, the remedy would be difficult to realize. A claim would have to be a derivative claim (assuming the board did not seek to recover the money on its own), and derivative actions are fraught with difficulties. Demand must be made on the board of directors, and if it is independent of the officer or officers who received the bonuses, it is unlikely that the plaintiff will be able to maintain the action.

Indeed, the leading Delaware case on the demand requirement, Aronson v. Lewis,47 illustrates the resistance of the Delaware Supreme Court to shareholder challenges to executive compensation. In Aronson, the plaintiff complained of an employment agreement entered into with the company's then 75-year-old chief executive officer (Leo Fink), who also owned 47% of the company's outstanding stock. Among other provisions, the agreement provided that upon Fink's retirement, he was to become a paid consultant to the company for the rest of his life, and payments under that agreement were not to be affected by his inability to perform services for the company.48 The Vice Chancellor denied defendants' motion to dismiss for failure to make a demand on the board, ruling that there was a reasonable inference under the complaint that the business judgment rule did not apply to the directors' approval of the transaction.49 The Vice Chancellor opined that as the consulting compensation was unaffected by Fink's ability to perform services, the transaction may have been wasteful on its face.50 Therefore, he concluded, demand was excused as futile because the director-defendants were potentially liable for waste and lacked the necessary impartiality to consider the demand.51

The Delaware Supreme Court reversed, holding that demand is required unless the complaint alleges particularized facts that create a reasonable doubt that "(1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."52 The Supreme Court found that the plaintiff's complaint failed under both tests, despite the obvious control that Fink had over the selection of directors. As to the Vice Chancellor's conclusion that the contract was potentially a waste of corporate assets, the Supreme Court's decision is most telling. The Court recited the facts

47. 473 A.2d 805 (Del. 1984).
48. Id. at 808-09.
49. Lewis v. Aronson, 466 A.2d 375, 384 (Del. Ch. 1983).
50. Id. at 383.
51. Id.
52. Aronson, supra note 47, at 814.
of a case on which the Vice Chancellor had relied, and then summarily concluded: "Contrasting the facts of Findanque with the complaint here, it is apparent that plaintiff has not alleged facts sufficient to render demand futile on a charge of corporate waste. . . ." While the facts of Findanque may have presented a somewhat stronger case for waste, in part because the agreement did not specify what consulting duties were required, the lack of analysis in the Supreme Court's decision is at least disquieting. The agreement in Aronson has all of the hallmarks of an abusive contract entered into by a dominated board, yet the case was dismissed because of the strong presumptions in favor of the disinterestedness and good faith of the director-defendants.

In short, Congress has become involved in corporate governance because the states have not, marking an important point in the development of corporate law. In Part V, I discuss whether the states have been reluctant to act because of competition among them to attract incorporation business. Regardless of motivation, however, the role of the states in regulating the substantive behavior of corporate management has been irrevocably altered by Sarbanes-Oxley. Combined with the actions of the stock exchanges and the SEC, discussed in the following sections, state law is nearly irrelevant in affecting the corporate governance of publicly-held corporations, with one important exception. That exception is the continuing relevance of state law in the area of takeover defenses, the effect of which is to protect management of poorly run firms that, perhaps, should be taken over.

B. THE STOCK EXCHANGES

The New York Stock Exchange and NASDAQ Stock Market, Inc. have long included corporate governance standards among their listing requirements. The most recent requirements were approved by the SEC on November 4, 2003, and are the most detailed and far-reaching corporate governance standards ever adopted by the exchanges. Though similar, the standards of the two exchanges do differ on some details. It is sufficient for present purposes, however, to consider just the standards promulgated by the NYSE.

The key provisions in the new standards relate to the concept of independent directors. Boards of all listed companies must have a majority of independent directors; independent directors must meet at least once each year in an executive session; and the company must have a nominating committee, an audit committee and a compensation committee con-

55. See infra, text accompanying notes 150-155.
56. See, e.g., supra note 1.
sisting solely of independent directors. The standards specify at some length what satisfies the definition of independence. For instance, the director is not independent of the listed company if the director has been an employee of the listed company in any of the most recent three years or the director has received more than $100,000 in direct compensation from the listed company, other than director fees, in any of the most recent three years. In addition, the director is not independent if the director or a member of his or her immediate family was an executive officer of another company and payments made to or from that company accounted for $1 million or two percent of that company's consolidated gross revenues.

These provisions, only some of which are summarized above, are striking in their philosophy and execution. The stock exchanges have adopted the view that the future of their listed companies is best assured by independent directors, and the exchanges themselves are best situated to define independence. Neither proposition is self-evident. In Part V, I consider the wisdom of the underlying philosophy that independent directors are the *sine qua non* for effective corporate governance. As to the definitions that the exchanges have adopted, I would observe that they are, as inevitably they must be, reliant on objective criteria. Yet, in real life, other, non-quantifiable criteria may affect one's independence. The recent case of *In re Oracle*, discussed further in Part IV, presents a fine example of this. There, the independence of the directors serving on a special litigation committee was challenged. The court agreed with the plaintiffs that the members of the special litigation committee were not independent of the management directors who were named as defendants in the shareholders' derivative action. The special litigation committee would have been independent under the stock exchange rules, but other factors suggested otherwise. One possible effect of the stock exchange rules may be to inhibit the kind of careful judicial inquiry undertaken in *Oracle*, as courts or other decisionmakers rely on the more objective criteria announced by the exchanges. In any event, the actions of the stock exchanges demonstrate how the notion of independent directors may be slipping away from state control.

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60. *Id.* § 303A2(b)(ii). If a member of the director's immediate family receives such compensation, the director is deemed not to be independent.
61. Or in the case of the director, an employee.
63. See, e.g., Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 Harv. L. Rev. 597, 611-12 (1982) (identifying various social and psychological constraints that limit the ability of a director to act independently).
64. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 942 (Del. Ch. 2003).
65. *Id.* at 947.
C. The SEC

1. Regulatory Action

In October, 2003, prompted by a report and recommendation from its staff,\(^66\) the SEC proposed a rule allowing shareholder access to a company's proxy statement for the purpose of nominating directors.\(^67\) Under the SEC's proposal, if certain triggering events occur, including an election for directors in which thirty-five percent or more of the shareholders indicated that they were withholding their votes, or a proposal allowing shareholder access to the proxy statement to nominate directors received more than fifty percent of the votes cast,\(^68\) shareholders will have access to the proxy statement for a period of two years. Shareholders who own at least five percent of the company's stock for at least two years may nominate one director for boards with fewer than nine members, two directors for boards of nine to nineteen members, and three directors for boards of more than nineteen members.

