DELAYERING CORPORATE LAW

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ABSTRACT

Corporate law has become unnecessarily complicated. Despite the proliferation of laws, problems fester and scandals erupt. Something is wrong. This Article seeks to delayer corporate law—to strip it down to its essence—and after doing so, offer concrete suggestions for reform. It is a first step toward a new minimalist architecture for corporate law.

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The Article begins by arguing that the core of state corporate law—corporation statutes and fiduciary duties—currently offers precious little protection to shareholders. Contractarianism, manifested through enabling statues, reflects weak economics. Existing fiduciary duties are little more than rhetorical flourish. Rather than reexamine why the core of corporate law is empty, policymakers have instead added a series of layers, most notably securities laws. These reforms, however, merely operate as bandages to recover from the most recent scandal and further obfuscate the hollow core of corporate law.

The bulk of the Article offers a fresh path to reform. It draws on emerging paradigms in regulatory theory to argue that substantively, corporate law must reinvigorate fiduciary duties by resetting judicial "standards of review" to match "standards of conduct," while at the same time addressing the behavior of officers, not just directors. Finally, the institutional approach proposed is one of cooperative federalism: the federal government would set minimum standards, but implementation would occur through state courts via a "reverse-*Erie*" principle.

I. INTRODUCTION

Corporate law has become unnecessarily complicated. A rough and ready measure approximates the problem. When I was a law student a decade ago, the statutory supplement assigned for our corporations class consisted of 1223 pages.[1] A newer edition of the same supplement, which I now assign when teaching corporations, has 2086 pages[2]—a whopping seventy-one percent increase in just ten years. Add this to any casebook, and the array of materials is dizzying: state statutes and common law; federal statutes, regulations, and common law; and a welter of miscellaneous edicts such as stock exchange listing requirements, standards of professional conduct, and the usual hortatory aspirations for corporate governance. Yet despite the extraordinarily wide swathe of corporate law, problems fester and scandals erupt. Somehow, this curious state of affairs must be explained.

1. *See* CORPORATIONS AND BUSINESS ASSOCIATIONS: STATUTES, RULES, MATERIALS, AND FORMS (Melvin Aron Eisenberg ed.) (1995).

2. *See* CORPORATIONS AND BUSINESS ASSOCIATIONS: STATUTES, RULES, MATERIALS, AND FORMS (Melvin Aron Eisenberg ed.) (2005). The comparison, of course, is not precise, given editorial choices to add or subtract items. Interestingly, in the face of the unwieldy expansion of statutory supplements, there has been a recent shift to produce streamlined supplements geared to individual casebooks. *See, e.g.*, WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION: 2005-2006 STATUTORY SUPPLEMENT (2006).

Perhaps reflecting the evolution of its subject, corporate law scholarship itself has proliferated. The classic disagreement, whether corporate law is "racing to the bottom"[3] or "racing to the top,"[4] has become a bit quaint. A second strand of scholarship, more interdisciplinary in its methodology, has emerged. One sub-branch seeks to apply the insights of public choice theory;[5] the other, learnings from the economics of industrial organization.[6] Concurrently, a third strand of scholarship has begun, critical in its orientation and advocating wholesale deconstruction of current doctrine.[7] Unfortunately, none of these theories is satisfactory. The "race to the top" theory suffers from a host of implausible assumptions—among them, that investors have perfect information, and that the corporate form does not present externalities.[8] For their part, public choice and deconstruction theorists do provide a useful critique of existing corporate law paradigms, but too

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3. *See, e.g.*, William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 701 (1974) ("The first step is to escape from the present predicament in which a pygmy among the 50 states [Delaware] prescribes, interprets, and indeed denigrates national corporate policy as an incentive to encourage incorporation within its borders, thereby increasing its revenue."). *See generally* Arthur Fleischer, Jr., *"Federal Corporation Law": An Assessment*, 78 HARV. L. REV. 1146 (1965).

4. *See, e.g.*, Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 290 (1977) ("The liberality of state law is thus evidence, not of management overreaching, but of the fact that state law has moved in a direction consistent with an economic model of the management function."); Roberta Romano, *Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?*, 21 OXFORD REV. ECON. POL'Y 212 (2005).

5. *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 509 (1987) ("Delaware law reflects an internal equilibrium among competing interest groups."); Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2496 (2005) ("The interest groups in play differ at each level: shareholders and managers at the state level, and a wider array of players at the federal level."). For a survey of public choice theory, see DANIEL A. FARBER & PHILIP P. FRICKEY, LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION (1991).

6. *See, e.g.*, Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 724 (2002) ("Our analysis suggests that both economic entry barriers and politics account for state inaction."); Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters*, 112 YALE L.J. 553, 557 (2002) ("The 'product' currently offered by Delaware should be viewed as including not only its rules but also its institutional infrastructure, including Delaware's specialized chancery court, and the network benefits currently enjoyed by Delaware corporations."). For a survey of industrial organization, see JEAN TIROLE, THE THEORY OF INDUSTRIAL ORGANIZATION (1988).