While there are other limitations on the ability of shareholders to nominate directors under the Commission's proposal,\(^69\) the proposal is ex-


\(^68\) The SEC also sought comment on a possible third trigger, that the company failed to implement a proposal approved by the shareholders. Id. at 60,791.

\(^69\) For instance, the proposed rule is limited to companies that meet these requirements:

The company's common equity public float was $75 million or more as of the last business day of its most recently completed second fiscal quarter;

The company has been subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least 12 calendar months;

The company has previously filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act; and

The company is not eligible to use Exchange Act Forms 10-QSB and 10-KSB.

To be eligible to submit a nomination in accordance with proposed Exchange Act Rule 14a-11, a security holder or group of security holders would be required to:

Beneficially own, either individually or in the aggregate, more than 5% of the company's securities that are eligible to vote for the election of directors at the next annual meeting of security holders (or, in lieu of such an annual meeting, a special meeting of security holders), with each of the securities used for purposes of calculating that ownership having been held continuously for at least two years as of the date of the nomination;

Intend to continue to own those securities through the date of that annual or special meeting;

Be eligible, as to the security holder or each member of the security holder group, to report beneficial ownership on Exchange Act Schedule 13G, rather than Exchange Act Schedule 13D, in reliance on Exchange Act Rule 13d-1(b) or (c); and

Have filed an Exchange Act Schedule 13G or an amendment to Exchange Act Schedule 13G reporting their beneficial ownership as a passive or institutional investor (or group) on such schedule before or on the date of the submission of the nomination to the company, which Schedule must include a certification that the security holder or security holder group has held more than 5% of the subject securities for at least two years.

Proposed Rule, supra note 66, at 60,788, 60,794.
pressly contingent on the ability of shareholders to nominate candidates under state law. Presumably, this limitation was included to avoid the claim that the Commission had exceeded its authority and was engaged in the regulation of corporate governance. 70 State law, however, is remarkably silent on the election process. The Model Business Corporation Act, for instance, simply provides that "directors are elected by a plurality of the votes cast. . . ." 71 While there are provisions permitting proxy voting and specifying what constitutes a valid proxy, 72 the MBCA is silent on the nomination process. Presumably, the drafters of the MBCA believed that the election of directors would proceed as a typical organizational election, with nominations taking place at the meeting. The provisions permitting proxies are consistent with that view, because nominations formally made at a shareholders' meeting of a publicly-held corporation could not succeed without proxy voting. The SEC's awareness of this approach under state law probably accounts for its assertion, expressed in the release proposing the rule, that the rule applies "unless applicable state law prohibits the company's security holders from nominating a candidate or candidates for election as a director." No state law prohibits shareholders from nominating directors; therefore, the proposed rule would apply in all states.

The proposed rule, however, dramatically changes the landscape of U.S. corporate governance and arguably exceeds the SEC's authority under §14(a) of the 1934 Act, upon which the SEC relied in proposing the rule. 73 The Business Roundtable decision, discussed briefly in Part II above, limited the SEC's rulemaking authority under §14(a) to disclosure rules. 74 Similarly, dicta in a few Supreme Court decisions support that view. 75

While the SEC might argue that the proposed rule is disclosure oriented, since shareholders already have the right to nominate directors, shareholders in fact have no right under state law to include a nominee in management's proxy statement.

The current practice of director elections in publicly-held corporations has two important aspects: first, that persons currently serving as direc-

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70. See supra, notes 15-18 and accompanying text.
72. Id. § 7.22.
73. 15 U.S.C. § 78n(a) (2000). The Commission also stated, without analysis, that it was relying on Sections 3(b), 10, 13-16, 23(a) and 36 of the Securities Exchange Act of 1934 and corresponding provisions of the Investment Company Act of 1940. 68 Fed. Reg. at 60,816.
74. See supra, notes 15-18 and accompanying text.
75. Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1086 (1991) (Section 14(a) authorizes the [SEC] to "adopt rules for the solicitation of proxies, and prohibits their violation."); J.I. Case Co. v. Borak, 377 U.S. 426, 431 (1964) (Section 14(a) and the rules thereunder "prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation."); See also SEC v. Kalvex, Inc., 425 F. Supp. 310, 314 (S.D.N.Y. 1975) (Section 14(a) serves to "ensure that full and fair disclosure would be made to stockholders whose proxies are being solicited so that an informed and meaningful consideration of the alternatives can be made.").
tors, or a committee of them, will nominate persons who will serve the best interests of the corporation; and second, that management of the company will solicit proxies, at the company’s expense, from the shareholders to assure the election of those persons. Any shareholder who wishes to elect other persons as directors is free to solicit proxies on their behalf. Arguably, state law, by failing to affirmatively alter this scheme (as, for instance, conditioning the ability of corporate management to use corporate resources to solicit proxies), has incorporated this scheme into law. The SEC’s proposal, by contrast, alters both aspects of the status quo. Not only is management’s proxy statement now open to non-management nominees, but it is open to nominees who may be committed to serving the best interests of the shareholder or shareholders who nominated them, like a labor union, and not the company as a whole.

The SEC’s proposal, however, does present a stronger case for passing judicial muster than did its proposed rule on disparate voting shares struck down in Business Roundtable. That rule clearly impinged on existing state law, which permitted the issuance of such stock. By comparison, existing state law does not prohibit shareholder access to management’s proxy statement. Moreover, the rule bears a resemblance to Rule 14(a)-8, a long-standing SEC rule that mandates shareholder access to management’s proxy statement to set forth proposals for shareholder consideration that are proper under state law.\(^\text{76}\) On the other hand, the current SEC proposal goes beyond Rule 14(a)-8 because the election of directors, and the manner in which they are elected, are so central to corporate governance. Moreover, disclosure is only an incidental aspect of the rule; the heart of the rule is the requirement that corporate management solicit proxies to facilitate the election of shareholder nominees.

Assuming the validity of the SEC’s proposed rule, there is a real question as to its advisability. As noted above, the rule opens the door to “special interest” directors, who may feel accountable to the shareholder group that elected them.\(^\text{77}\) Such directors may adversely affect the working environment and cohesiveness of the board, to the detriment of the corporation. These issues, once thought to be concerns of state law, are now questions of federal law, in turn raising the question as to whether the SEC is better positioned to resolve them than state legislatures. Arguably, the Commission is better positioned, inasmuch as it has considerable expertise in the regulation of publicly-held companies. Moreover, state legislators have little incentive to tinker with the election process; no obvious constituency is likely to raise the matter with the legislature. The only well-organized lobby consists of corporate management, which has successfully obtained anti-takeover legislation at the state level. It

\(^\text{76}\) 17 C.F.R. § 240.14a-8.

\(^\text{77}\) For a discussion of this concern, see Detailed Comments of the Business Roundtable on the “Proposed Election Contest Rules” at 40-43. Available at http://sec.gov/rules/proposed/s71903/brt122203.pdf.
remains to be seen whether that lobby will seek to undo the shareholder access rule (assuming its adoption by the SEC) with amendments to the state corporate law prohibiting shareholder nominations.

As a matter of policy, there is no reason to leave the matter of election of directors exclusively to state law. In this regard, one might challenge the notion, expressed above, that state law has somehow incorporated the status quo as desirable. This is an argument of convenience, and lacks any empirical support whatsoever. State law, though applicable to publicly-held corporations, seems better designed for privately-held ones. Despite increasing public concern with the corporate governance of publicly-held corporations, state law has clearly moved in the direction of a reduction in the number of mandatory provisions. The trend of state corporate law has been in the direction of pure “enabling” statutes; that is, statutes that allow the corporate actors freedom to shape the corporation as they wish.78 This seems entirely appropriate when the relevant corporate actors—investors, promoters, lenders—are private parties negotiating with one another at arm’s length. But this hardly describes the modern publicly-held corporation, with a large divide between ownership and control and no opportunity on the part of the owners to negotiate with the managers. For these corporations, the trend has been in the opposite direction, led by the SEC and the stock exchanges, with the states playing no role. One interpretation may be that the states have conceded the irrelevance of state law in terms of the governance of publicly-held corporations,79 so federal rules on the proxy statement neither “conflict” with any state law, nor encroach upon an area under scrutiny by state legislators.

2. Enforcement Action

In recent enforcement actions, typified by In the Matter of Michael Marchese,80 the SEC has also indicated a willingness to challenge the traditional supremacy of state law. The respondent in this action was an outside director of Chancellor Corporation, which was controlled and dominated by Brian Adley, Chancellor’s principal shareholder, board chair and CEO. Adley defrauded Chancellor and caused it to file false and misleading financial statements. Marchese was innocent of any active wrongdoing, but was charged by the SEC with violations of reporting rules and Rule 10b-5. He consented to cease and desist from future violations of these provisions.

What is noteworthy about the case is that the facts alleged against the respondent presented a classic case of director breach of fiduciary duty, not fraud. The SEC alleged that Marchese was reckless in failing to

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79. The notable exception is state law in the area of takeover defenses. See infra, notes 142-155 and accompanying text.
learning that transactions were not properly reported and that other matters related to the corporation’s financial statements were not properly recorded. There was no intimation that Marchese benefited personally from the fraud, or was otherwise motivated to participate in it. He was a director who simply trusted others to handle these matters. The standard of director conduct has traditionally been a matter of state law, but this action demonstrates how easily it can be transformed into an enforcement action under the federal securities laws.

The implications of Marchese are significant. Consider, for example, the classic fiduciary duty case of Smith v. Van Gorkom. In that case, the Delaware Supreme Court held that the directors of a company acquired in a statutory merger were liable to their shareholders for breach of fiduciary duty because they failed to adequately inform themselves before agreeing to the merger and recommending that the shareholders approve it. As a consequence, the proxy statement prepared by the company was false and misleading. The SEC could take such a case and allege that the directors violated Rule 14a-9, which prohibits the making of false or misleading statements in a proxy solicitation. Traditionally, the SEC has eschewed such action.

Van Gorkom is famous, of course, because it marked one of the few times that a court found directors liable for breach of the duty of care. Of equal importance, it motivated the Delaware legislature (at the prompting of the corporate law committee of the Delaware bar) to enact legislation that allowed Delaware corporations to exempt directors from monetary damages for breaches of the duty of care. The SEC is now filling the void created by that legislation, and while Delaware directors may be freed from liability for monetary damages to their shareholders

81. The Marchese case is not the first SEC action centering on the fiduciary duty of directors. In Report of Investigation in the Matter of the Cooper Companies, Inc. as it Relates to the Conduct of Cooper’s Board of Directors, Release No. 34-35082, 58 S.E.C. Docket 591, 1994 WL 707149 (S.E.C. Release) (Dec. 12, 1994) the SEC issued a report under Section 21(a) of the Securities Exchange Act on its investigation into the conduct of the Board of The Cooper Companies when it confronted fraudulent conduct by certain of its officers. The SEC was strongly critical of the Cooper board and stated: “The Commission has long viewed the issue of corporate governance and the fiduciary obligations of members of management and the boards of directors of public companies to their investors as an issue of paramount importance to the integrity and soundness of our capital markets.” Id. at *6. The case was not, however, merely one of lack of due care. Rather, the board, aware of fraudulent conduct, not only failed to take action to redress it, but issued a false and misleading press release denying knowledge of the conduct. Moreover, unlike Marchese, Cooper involved an allegation against the intentional conduct of the entire board, not the negligent conduct of a single, disengaged director. See also Report of Investigation in the Matter of National Telephone Co., Inc., Exchange Act Release No. 14380 (Jan. 16, 1978); Report Regarding the Investigation of Gould, Inc., Exchange Act Release No. 13612 (June 9, 1977); Report of Investigation in the Matter of Stirling Homes, Exchange Act Release No. 11516 (July 2, 1975); and Staff Report of the Securities and Exchange Commission on the Financial Collapse of the Penn Central Company (August 3, 1972); Microformed on CIS (Cong. Info. Serv.) No. H.


83. Id. at 893.


85. The applicable Delaware provision is:
for breach of the duty of care, they face enforcement actions from the SEC.

The Delaware legislation had a second effect—it motivated judges to find a way around the exemption when the facts were sufficiently compelling. The next section considers some recent cases demonstrating that effect.

IV. THE REACTION IN THE COURTS

Judges are human and it is no wonder that the corporate scandals have affected the way that judges decide cases. In this Part, I consider just three examples, two from Delaware (In re The Walt Disney Co. Derivative Litigation and In re Oracle Corp. Derivative Litigation) and one from the U.S. Court of Appeals for the Seventh Circuit (In re Abbott Laboratories Derivative Shareholders Litigation). All three are shareholder derivative claims. Disney and Abbott involve claims that directors breached their duties of care, historically a notoriously difficult claim for plaintiffs, while Oracle challenges the independence of a special litigation committee, also a problem for plaintiffs.

b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective.


86. The author participated with a member of the Delaware Chancery Court in a 2003 symposium on corporate law. The judge freely conceded that the Chancery Court has been affected by the news and the decisions noted in this Part may be evidence of that effect.