7. *See, e.g.*, JOEL BAKAN, THE CORPORATION 110 (2004) (describing corporations as "institutional psychopaths who lack any sense of moral conviction and who have the power and motivation to cause harm and devastation in the world"); David A. Westbrook, *Corporation Law After Enron: The Possibility of a Capitalist Reimagination*, 92 GEO. L.J. 61, 122 (2003) ("Ultimately at stake in corporation law is the degree of credibility—and hence authority—achieved by a market in a given time and place.").

8. *See, e.g.*, Winter, *supra* note 4, at 253, 256-57, 266; Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1421 (1989).

often they propose little by means of reform. The "race to the bottom" theory, for its part, while descriptively accurate, typically ends up proposing a solution that is neither politically feasible, nor even normatively desirable: the federalization of corporate law.[9]

While selectively drawing from much of this scholarship, this Article is different. It seeks to delayer corporate law—to strip it down to its essence—and after doing so, offer concrete suggestions for reform. It represents a small first step toward a new minimalist architecture for corporate law.[10]

I start simply by noting that the central problem of the modern public corporation—the separation of ownership and control—has not changed in a century.[11] At their core, laws are trying to structure the agency relationship between dispersed shareholders ("outsiders") and a small group of managers ("insiders").[12] Somehow, this relationship must be regulated, but the proliferation of laws makes it woefully clear that previous attempts have been unsuccessful.

The Article is structured in three principal parts. Part II argues that the center of state corporate law—corporation statutes and fiduciary duties—offers precious little protection to shareholders. Contractarianism, manifested through enabling statutes, makes for bad economics. For its part, existing fiduciary duty doctrine is little more than rhetorical flourish.

Rather than reexamine why the core of corporate law is empty, policymakers have instead added a series of layers, most notably federal securities laws. Part III argues that while these might be useful specifically to regulate securities transactions, in the context of corporate governance, they operate merely as bandages to recover from the most recent scandal—much like an antiquated computer operating system requires downloading patches to hobble along. On the one hand, these layers have become a coping mechanism to an empty core. But existing securities laws operate through different mechanisms to serve a different

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9. Different writers have explored variations on this theme. *See, e.g.*, Cary, *supra* note 3; Fleischer, *supra* note 3.

10. *Cf.* JAMES STEELE, ARCHITECTURE TODAY 110 (2001) ("For the true minimalist the object of all design is to define the true essence of any given piece, whether it be a piece of cutlery, a gallery space or a house in the landscape.").

11. Indeed, this divergence is central to Berle and Means' seminal text on corporate organization. *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). *Cf.* Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 546-47 (1990) ("I define 'corporate law' to include laws—whether made by legislators, judges, or regulators—that primarily govern the relationship between a company's managers and investors.").

12. *See, e.g.*, REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW 2 (2004).

purpose. More perniciously, layering obfuscates the underlying problem: the hollow core of empty statutes and weak fiduciary duties.

Part IV offers a fresh path to reform of corporate law. It draws on two emerging paradigms in regulatory theory and applies them to corporate law: substantively, confining regulation narrowly only to "bottleneck" elements within a system; and procedurally, experimenting with cooperative federalism as an alternative to either dual or preemptive federalism. I argue that reforming corporate law requires targeting the "bottleneck": reinvigorating core fiduciary duties by resetting judicial "standards of review" to match "standards of conduct," while at the same time focusing on the behavior of officers, not just boards of directors. Finally, the institutional approach proposed is one where the federal government would set minimum standards, but implementation would occur through state courts via a "reverse-*Erie*" principle.

II. A HOLLOW CORE

Before moving to an analysis of the confusing regulatory layers that have muddled corporate law, it is first important to understand why these layers have emerged in the first place. I posit that their emergence can be explained by the fact that the core of corporate law—corporation statutes and fiduciary duties—offers precious little protection to shareholders. Layers, as we shall see in Part III, have become a coping mechanism to this hollow core.

A. Empty Statutes

State corporation codes provide the underlying statutory framework for corporations. These statutes, however, are generally nothing more than a series of default provisions around which management and shareholders can theoretically contract. As Mark Roe notes, these codes reflect the belief "that corporate law is, or should be, the contract that investors and managers want"[13]—within this mindset, "[c]ontract law seems good, and corporate law, which also seems good, is in many dimensions a special form of contract law."[14] In the corporate law

13. Roe, *Delaware's Politics*, *supra* note 5, at 2496.

14. Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 262 (2002). As one commentator points out, the "dominant contemporary view of corporate law is contractarian, meaning that corporate constituencies are assumed to be best able to determine their mutual rights and obligations by way of voluntary arrangement." Kent Greenfield, *Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as Regulatory Tool*, 35 U.C. DAVIS L. REV. 581, 584 (2002).

vernacular, we live in a world of "enabling statutes."[15] Needless to say, the "rationale behind this statutory scheme is that the business of business is better left to those in charge of it rather than to judges and legislators."[16]

The history of how these enabling statutes have emerged, however, is less auspicious. Over the past century, as states competed for charters, they did so by offering reduced public regulatory oversight of the corporation.[17] As Bernard Black chronicles:

> Once states learned that writing flexible rules can increase franchise tax revenue and writing strict rules is pointless, the course of corporate law in the twentieth century was predictable .... When one state innovated by providing new flexibility, others soon followed. Whatever the pros and cons of this responsiveness, chartermongering has been with us for a century and isn't about to go away.[18]

The State of Delaware has best capitalized on the "chartermongering." When New Jersey heightened its regulatory restrictions in 1913, many large corporations fled to Delaware's lax regulatory regime.[19] And Delaware has never looked back. Today, it is the leading jurisdiction for corporate law where "more than 50% of all U.S. publicly-traded companies and 60% of the Fortune 500" are incorporated.[20] The state boasts of its "modern and flexible corporate laws" and "business-friendly State Government."[21] Given the loosening

15. *See, e.g.*, Romano, *supra* note 4, at 216 ("State corporate law is in essence enabling, following a menu approach that permits firms to alter statutory defaults to fit their needs."); William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism* 6 (European Corporate Governance Inst. Law Working Paper Series, Working Paper No. 23/2004 and Georgetown Univ. Law Ctr., Bus., Econ. & Reg. Pol'y, Research Paper No. 606481, 2004), *available at* http://ssrn.com/abstract=606481 [hereinafter, Bratton & McCahery, *Equilibrium*] ("State law's enabling structure is apparent immediately.").

16. Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 457 (2004).

17. *See, e.g.*, Bratton & McCahery, *Equilibrium*, *supra* note 15, at 15-35.

18. Black, *supra* note 11, at 549.

19. *See, e.g.*, *id.* at 548 ("The costs of not meeting corporate desires became all too apparent when New Jersey tightened its antitrust rules in 1913. Corporations fled to Delaware and other states, and didn't return when New Jersey repealed the new restrictions in 1917. Delaware did not repeat New Jersey's mistake.").

20. Delaware Division of Corporations, Why Choose Delaware as Your Corporate Home?, http://www.state.de.us/corp/default.shtml.

21. *Id*; *see also* John Gapper, *Capitalist Punishment*, FIN. TIMES, Jan. 29, 2005, at 16 ("Indeed, officials make no bones about the importance of attracting companies. 'We are a small state, so the prestige means a lot to us,' says Ruth Ann Minner, Delaware's governor.").

of regulatory restrictions that Delaware has hastened, however, some critics have labeled it "the brothel of corporate law."[22]

It is unfair, however, to single out Delaware. As Jill Fisch has pointed out, "state corporation statutes contain relatively little substantive variation. Careful empirical research reveals that corporate codes tend toward uniformity."[23] The reason for this consistency is intimately related to the competition for incorporations: state corporate codes must be attractive enough both for new local companies to incorporate at home rather than bear the additional costs of going to Delaware,[24] as well as sufficiently attractive for local corporations to remain in-state rather than reincorporate in Delaware.[25] As Roberta Romano observes, "a Delaware domicile might not be worth the cost compared to paying lower fees in a state that has a reasonably up-to-date statute. An added benefit is that should there be litigation, the defendants will be less likely to have to bear the additional expense of litigation at a distance from home."[26] The issue, thus, is not with the Delaware General Corporation Law per se, but with state corporate statutes in general—many of whom simply follow Delaware's lead.[27]

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22. Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?*, 48 VILL. L. REV. 1189, 1189 (2003).

23. Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1066 (2000) [hereinafter Fisch, *Delaware Courts*]; *see also* Romano, *supra* note 4, at 221 ("Most state codes do not sharply differ either from the Delaware or Model Act statutes on key dimensions of interest to firms."); Mark J. Loewenstein, *The SEC and the Future of Corporate Governance*, 45 ALA. L. REV. 783, 787 (1994) [hereinafter, Loewenstein, *SEC*] ("[S]tate law does not vary significantly on questions of corporate governance.").

24. *See, e.g.*, Bebchuk & Hamdani, *supra* note 6, at 575 ("[T]he vast majority of firms that opt for out-of-state incorporation go to Delaware, and firms in each local market are currently making a choice that is effectively between incorporating in their home state or in Delaware."); Robert B. Thompson, *Delaware, the Feds, and the Stock Exchange: Challenges to the First State as First in Corporate Law*, 26 DEL. J. CORP. L. 779, 784 (2004) [hereinafter Thompson, *Challenges*] ("The only relevant race is between Delaware and the home state where a company is located."); William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 720 (1998) ("The principal concern of corporate lawyers in states other than Delaware seems to be only that their law not become so antiquated that corporations are tempted to incur the substantial transaction costs of moving."). As Carney points out, "[t]o reduce the costs associated with writing a complex corporate law, many states rely on the Model Business Corporation Act (Model Act) as a source of law reform." *Id.* at 725.

25. *See, e.g.*, Romano, *supra* note 4, at 218 (charter competition is not only about "state officials' actions to induce foreign corporations to reincorporate from another state" but should also consider "actions to maintain local firms' domicile in-state").

26. *Id.* at 219.

27. *See, e.g.*, Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1443 (1992) [hereinafter Bebchuk, *Federalism*] ("Delaware's dominance of the state charter competition has resulted in the widespread diffusion of its law. Other states, anxious to stem the exodus of corporations from their

Few, if any, commentators are likely to contest the evolution toward loose enabling statutes—default rules that can be contracted out of. The more interesting question, at least historically, has been whether this competition, or "race" for corporate charters, is a "race to the top" or a "race to the bottom."[28] This question has dominated corporate law scholarship for decades, so I will be necessarily brief.