87. 825 A.2d 275 (Del. Ch. 2003).
88. 824 A.2d 917 (Del. Ch. 2003).
89. 325 F.3d 795 (7th Cir. 2003).
90. This was the case even before state statutes permitted corporations to exempt directors from monetary damages to shareholders for breach of the duty of care. See Joseph W. Bishop, Jr., Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 Yale L. J. 1078 (1968).
A. *In re Disney*

The Disney case is part of a history of litigation challenging the compensation paid to Michael Ovitz, who served as Disney's CEO for one year, yet received termination pay exceeding $140,000,000. The plaintiffs' basic allegation was that the board simply did not do its job in informing itself about Ovitz's contract, a classic claim for breach of the duty of care. However, the procedural posture of the case was whether demand on the board would be excused as futile, and this would be the case only if the plaintiffs could plead with particularity facts sufficient to rebut the presumptions of the business judgment rule. Plaintiffs' case was complicated by the fact that under Disney's articles of incorporation, the "directors would be protected from personal damages liability for any breach of their duty of care." Thus, even a well-pleaded claim that the directors breached their duty of care could not succeed. Nevertheless, the court declined to dismiss the case.

The Chancery Court held in *Disney* that "[a] fair reading of the new complaint . . . gives rise to a reason to doubt whether the board's actions were taken honestly and in good faith. . . ." The court amplified this assertion a bit later in the opinion: "the [alleged] facts belie any assertion that the [Disney boards] exercised any business judgment or made any good faith attempt to fulfill the fiduciary duties they owed to Disney and its shareholders." Thus, the case was recast from one of care to one of good faith. The provision in Disney's articles of incorporation did not (and under the statute could not) relieve the directors from liability for monetary damages if they failed to act in good faith. Therefore, the court concluded that the case could proceed to discovery notwithstanding the lack of demand made by the plaintiffs.

The allegations in *Disney* are strikingly similar to those in *Van Gorkom*, the paradigmatic due care case. In both cases, the board relied heavily on the CEO to negotiate the transaction at issue, in *Disney* an employment agreement and in *Van Gorkom* a sale of the company. In both cases, the CEO had a personal friendship with the party with whom he was negotiating on the opposite side of the transaction. Eisner (for Disney) was a personal friend of Ovitz, while Van Gorkom (the CEO of Trans Union) was a personal friend of Pritzker, who was seeking to acquire Trans Union. In *Van Gorkom*, the board's detachment was characterized as gross negligence, but the case has been understood to impose

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93. *In re Walt Disney Co.*, 825 A.2d at 279.
94. Plaintiff could also avoid demand if the board had a conflict of interest. The facts did not, however, support such an allegation. *Brehm*, 746 A.2d at 253-55.
95. *In re Walt Disney Co.*, 825 A.2d at 286.
96. *Id.*
97. *Id.* at 286-87.
98. *Id.* at 287.
special obligations on a board when the question before it is the disposition of the company itself. In Disney, however, the board’s detachment was characterized as a good faith violation, and the issue before it was not, of course, the disposition of the company. Moreover, much of the decision in Disney seemed to turn on the personal relationship between Eisner and Ovitz, with the suggestion that Disney was unrepresented in the negotiations and the board should have been more engaged as a result.

Despite the similarities in the cases, and the fact that Van Gorkom is the leading Delaware Supreme Court case on due care, the Chancery Court did not even cite Van Gorkom in considering the allegations of the plaintiff’s complaint. While the cases can be distinguished factually—perhaps the directors were more disengaged in Disney—a comparison of the cases still seems necessary. One might conclude from this that the Delaware courts, at least the Chancery Court, are becoming more sensitive to claims involving corporate excesses. The good faith doctrine, though rarely explored in Delaware case law, is now an area ripe for development.

B. In re Abbott

This theme, the rising importance of the doctrine of good faith, was the critical factor in the Seventh Circuit’s decision in Abbott as well. Abbott arose out of penalties and losses the company suffered because one of its manufacturing facilities did not meet FDA standards. Differences with the FDA over the facility had been ongoing for several years and ultimately resulted in a FDA order closing the facility. The shutdown resulted in lost sales, a $168 million charge to earnings, a $100 million fine, the loss of a planned acquisition and a decline in Abbott’s stock price. These losses, the shareholders alleged, resulted from the board’s failure to take action when the FDA raised its concerns. Like Disney, Abbott involved a question as to whether shareholders must make a demand on the board before proceeding with a derivative action. Like Disney, Ab-

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101. Hillary A. Sale, Delaware’s Good Faith, 89 CORNELL L. REV. 456, 463 (2004) (“The good faith element has not been explored in much detail, either by the courts or academics.”). See, e.g., In re Rexene Corp. S’holders Litig., 1991 WL 77529, at *4 (Del. Ch. May 8, 1991) (“Bad faith will be inferred where ‘the decision is so beyond the bounds of reasonable judgment that it seems essentially inexplicable on any [other] ground. . . . ’”) (quoting from In re J.P. Stevens & Co., 542 A.2d 770, 780 (Del. Ch 1988)). In neither Rexene nor J.P. Stevens did the court uphold the claim that the directors acted in bad faith.

102. See Grogan v. O’Neil, 292 F. Supp. 2d 1282, 1293 (D. Kan. 2003) (a recent case applying Delaware law) (“The standards for [pleading] corporate waste and bad faith are similar: to prevail on either claim, plaintiff must show that the board’s decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation’s best interests.”).

103. In re Abbott Labs., 325 F.3d at 800-01. Abbott and the FDA were in conflict over manufacturing processes at Abbott’s Diagnostics Division from 1993 to 1999. Id. at 799-801.

104. Id. at 800-01.
bott was essentially a due care case recast as a good faith case to permit plaintiff to avoid the demand requirement.

Abbott, however, seemed to go beyond Disney in at least one significant respect. Disney involved the approval of a material agreement that was before the board for its approval. Abbott, by contrast, involved the failure of the board to act. Assuming the truth of the allegations in the complaint, the court characterized this failure to act as a "sustained and systematic failure of the board to exercise oversight. . . ." Inasmuch as this failure was intentional and repeated over a long period of time, it "indicate[s]" that "the directors' decision to not act was not made in good faith and was contrary to the best interests of the company."106

This analysis is flawed in at least two respects. First, it incorrectly draws on a decision of the Delaware Chancery Court, In re Caremark,107 where the court announced that a board has a duty to assure that the corporation has in place a system to assure the corporation's compliance with applicable law. If the corporation violates the law, and it turns out that no such law compliance program was in place, then the board might be liable for a breach of its duty of care, provided the plaintiff can demonstrate a sustained and systematic failure on the part of the board to exercise oversight. In Abbott, the board was aware of the FDA's concerns, but apparently made the business decision that management of the company was properly attending to the dispute, the very sort of decision that Caremark sought to immunize. More importantly, however, the decision is entirely conclusory in finding that the behavior of the Abbott board lacked good faith. The decision provides no guidance as to why the board's conscious decision not to acquiesce in the FDA's demand was not protected by the business judgment rule. Finally, the Delaware Supreme Court has clearly stated that "a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the rule."108 The Abbott court should have addressed this aspect of the business judgment rule.