"Race to the top" theorists concede the loosening,[29] but view it as positive.[30] At one level, their argument is Panglossian. They argue, for instance, that "substituting a mandatory legal rule for bargaining . . . may impose a cost in the form of the elimination of alternatives which the parties may prefer,"[31] that management needs flexibility to "attract investors away from the almost infinite variety of competing opportunities,"[32] or even that "the competition of states in producing corporate law . . . has, however modestly, facilitated the reorganization of the U.S. economy in the last several decades."[33] The assertions are seductive. In his classic article, Ralph Winter argues, for instance, that there is "no established or even apparent connection between increasing shareholder power and increasing the yield to investors"[34] and that "management is not a monolith but a group of persons who individually have little incentive to see their colleagues shirk or otherwise impair the corporation."[35] Unfortunately, these bold assertions are made without adducing evidence.

Digging a little deeper, however, reveals that the intellectual underpinnings of such an approach can be found in influential law and economics literature that extols the virtues of private contract; more specifically, the antiregulatory stance characteristic of the Chicago

jurisdictions, have followed Delaware in adopting various legal rules."); Carney, *supra* note 24, at 740 ("This evidence suggests that the process of adopting corporate innovations is widespread, with a strong tendency towards uniformity over time.").

28. The debate, of course, is not confined to corporate law. *See, e.g.*, Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the "Race-to-the-Bottom" Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210 (1992); Clayton P. Gillette, *Business Incentives, Interstate Competition, and the Commerce Clause*, 82 MINN. L. REV. 447 (1997).

29. *See, e.g.*, Winter, *supra* note 4, at 254-55 ("No one denies that Delaware's open bidding for corporate charters has led to a steady lessening of the restrictiveness of state corporation law . . . . The history of state corporation law is thus largely a history of drastic reduction of legal restrictions on management and of the legal rights of shareholders.").

30. *See id.* at 258-60.

31. *Id.* at 259.

32. *Id.* at 257.

33. Romano, *supra* note 4, at 229.

34. Winter, *supra* note 4, at 260.

35. *Id.* at 271.

School.[36] It is no coincidence that two icons of the Chicago School, Frank Easterbrook and Daniel Fischel, famously proclaimed that "the corporate structure is a set of contracts through which managers and certain other participants exercise a great deal of discretion that is 'reviewed' by interactions with other self-interested actors."[37] As one commentator notes, the "rhetoric of enablingism is quintessentially that of free-market and laissez-faire economics. The government should simply create the context in which private parties can negotiate to their mutual benefit."[38] Unfortunately, the laissez-faire law and economics approach, of which "race to the top" theory is a manifestation in the context of corporate theory, rests on a remarkably shaky foundation.[39]

To begin with, "race to top" defenses of enabling statutes suffer from facile assumptions. First, its theorists extol "corporate efficiency"[40] but cleverly do not define what this means.[41] Second, they assume that parties to the corporate contract are rational, perfectly-informed parties with equal bargaining power[42]—conveniently ignoring that a market-based contractarian approach brings with it all the problems of classical contract theory.[43] For instance, leading commentator Stephen Bainbridge, asserts that:

> Basic economic sense tells us that investors will not purchase, or at least not pay as much for, securities of firms incorporated in states that cater too excessively to management. Lenders will not lend to such firms without compensation for the risks posed by management's lack

36. For example, Ralph Winter's classic article reveals references to articles by Chicago school theorists such as George Stigler, Harold Demsetz, and Armen Alchian. *See, e.g.*, Winter, *supra* note 4, at 258, 271-73.

37. Easterbrook & Fischel, *supra* note 8, at 1418 (1989) ("For debt investors and employees, everything (literally) is open to contract; for equity investors, almost everything is open to choice.").

38. Kent Greenfield, *September 11th and the End of History for Corporate Law*, 76 TUL. L. REV. 1409, 1419 (2002) [hereinafter Greenfield, *End of History*].

39. For a detailed critique of the Chicago school and discussion of new approaches to law and economics, see Reza Dibadj, *Beyond Facile Assumptions and Radical Assertions: A Case for "Critical Legal Economics"*, 2003 UTAH L. REV. 1155 [hereinafter Dibadj, CLE]; Reza Dibadj, *Saving Antitrust*, 75 U. COLO. L. REV. 745 (2004).

40. Winter, *supra* note 4, at 260.

41. For instance, both Pareto efficiency and Kaldor-Hicks efficiency are problematic measures of social welfare. *See* Reza Dibadj, *Weasel Numbers*, 27 CARDOZO L. REV. (forthcoming 2006).

42. *See, e.g.*, Peter C. Kostant, *Team Production and the Progressive Corporate Law Agenda*, 35 U.C. DAVIS L. REV. 667, 679-80 (2002).

43. *See, e.g.*, Roberto Mangabeira Unger, *The Critical Legal Studies Movement*, 96 HARV. L. REV. 561, 625-26 (1983) ("A regime of contract is just another legal name for a market. It ceases to exist when inequalities of power and knowledge accumulate to the point of turning a set of contractual relations into the outward form of a power order.").

of accountability. As a result, those firms' cost of capital will rise, while their earnings will fall.[44]

Empirical research, however, confirms that those who invest in markets rarely even consider where a firm is incorporated.[45] Similarly, race to the top theorists are fond of claiming that states compete for citizens the way they do for firms and investors.[46] Their assertion, however, is predicated on Charles Tiebout's famous hypothesis that the "consumer-voter may be viewed as picking that community which best satisfied his preference pattern for public goods."[47] Tiebout's work, however, is only a hypothesis based on a welter of unrealistic assumptions predicated on consumer-voters having perfect information.[48] As William Bratton and Joseph McCahery observe, the "Tiebout model, viewed in isolation, provides no basis for predicting that competitive behavior by government leads to optimal preference matching."[49]

Third, contractarians conveniently assume that the corporate "contract" is a self-contained instrument that does not impose externalities.[50] Easterbrook and Fischel, for example, state that "firms and managers that make the choices investors prefer will prosper relative to others. Because the choices do not generally impose costs on strangers to the contracts, what is optimal for the firms and investors is optimal for society."[51] Similarly, Roberta Romano claims that "[s]uch externalities are rarely produced in corporate law, which concerns manager-shareholder relations. That is precisely at the core of charter competition."[52] Of course, corporations can impose externalities on other stakeholders such as employees, customers, and communities.[53] Part IV

44. Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REG., Spring 2003, at 26, 30.

45. *See* Elliott J. Weiss & Lawrence J. White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 CAL. L. REV. 551 (1987).

46. *See, e.g.*, Romano, *supra* note 4, at 216.

47. Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 418 (1956).

48. *See id.* at 419.

49. William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201, 230 (1997).

50. *See, e.g.*, Easterbrook & Fischel, *supra* note 8, at 1421; Winter, *supra* note 4, at 253.

51. Easterbrook & Fischel, *supra* note 8, at 1421.

52. Romano, *supra* note 4, at 226.

53. *See, e.g.*, Greenfield, *End of History*, *supra* note 38, at 1419 ("Because the law largely stands aside in the formation of the corporate governance 'contract,' the parties with power, the shareholders and managers, can largely agree to whatever arrangement will benefit them. They can externalize the cost of the contract onto those who have less power to do anything about it."). Unsurprisingly, state competition in other contexts also imposes similar externalities. *Cf.* Susan

will argue, however, that incorporating such concerns into corporate law may be counterproductive. The more important point for our purposes is to recognize that enabling statutes allow corporate "insiders"—directors and officers—to impose externalities on shareholders who face imperfect information and a host of collective action problems.[54]

Fourth, if all else fails, "race to the top" theorists argue that the capital and labor markets will discipline managers.[55] Winter notes, for example, that "if a firm is mismanaged, robbed, or overly attentive to nonprofit goals, the price of its shares will drop and others will perceive an opportunity to take over the corporation and install new and more efficient management to raise the share price."[56] As Mark Loewenstein observes, insiders often "have other incentives than to maximize the firm's ability to raise capital—namely, to retain and enhance their positions within the firm, even if the policies they choose adversely affect the firm's ability to raise capital."[57] More generally, as Bernard Black notes, such market discipline theories can be "just plain silly."[58]

These concerns have been borne out in an era replete with corporate scandals and grossly excessive executive compensation. To add insult to injury, state corporate charters conveniently lose their "enabling" characteristic when they impose prohibitions on takeovers. Contractarianism is apparently not good enough when protecting insiders.[59] As William Bratton and Joseph McCahery summarize:

Rose-Ackerman, *Cooperative Federalism and Co-optation*, 92 YALE L.J. 1344, 1345 (1983) ("States may compete for business and population and seek to impose external costs—such as air and water pollution or taxes—on residents of other states.").

54. *Cf.* Bratton & McCahery, *Equilibrium*, *supra* note 15, at 2 ("Externalities do occur because Delaware's strategy structurally favors management on allocational questions.").

55. *See, e.g.*, Reza Dibadj, *Reconceiving the Firm*, 26 CARDOZO L. REV. 1459, 1475-77 (2005); Note, *The Case for Federal Threats in Corporate Governance,* 118 HARV. L. REV. 2726, 2727-28 (2005).

56. Winter, *supra* note 4, at 266. The roots of this approach lie in an article by the prominent agency theorists Jensen and Meckling. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). For a critique of agency theory, see Dibadj, *supra* note 55, at 1473-81.

57. Loewenstein, *SEC, supra* note 23, at 810.

58. Black, *supra* note 11, at 579.

59. Of course, the inconsistency goes well beyond state antitakeover statutes. Kent Greenfield observes:

> Indeed, it is more than a bit ironic that the contractarian, free-market rhetoric is so strong within corporate law scholarship, when so few firms, executives, or shareholders would sign on to such rhetoric outside the limited area of corporate governance. To be sure, corporations depend mightily on government assistance to survive and make money. I am speaking not only of the billions of dollars a year that go into export subsidies, price supports, tax concessions, and other examples of "corporate welfare." I refer also to the

> The market-based race to the top validation of state law had bypassed the problem of shareholders' lack of influence over state lawmaking with a reference to the control market deterrent. The assertion, in effect, was that the managers' option of exit adequately disciplined the states, while the possibility of shareholder exit by tender to a hostile offeror adequately disciplined the managers. The collaboration of managers and state politicians to hamper the market deterrent presented a manifest case of charter market failure.[60]