One might conclude from Abbott, as from Disney, that the court was skeptical of the combined effect of the business judgment rule and the provision in the company's articles limiting the directors' liability. The avenue for review was the good faith exception, which now seems inexorably tied to due care; gross negligence, or reckless violations of the duty of due care, indicate that the directors failed to act in good faith. If this definition holds, then the Delaware Supreme Court's decision in Van Gorkom has been resuscitated and the exemptive provisions in so many articles of incorporation have been judicially amended.

105. Id. at 809 (quoting from In re Caremark Int'l, 698 A.2d 959, 971 (Del. Ch. 1996)).
106. In re Caremark, 698 A.2d at 971.
107. Id. at 972.
108. Aronson, supra note 47, at 813.
C. In re Oracle

Just as Disney and Abbott have re-defined due care and good faith, In re Oracle re-defines independence. Oracle involved a challenge to a recommendation from a special litigation committee to dismiss a shareholder’s derivative claim. The claim itself centered around alleged insider trading by three officers of Oracle. The special litigation committee consisted of two directors, neither of whom was employed by the company nor related by blood or marriage to any of the defendant directors. They were both members of the Stanford University faculty at the time of the litigation and when the events in question occurred. Neither of the members of the special litigation committee had any business dealings with Oracle or with any entity affiliated with any of the defendants. The two members joined the board after the events in question. They thus satisfied traditional notions of independence, which tend to focus on family and financial relationships. Nevertheless, the court found otherwise.

In a thorough, well-reasoned, and persuasive opinion, Vice Chancellor Strine considered the relationship between the defendant-directors and Stanford University, concluding that given those relationships, which included substantial past and possible future financial contributions by the defendants, the special litigation committee might not be able to act impartially. In eschewing the more traditional notions of independence, the court turned to its “general sense of human nature.” This analysis takes into account the individual circumstances of the people in question as well as structural bias, and is far more nuanced than a typical analysis of independence. The opinion opens the door to a consideration of other relationships, such as personal friendship, service on the same nonprofit board, membership in the same religious organization, etc., that may affect the ability of a person to judge another impartially.

Oracle, at its core, demonstrates the same sort of skepticism of board behavior evident in Disney and Abbott. To provide relief to shareholders in the latter two cases, the court had to overcome a provision in the companies’ articles of incorporation that protected directors from liability. In Oracle, the court had to reinterpret precedent on the issue of inde-

110. Id. at 943-45.
111. Id. at 943.
112. See also Krasner v. Moffett, 826 A.2d 277, 279 (Del. 2003). Krasner is another recent Delaware case demonstrating skepticism of board independence. In this case, the Delaware Supreme Court reversed the dismissal by the Court of Chancery of a class action complaint challenging a board decision to approve a merger. Id. at 279. The board was represented by a special committee and the Chancery Court found that the plaintiffs failed to allege facts “sufficient to [impugn] the disinterest, independence or processes of the special committee. . . .” Id. at 282. The Delaware Supreme Court reversed, holding that the defendant directors, not the plaintiffs, bear the burden of proving that the committee that approved the merger was disinterested and acted “independently, with real bargaining power to negotiate the terms of the merger.” Id. at 284-85. By shifting the burden to the defendants, the Court precluded resolution of these cases on a motion to dismiss. Id. at 287.
pendence. One irony of *Oracle*, in light of the recent stock exchange rules, is that the Delaware court seems to be moving toward a more flexible meaning of independence while the stock exchanges have opted for a more precise definition based on financial relationships.

V. THE INDEPENDENT DIRECTOR AS SUPERHERO AND SOME THOUGHTS ON THE BUSINESS JUDGMENT RULE AND THE MARKET FOR CORPORATE CONTROL

A. INDEPENDENT DIRECTORS

In some sense, it is ironic, and maybe illogical, that Congress and the stock exchanges have strengthened the hand of the independent director and placed increasing confidence in the independent director to achieve improved corporate governance. The irony is that in all of the high-profile scandals, independent directors dominated the companies' boards. It is therefore illogical to assume that a greater role for independent directors would or might have avoided the identified problems. Moreover, the clear trend in the last twenty years or so has been to increase both the proportion of independent directors on boards and to increase their role, yet the number and size of corporate scandals seem only to increase. One might speculate that the independent directors are the cause of the problem, not the solution.

113. See supra, notes 56-62 and accompanying text.


116. Of course, directors serve a role beyond guarding against management overreaching; the board is also supposed to pay attention to the business of the company. On this latter score, there is scant evidence that independent directors are better overseers of the company's business and some empirical evidence that they are not. Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Perform-
Such speculation has no support among corporate observers, of course, and much less among legislators and regulators. This lack of support is understandable, and probably correct, because from a structural perspective independent directors are best situated to check overreaching by corporate officers. If not independent directors, one might ask, who? The only other candidates are governmental regulators, a solution that no one embraces because of the fear that government has neither the resources nor the expertise to monitor corporate governance. Moreover, regulatory solutions might stifle corporate competitiveness and economic efficiency.\footnote{See Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law, ch. 1 (1991).}

Independent directors have failed the system not because they lack the systemic authority to monitor corporate management, but rather because, in many instances, they lack the will, the time and/or the incentives to do so. American corporate governance is wedded to the notion of directors who serve only part time and who have substantial, often overwhelming, responsibilities outside of the corporation(s) on whose board(s) they serve. Despite the legal responsibilities of serving as a director, a number of boards of prominent companies feature former governmental officials and various celebrities who add "luster" to the company on whose boards they serve and who accept the positions for the prestige that comes with a prominent directorship.\footnote{For example, MGM Inc. lists filmmaker Francis Ford Coppola and actress Priscilla Presley among its list of directors. 2002 Metro-Goldwyn-Mayer Annual Report, at http://www.mgm.com/corporate/shareholder_reports/2002/MGM_2002_Annual_Report.pdf. Coca-Cola's board includes former Senator Sam Nunn. Coca Cola Board of Directors, at http://www2.coca-cola.com/ourcompany/board.html. And former Georgetown University and United States Olympic basketball coach John R. Thompson, Jr., sits on the board of directors at Nike. Corporate Governance, at http://www.nike.com/nikebiz/nikebiz.jhtml?item=board&ex=johnr.}

Such persons may, of course, be active, engaged, competent and effective directors. There is, however, no reason to assume that they are.