"Race to the top" theorists are, of course, at a loss to explain this chilling irony. As Lucian Bebchuk and Allen Ferrell observe, "supporters of state competition are unable to square their position on state competition with their views on the type of takeover regulation that maximizes shareholder value."[61] Framed more broadly, "even the most outspoken proponents of the race-for-the-top theory have been forced to acknowledge that states do not always enact optimal corporate laws."[62]

Quite apart from any economic debates, the weakness of corporate statutes perhaps becomes most evident if we simply look at how the laws are made. Even "race to the top" theorists, who proudly point to the fact that state corporate codes are frequently updated,[63] acknowledge that the "critical factor for the working of the charter market is the role of the local corporate bar and their clients."[64] One commentator well familiar with the drafting process summarizes a poorly kept secret within corporate law circles, that "[a]t least two interest groups benefit from modern corporate laws—local corporate lawyers and managers of firms incorporated within a state."[65] Proposals from these private groups, often

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> very infrastructure of the market, which is in large part a creation of government and government regulation.

Greenfield, *End of History*, *supra* note 38, at 1420-21.

60. Bratton & McCahery, *Equilibrium*, *supra* note 15, at 29.

61. Lucian Arye Bebchuk & Allen Ferrell, *The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168, 1193-94 (1999); *see also* Fisch, *Delaware Courts*, *supra* note 23, at 1067 ("Romano and other scholars in the Winter camp agree that state antitakeover regulation inefficiently interferes with the market for corporate control, yet these scholars are unable to reconcile this inefficiency with their defense of regulatory competition.").

62. David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 530 (1994).

63. *See, e.g.*, Romano, *supra* note 4, at 216 ("Delaware attentively updates its code, issuing frequent revisions on technical as well as substantive matters almost on an annual basis.").

64. *Id.* at 13.

65. Carney, *supra* note 24, at 716. Carney's experience includes "more than ten years serving as a reporter, member, and chair of a state bar committee concerned with changes in corporate law." *Id.* at 748. Carney explains the presence of state antitakeover statutes in similar terms. *See id.* at 751-52 ("On the whole, however, all corporate managers feel they may be potential takeover

acting through bar committees, are then adopted as a matter of course by the legislature.[66] Shareholders are conspicuously absent from the calculus.[67]

This troubling pattern repeats itself not only in Delaware,[68] but also in other states.[69] As Marcel Kahan and Ehud Kamar write, "states occasionally take actions, such as revising their corporation codes, that have the incidental effect of making them more attractive as corporate domiciles. But they take these actions largely to satisfy political constituents, such as owners of local close corporations or managers of local public corporations."[70] Overall, as Jill Fisch observes, the "result of

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targets, while a much smaller number also view themselves as potential bidders. Thus, lawyers can be expected to reflect this bias of their corporate clients and not oppose these laws.").

66. *See, e.g.*, Marcel Kahan & Edward Rock, *Our Corporate Federalism and the Shape of Corporate Law* 19-20 (University of Pennsylvania Law Sch. Inst. For L. & Econ. Research Paper No. 04-12 & New York University Law Sch. Law & Econ. Research Paper Series Working Paper No. 04-020, 2004), *available at* http://ssrn.com/abstract=564685 (forthcoming VAND. L. REV.) ("Although formally adopted by the legislature, Delaware's elected representatives have no significant role in the crafting of Delaware's statutory corporate law. It is the Council of Corporation Law Section of the Delaware Bar Association, rather than a legislative committee, that prepares drafts of proposed amendments to the General Corporation Law."); William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1888-89 (1995) [hereinafter Bratton & McCahery, *Regulatory Competition*] ("Delaware delegates to its bar association both agenda control and drafting responsibility for any amendments to its corporate code."); Brett H. McDonnell, *Two Cheers for Corporate Law Federalism*, 30 IOWA J. CORP. L. 99, 118 (2004) [hereinafter McDonnell, *Two Cheers*] ("[I]n most states, the only well-organized groups that care about corporate law are corporate managers and corporate lawyers. The latter group dominates the lawmaking process and the state legislature often rubberstamps changes proposed by the corporate bar.").

67. *See, e.g.*, Mark J. Loewenstein, *The Quiet Transformation of Corporate Law*, 57 SMU L. REV. 353, 384-85 (2004) [hereinafter Loewenstein, *Transformation*] ("Shareholders have not yet become effective lobbyists at the state level, while corporate management has been for a long time. State 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.").

68. *See, e.g.*, Kahan & Rock, *supra* note 66, at 2 ("Statutory amendments to the [Delaware] corporation law are initially drafted by a bar committee, are adopted without change and debate by the legislature, and address largely technical and non-controversial matters."); Roe, *Delaware's Politics*, *supra* note 5, at 2501 ("Bar advisory committees do propel the Delaware legislature, but the Delaware bar typically represents managers and investors (as well as themselves)."); Macey & Miller, *supra* note 5, at 515 ("[T]his equilibrium is likely to be strongly biased in favor of the bar.").

69. *See, e.g.*, Kahan & Kamar, *supra* note 6, at 705 ("The driving force behind many corporate statutes is corporate lawyers."); Loewenstein, *Transformation*, *supra* note 67, at 383 ("While lawyers on law revision committees try to 'do the right thing,' they typically represent corporate officers and directors.").

70. Kahan & Kamar, *supra* note 6, at 701; *see also* Bebchuk & Hamdani, *supra* note 6, at 606 ("The bar usually plays a significant role in choosing and changing the state's corporate law rules. The interests of local law firms lie in having a corporate law system that is sufficiently attractive for incorporation by local firms that they have as clients. These law firms would wish to avoid a system that would force out-of-state incorporation. The other group consists of firms located in the state

this political influence is legislation that uniformly favors the interests of corporate management."[71] Corporate statutes, the product of private lobbying,[72] are predictably empty as public policy tools. They are an example of a "regulatory giving."[73]

In sum, the metaphor of corporate law as contract is especially weak. As Joel Seligman summarizes:

> First, there is no formal written contract to that effect between common shareholders and managers, no negotiating process, no volition on the part of the shareholders to such a contract, nor consent to it. Second, modern investment theory, particularly "portfolio" theory, posits that investors can diversify virtually all firm-specific risk . . . . To the extent that portfolio theory is adopted by major investors, it eliminates any incentive to negotiate a contract with managers. Third, it is reasonable to assume that most shareholders would view federal securities fraud and state corporate law and derivative actions—rather than a hypothetical contract—as their basic protection against managerial misconduct . . . . [T]he agency costs theory can be criticized on a fourth ground: its indeterminance. Once it is conceded that market forces are imperfect under certain circumstances, such as takeover contests in which managerial conflicts of interest are particularly acute, the analytical utility of both the nexus-of-contract and the agency-cost theories is significantly eroded.[74]

The idea that contractarianism, manifested here through enabling statutes, makes for good corporate law is simply bad economics.

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and their managers."); Carney, *supra* note 24, at 755 ("Rather than refer to a competition among the states, it may be more accurate to refer to a competition among localized interest groups.").

71. Fisch, *Delaware Courts*, *supra* note 23, at 1095.

72. *Cf.* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 594 (2003) ("This public indifference to the actual corporate law rules allows for something akin to organized private lawmaking among the corporate players.").

73. For a discussion of how a regulatory giving can create an anticommons, see Reza Dibadj, *Regulatory Givings and the Anticommons*, 64 OHIO ST. L.J. 1041 (2003).

74. Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947, 948-49 (1990) [hereinafter Seligman, *Minimum Corporate Standards*]; *see also* Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1420 (1985) ("[I]nvestors in large publicly held corporations have little or no ability to choose or negotiate the terms of management with original owners who go public or with corporate management; and their understanding about the looseness of management's obligations is problematic."); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 759 (1995) ("[T]he contractarian paradigm provides an incomplete account of the role of corporate law and the process by which states compete to sell corporate charters."). For a broader critique of contractarianism as a theory of the firm, see Dibadj, *Reconceiving the Firm*, *supra* note 55.

B. Weak Fiduciary Duties

As Robert Clark notes in his treatise, the fiduciary principle is "[c]orporate law's major conceptual contribution"[75] to addressing the problem of managerial discretion. After all, courts could impose strong fiduciary duties to regulate, ex post, corporate behavior. Not only would these duties help compensate for empty enabling statutes, but they could provide "a set of standards to restrain insiders in exercising their discretionary power over the corporation and its shareholders in contingencies not specifically foreseeable and thus over which the parties could not contract."[76] Perhaps most importantly, fiduciary duties—such as the duty of care and duty of loyalty—represent responsibilities that corporate actors should not be able to contract around, given a recognition that the "common law simply could not live with an unfettered freedom of contract because of the abuses that might occur."[77]

But how robust are these fiduciary duties? To address this question, I focus on Delaware for two reasons. First, given the centrality of Delaware to corporate law,[78] its cases are highly influential. Second, its case law is richer than that of other states: even though "corporate law seems to vary little from state to state,"[79] Delaware courts have crafted their fiduciary duties as a matter of common law with little legislative guidance.[80] The analysis will show that fiduciary duties in corporate law are in fact little more than eloquent rhetorical flourish.

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75. ROBERT CHARLES CLARK, CORPORATE LAW xxiii (1986).

76. Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1593 (1989). *Cf.* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1102 (1997) ("[T]he Delaware legislature and courts cannot promulgate ex ante the standards to govern new situations until they see a variety of cases and figure out how well or badly people behaved.").

77. Mark J. Loewenstein, *Delaware as Demon: Twenty-Five Years After Professor Cary's Polemic*, 71 U. COLO. L. REV. 497, 537 (2000) [hereinafter Loewenstein, *Cary's Polemic*].

78. *See supra* notes 19-21 and accompanying text.

79. McDonnell, *Two Cheers*, *supra* note 66, at 109; *see also supra* Part II.

80. *See, e.g.*, Kahan & Rock, *supra* note 66, at 13 ("The most noteworthy trait of Delaware's corporate law is the extent to which important and controversial legal rules are promulgated by the judiciary, rather than enacted by the legislature."); Fisch, *Delaware Courts*, *supra* note 23, at 1074 ("[T]he interpretation and application of these fiduciary principles is the heart of corporate law, yet the Delaware statute provides almost no guidance on the subject."); McDonnell, *Two Cheers*, *supra* note 66, at 129 ("Delaware can rely on its courts to provide more guidance for corporations, whereas states adopting the MBCA [Model Business Corporation Act] tend to have less developed case law.").