One solution, suggested by Professors Gilson and Kraakman, is to staff boards with "professional" directors.\footnote{Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 STAN. L. REV. 863, 884 (1991).} They propose that large institutional investors cooperate with one another to create a cadre of independent, professional directors. Such directors would then serve on a limited number of boards—the authors propose six—but have no other signifi-

cant employment. Their compensation from each directorship would be significantly greater than current director compensation, and the aggregate compensation from six or so boards would be enough to attract highly qualified individuals to the cadre. These professional directors would be more effective as monitors, presumably, because they would have “a focused mandate and the time to familiarize themselves with their companies.”

The notion of a professional cadre of outside directors, who have both the skills and the resources to serve as directors, is an attractive idea. It is not, however, an idea that has moved beyond the theoretical stage in the thirteen years since it was first promulgated. It may be that it is too difficult for institutional investors to coalesce around such an idea, or that such investors do not believe that the idea is feasible or preferable to the status quo. Whatever the reasons, however, institutions have not moved in the direction that Professors Gilson and Kraakman have suggested, nor are they likely to do so.

B. THE BUSINESS JUDGMENT RULE

Instead of dramatic new models for corporate governance, regulators and courts have preferred to tinker with the current model, and investors have taken few initiatives of their own. Arguably, the latest reforms, discussed above, will not prove equal to the task. Despite the increased responsibilities and power of independent directors, their incentives to monitor and challenge management compensation and self-dealing have not changed. At the core of the problem is the business judgment rule, which limits the potential liability of a director for breaches of the duty of care. A director is only liable if he or she is grossly negligent, and the rule presumes that the director acted with due care. Thus, a shareholder challenging director conduct bears the burden of proving that the director acted with gross negligence. If the company has an exculpatory provision in its articles of incorporation, as nearly all publicly-held corporations do, the plaintiff-shareholder must prove that the director failed to

120. *Id.* at 885.

121. The Delaware Supreme Court has characterized the rule as:

[A] presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. . . . Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.


122. *Aronson* 473 A.2d at 812. See also *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985) (“We again confirm that view [expressed in *Aronson*]. We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one.”).

act in good faith or intentionally harmed the corporation. As if these legal standards were not enough to reduce a director’s incentives to act with care, directors invariably have indemnification rights and insurance, and courts have limited the ability of shareholders to obtain discovery in derivative actions alleging director misconduct. While in some recent cases the courts have been scaling back on these procedural protections, the business judgment rule remains a formidable protection for outside directors. Is this as it should be?

The core philosophy of the business judgment rule, developed throughout the twentieth century, is widely accepted, and indeed, widely embraced. Without the rule, it is said, qualified persons would not serve as directors and people who did serve would be highly risk averse, to the detriment of shareholders. Scholars argue that shareholders are diversified and, therefore, have different risk preferences than managers. Moreover, the market for corporate control acts as a check against incompetent corporate management; litigation and/or regulation are unnecc-


126. E.g., Levine v. Smith, 591 A.2d 194, 208-10 (Del. 1991), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (requiring shareholder’s derivative suit to be subject to dismissal on the basis of a well-pleaded complaint and not allowing discovery); Resnick v. Karmax Camp Corp., 491 N.Y.S.2d 692, 693 (1985) (noting that courts impose more strict requirements on discovery when dealing with shareholder derivative suits due to their harassment potential); cf. In re PSE & G S’holder Litig., 801 A.2d 295, 312 (2002) (allowing shareholders limited discovery into director decision-making in a derivative suit where demand was refused).

127. See supra notes 88-113 and accompanying text.


129. Easterbook & Fischel, supra note 117 at 99-100 ("Managers especially want to avoid risk because they cannot diversify the value of their human capital. Shareholders, however, readily diversify risk through capital markets. They want managers to take the projects with the highest mean returns, which may entail high risk"). But see William K.S. Wang, Selective Disclosure by Issuers, Its Legality and Ex Ante Harm: Some Observations in Response to Professor Fox, 42 Va. J. Int’l L. 869, 880 & n. 63 (2002) (arguing that shareholders are not diversified).
necessary and inefficient. Finally, the rule is justified on the basis that judges are ill-equipped to make business decisions; therefore, they should not be in the position of substituting their decisions for those of the directors.

The foregoing conventional wisdom about the business judgment rule is only partially true, and, in any case, misses the point. The business judgment rule addresses process, not investment philosophy. Directors can, and probably should, be risk preferring and so long as they act with care, they should not be liable if their judgment proves to be mistaken. The market for corporate control, in theory, can act as a check against incompetent boards, but that market is hardly free and vigorous. In fact, state law that provides corporate management with a wide array of defenses to a hostile takeover has radically changed the market for corporate control in the last twenty years. Today, it hardly exists. Moreover, the market does not work for individual directors; there is no evidence that persons who serve on the boards of failed corporations suffer reputational harm from their service.

The most prominent argument in favor of the business judgment rule—that qualified persons will not serve without the rule—is similarly flawed. The decision of whether to serve on a corporate board is influenced not only by the potential liability, or costs, of service, but also by potential rewards. Corporations have been successful at attracting prestigious individuals to serve as directors, at relatively nominal fees, because the costs of being a director are low and are outweighed by the rewards. The costs, which are primarily time commitments and potential liability, have been held down by the business judgment rule. On the other hand, the rewards, which consist primarily of the prestige of serving on a corporate board and the compensation that accompanies it, have been increasing. If the protections of the business judgment rule were scaled back, or the availability of exculpatory provisions were eliminated, the costs of serving as a director would surely increase. But this only means that the rewards would have to increase commensurately to assure the availability of directors. It would mean that persons serving as directors would have to devote more time to their work (and thus, by necessity, serve on fewer or no other boards) and would expect more compensation. In short, a


131. In re Caremark, 698 A.2d at 967 (cautioning that a rule which would "expose directors to substantive second guessing by ill-equipped judges or juries . . . would, in the long-run, be injurious to investor interests").


133. See Julian Velasco, The Enduring Illegitimacy of the Poison Pill, 27 J. Corp. L. 381, 384-85 (2002) (cautioning that the poison pill, as the ultimate defense in a hostile takeover, prevents meritorious hostile takeovers and can harm shareholders).
change in the legal rules governing director conduct could have the effect of professionalizing the boardroom.

Proposing a significant change to the business judgment rule is indeed a radical idea and one not easily implemented. The standard for director conduct, despite Sarbanes-Oxley, remains a question of state law, which could change either by legislative action or judicial decision. As noted above, the Disney and Abbott cases suggest that judicial attitudes are changing.\textsuperscript{134} The changes appear, however, to be marginal. Significant change could come through legislative action, but state legislators may not have sufficient incentive to change the law. On the one hand, state legislators may believe that their constituents would be best served by more stringent standards on directors. Whether such beliefs would provide sufficient motivation to change the law depends, in part, on whether states compete with one another for attracting and retaining incorporations. Arguably, states that impose higher standards on directors would fail to attract new incorporations and would lose incorporations as companies re-incorporate in other, more permissive jurisdictions. This, in turn, arguably would have an economic consequence, as the states losing incorporations would also lose the corresponding franchise fees and, possibly, the physical presence of the corporation as well.

This dynamic of promoters and corporate managers seeking a favorable jurisdiction in which to incorporate or re-incorporate suggests a competition among the states. In 1974, writing for the Yale Law Journal, Professor William Cary lamented the fact that state law did not adequately protect the interests of shareholders.\textsuperscript{135} He attributed this to a competition among the states to attract incorporations.\textsuperscript{136} To win in this competition, he argued, states would design their laws to appeal to corporate managers, and shareholders would (and had) suffered as a result. He characterized this competition as a “race to the bottom.”\textsuperscript{137} To rectify this state of affairs, he suggested a federal corporate code.\textsuperscript{138}

Professor Cary’s thesis has been vigorously contested, with other commentators arguing that if a state’s corporate law disadvantaged investors, they would discount the shares of companies incorporated there, raising.

\footnotesize
\textsuperscript{134} See supra notes 82-102 and accompanying text.
\textsuperscript{136} This idea predates Cary. Justice Brandeis, writing in \textit{Louis K. Liggett Co. v. Lee}, 288 U.S. 517, 557-60 (1933) expressed the same skepticism:
Lesser States, eager for the revenue derived from the traffic in charters had removed safeguards from their own incorporation laws. . . . \[T\]he great industrial States yielded in order not to lose wholly the prospect of the revenue and, the control incident to domestic incorporation.
\textsuperscript{137} Cary, supra note 135, at 705.
\textsuperscript{138} For an overview of this debate see Allen D. Boyer, \textit{Federalism and Corporation Law: Drawing the Line in State Takeover Regulation}, 47 \textit{OHIO ST. L.J.} 1037, 1041-56 (1986). Others have advocated for a federal corporate code as well. See, e.g., NADER, GREEN & SELIGMAN, supra note 6 and accompanying text.
the company's cost of capital. Companies facing a higher cost of capital than their competitors would suffer in the markets in which they compete; thus, promoters and managers would seek state corporate codes that result in a lower cost of capital. This phenomenon would lead states to compete for the most economically efficient corporate law, that is, a race to the "top."

While the "race" debate has spawned an impressive and growing literature, it seems sufficient to say that only in a few states, primarily Delaware, are corporate franchise fees a material part of state revenues, and there is no evidence that corporate promoters or managers choose their state of operations based on where the company is incorporated. In other words, with a few exceptions, states do not craft their corporate laws to attract, or avoid losing, corporate franchise fees, and it is unlikely that states fear the loss of jobs or tax revenue (other than franchise fees) if businesses choose to organize under the laws of another jurisdiction.

This does not, however, mean that state statutes are drafted or amended without regard to the law of other states. To the contrary, innovative corporate law provisions, which generally originate in Delaware, are frequently copied across the country. It is unjustified, however, to

139. This view was most prominently stated in Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. LEGAL STUD. 251 (1977).
140. Id. at 289-92.
141. A recent contribution is that of Mark J. Roe, supra note 7 (arguing that Delaware is limited in its lawmaking discretion by its perception of how the federal government might respond to its actions). For further scholarly debate on the race question, see Robert Daines, Does Delaware Law Improve Firm Value?, 62 J. FIN. ECON. 525, 533 (2001) (finding that incorporating in Delaware can enhance share values by as much as five percent); Guhan Subramanian, The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching, 150 U. PA. L. REV. 1795 (2002) (supporting the notion of a race to the bottom); Marcel Kahan & Ehud Kamar, The Myth of State Competition in Corporate Law, 55 STAN. L. REV. 679 (2002) (concluding that Delaware has won the race, precluding further competition); Mark J. Loewenstein, Delaware as Demon: Twenty-Five Years After Professor Cary's Polemic, 71 U. COLO. L. REV. 497, 501 (2000) (arguing that states do not compete).
142. See Loewenstein, supra note 132, at 506-07 ("the vast majority of states charged [incorporation fees of] $100 or less, with some charging as little as $10"). Nevada is reputed to be a state anxious to attract additional incorporations. See, e.g., Lucian Arye Bebchuk, Firms' Decisions Where to Incorporate, 46 J.L. & ECON. 383, 394 (2003) ("Other than Delaware, which is a huge "importer" [of re-incorporations], only Nevada has a significant net inflow of firms."); Brett H. McDonnell, Getting Stuck Between Bottom and Top: State Competition for Corporate Charters in the Presence of Network Effects, 31 Hofstra L. REV. 681, 731 (2003) ("A few individual states have also remained or emerged as competitors with Delaware, with some limited success. Nevada has attempted to become the Delaware of the West. In some ways it offers laws that are even more pro-management than those of Delaware.")
conclude that this is so because states must "meet the competition," because at the same time one can find a good deal of variation from state to state in corporate law.\textsuperscript{144} This variation is utterly inconsistent with the thesis that states are competing for incorporations. Rather, the widely-adopted provisions, the commonality between and among statutes (and there is a good deal of that as well), are explainable by other factors, including legislators' good faith perceptions of sound public policy.\textsuperscript{145}

If states are not constrained by competition, why have they not, in the face of mounting corporate scandals, repealed provisions that allow corporations to exempt directors from the duty of care? Similarly, why have they not amended the business judgment rule? One can only theorize the answer to these questions, and I can offer a few ideas. First, legislators may not perceive a relationship between their corporate codes and corporate behavior. Nearly sixty percent of the Fortune 500 companies are incorporated in Delaware,\textsuperscript{146} so to the extent a legislator considers corporate scandals as a function of state law, he would (unless a Delaware legislator) place the blame elsewhere. Second, legislators may consider this a "federal" problem, one to be solved by Congress or the stock exchanges. Indeed, both responded swiftly and dramatically to the current wave of corporate scandals, as they (especially Congress and the SEC) have since the stock market crash of 1929.\textsuperscript{147}

\textsuperscript{144} See Loewenstein, supra note 132, at 524-29.
\textsuperscript{145} Id. at 536-39.
\textsuperscript{146} See Delaware Division of Corporations (last modified February 14, 2004), \textit{at} http://www.state.de.us/corp/default.shtml.

Third, the most prominent culprits in this wave of scandals are executive officers, not the independent, outside directors. As these officers are being prosecuted by criminal laws long on the books, a legislator might view the problem as one already adequately addressed by law. It is human nature to seek a limited solution to a problem, if one seems to be available, and rethinking the construct of corporate governance is more complicated than focusing on the visible wrongdoers. Thus, it is reasonable for an observer to conclude that the frauds resulted from the avarice of corporate officers, and if the laws that prohibit such conduct need to be tightened, then that is the answer. By contrast, to approach the problem from the perspective of corporate governance is complicated and subtle. The solutions it might yield are less direct, and therefore might be perceived by the public as inadequate.\footnote{148}

Finally, corporate governance is not a priority in state legislative halls. Revisions to statutes dealing with business organizations typically originate with bar association committees. The Model Business Corporation Act, for instance, is a project of a committee of the American Bar Association.\footnote{149} Once approved by that committee, the act, or revisions of it, are reviewed by state bar committees who then may propose a bill to their state legislatures. It is unlikely that corporate lawyers would take the initiative to reverse the business judgment rule or the exculpatory provisions on director liability. While lawyers on law revision committees try to "do the right thing," they typically represent corporate officers and directors. It is difficult to recommend a law that would increase the liability of their clients. Moreover, these lawyers may not be convinced (or even be amenable to being convinced) that a higher legal standard of care for directors would have avoided the problem. The conventional wisdom on the business judgment rule—its role in attracting competent directors and encouraging them to take risks—is so deeply embedded in the psyche of most corporate lawyers that it is not reasonable to expect them to be the engines of change.

A change in standards of director conduct is therefore unlikely to come from state legislatures. Surely Delaware has no incentive to change its law and jeopardize its lucrative incorporation business. While some legislators elsewhere around the country may identify the business judgment rule and the exculpatory provision as potentially part of the problem, they, too, are unlikely to act. This explains, of course, why Congress and the stock exchanges acted with such gusto in the aftermath of Enron. Though often derided, Professor Cary's advocacy of a federal corporate

\footnote{148. It is interesting to note that the stock exchanges focused more heavily on corporate governance than did Congress in Sarbanes-Oxley. This may be because the listing requirements might strike member of Congress as overly detailed for a federal statute.}

\footnote{149. The Committee on Corporate Laws of the Section of Corporation, Banking and Business Law of the American Bar Association.}
code is becoming a de facto reality with the combination of Sarbanes-Oxley and the stock exchange rules. While neither Congress nor the stock exchanges have tinkered with the business judgment rule, that may come with another round of scandals, completing the transformation in corporate law.

C. The Market for Corporate Control

The business judgment rule is not the only state law concept that has stymied meaningful reform in corporate governance. Among the other candidates are state laws or judicial decisions that inhibit the market for corporate control. If the market for corporate control were more robust, incentives for active monitoring would increase. Potential acquirers of corporate assets would form another highly incentivized group of corporate monitors.

The takeover wave of the 1980s, however, led corporate management to seek protective legislation from their state legislatures, and in many instances, the legislatures complied. Of equal importance, many corporations enacted self-help protections, in the form of poison pills and other devices, to discourage hostile takeover attempts. The courts generally upheld these devices, providing management with considerable freedom to ward off such attempts.

These laws and judicial decisions have hurt shareholders, yet, as in the case of the business judgment rule, relief from state legislatures seems unlikely. Shareholders have not yet become effective lobbyists at the state level, while corporate management has been for a long time. State


152. See Guhan Subramanian, Bargaining in the Shadow of Takeover Defenses, 113 YALE L.J. 621 (2003) (concluding that reviving the hostile takeover marketplace will improve corporate governance and suggests re-evaluating the costs of takeover defenses); John C. Anjier, Anti-Takeover Statutes, Shareholders and Risic, 51 LA. L. REV. 561 (1991) (noting that the rate of mergers and acquisitions was at an all time high in the 1980’s, to the benefit of shareholders, after which most states adopted anti-takeover statutes without public debate and which protect corporate management while increasing divergence of interests between managers and shareholders).


154. E.g., the Indiana share control law, supra note 150, was passed by the Indiana legislature at the behest of CTS Corp., which immediately invoked the provisions of the Act.

155. See supra note 152.
legislators respond to a CEO who might threaten to move corporate offices outside of the state, but not to a shareholder who threatens to dump her shares. In short, the promise of a change of control as a prescription for sick management is more a myth than a reality.

VI. CONCLUSION

Enron and other corporate scandals that emerged at the turn of the millennium generated strong reaction from several different potential regulators: Congress, the SEC, the stock exchanges and the courts. Ironically, and somewhat unfortunately, one key player in the development of corporate law, the state legislature, was remarkably absent in enacting reforms. The states seem to have abdicated their traditional role of defining the internal affairs of corporations, at least insofar as publicly-held corporations are concerned.

Despite these many initiatives, however, the underlying problem of corporate governance remains unsolved. In the high-profile cases, corporate officers were able to mulct their corporations because their boards failed to adequately monitor either the behavior of the officers or the affairs of the corporation. The reason for this failure is well known—-independent directors lack the incentives and resources to discharge their duties. Yet many of the reforms noted above merely seek to increase the number and clout of the independent directors without altering their incentives or resources.

State law can address this fundamental problem, but, with some exceptions in the judicial realm, has actually moved in the opposite direction the past twenty years. State law could increase the incentives to monitor by requiring a higher standard of care for directors and by removing the barriers to a change of control. Doing so would incentivize independent directors to be more professional as directors, and they would, in turn, demand the resources (and compensation) to discharge their heightened duties. Potential legal liability and the market for control are powerful incentives to behavior, yet state law has disabled both.

The next wave of corporate scandals may well result in a further transformation of state control over the internal affairs of our corporations. The calls for federal corporate codes will, at that time, be difficult to resist. Yet, it is unlikely that states will act before then. Outside of Delaware, there is little economic incentive for them to do so. Whether Delaware, which has powerful incentives to act, will take the initiative remains to be seen. While the Delaware courts seem to be reacting, the legislature has thus far remained silent. In light of the current Delaware corporate code, the influence of the courts is somewhat limited. At the same time, however, it seems unlikely that the Delaware bar will recommend to its legislature that it radically alter the standard of conduct.

156. See Sale, supra note 101, at 457 (commenting on the silence of the Delaware legislature).
for directors or open the market for control of Delaware corporations. Thus, the days of Delaware’s and, indeed, other states’ influence in matters of corporate law may be numbered.