It is useful to begin by understanding the conventional wisdom. Delaware is effusive in its praise of its court of first instance for corporate matters:

> The Delaware Court of Chancery is widely recognized as the nation's preeminent forum for the determination of disputes involving the internal affairs of the thousands upon thousands of Delaware corporations and other business entities through which a vast amount of the world's commercial affairs is conducted. Its unique competence in and exposure to issues of business law are unmatched.[81]

Indeed, distinguished commentators praise the "expertise and efficiency of the Delaware judiciary,"[82] and the "greater and more balanced access to the lawmaking process, increased political independence, and enhanced decision-making transparency"[83] that Delaware's courts can provide. Some argue that the advantage "that Delaware offers corporations is a highly developed case law that provides not only a useful set of precedents, but also a substantial degree of certainty about legal outcomes."[84] While applauding the procedural efficiency of the Delaware courts, I argue that the fiduciary standards that its courts promulgate are muddled and ultimately weak.

I begin with the two duties most familiar to students of corporate law: the duty of care and the duty of loyalty. The duty of care requires corporate directors and officers to behave as a reasonably prudent person would under the circumstances.[85] At first blush, this standard might appear akin to a tort-like negligence standard. However, courts have watered down the duty of care through the "business judgment rule"

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81. Welcome to the Delaware Court of Chancery, http://courts.delaware.gov/Courts/Court%20of%20Chancery/.

82. Loewenstein, *Cary's Polemic*, *supra* note 77, at 505-06 ("The Delaware Chancery Court . . . hears approximately 500 business-related cases a year. The Chancery Court resolves these cases promptly, and its decisions are rarely appealed. Only five percent of its decisions are appealed to the state Supreme Court . . . and in those appeals the Supreme Court upholds the Chancery Court in seventy-five percent of the cases."); Kahan & Rock, *supra* note 66, at 24 ("The chancery court is well-funded, enjoys wide respect, resolves disputes speedily, and probably accounts for the fact that Delaware's overall court system is ranked first among all states. If needed, appeals from the chancery court are heard by the Delaware supreme court quickly and decided instantaneously after oral argument.").

83. Fisch, *Delaware Courts*, *supra* note 23, at 1099.

84. Macey & Miller, *supra* note 5, at 484. *Cf.* Kahan & Kamar, *supra* note 6, at 725 (An "important advantage that Delaware offers is its extensive and widely known corporate case law.").

85. *See* ALI PRINCIPLES OF CORPORATE GOVERNANCE § 4.01 (1992). The ALI, for example, suggests that a director or officer is required to act "(1) in good faith, (2) in a manner he reasonably believes to be in best interests of corp., and (3) with the care that an ordinarily prudent person would reasonably expect to exercise in a like position and under similar circumstances." *Cf.* REV. MODEL BUS. CORP. ACT. § 8.30 (2002).

("BJR") which presumes that "in making a business decision the directors of a corporation acted on an informed basis . . . and in the honest belief that the action taken was in the best interests of the company."[86] The BJR "operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation."[87] In effect, the BJR shifts the duty of care from negligence to gross negligence: violations are found only where there is "reckless indifference to or a deliberate disregard of the interests of the whole body of stockholders"[88] or "actions which are without the bounds of reason."[89] As three current and former prominent Delaware judges themselves admit, the BJR "is not, functionally speaking, a standard of review at all. Rather, it is an expression of a policy of non-review of a board of directors' decision when a judge has already performed the crucial task of determining that certain conditions exist."[90]

Amusingly enough, in the rare instance where the Delaware Supreme Court found directors to have behaved in a grossly negligent manner,[91] the Delaware legislature subsequently permitted corporations to contract out of even gross negligence, at least as to monetary liability.[92] Put simply, the current duty of care is anemic at best. As one commentator summarizes:

> A director is only liable if he or she is grossly negligent, and the rule presumes that the director acted with due care . . . . 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

86. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

87. Cede & Co. v. Technicolor, 634 A.2d 345, 360 (Del. 1993).

88. Allaun v. Consol. Oil Co., 147 A. 257, 261 (Del. Ch. 1929).

89. Gimbel v. Signal Cos., 316 A.2d 599, 615 (Del. Ch. 1974). As Mark Roe has noted, the BJR "has courts refusing to directly help shareholders who attack managerial mistake." Roe, *Corporate Law's Limits*, *supra* note 14, at 235.

90. William T. Allen, Jack B. Jacobs, & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 26 DEL. J. CORP. L. 859, 870 (2001); *see also* Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 34 (2005) ("Process review is, of course, duty of care review."); Kostant, *supra* note 42, at 677. For a general critique of the BJR, see Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287 (1994) [hereinafter Gevurtz, *BJR*].

91. *See* Smith v. Van Gorkum, 488 A.2d 858, 881 (Del. 1985).

92. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2004); *see also* Roe, *Corporate Law's Limits*, *supra* note 14, at 243 ("One does not exaggerate much by saying that American corporate law has produced only one major instance in which nonconflicted managers were held liable to pay for their mismanagement: *Smith v. Van Gorkum*, a decision excoriated by managers and their lawyers, and one promptly overturned."); Black, *supra* note 11, at 584 ("But if courts stray too far from what companies want, the state legislature will change the law or companies will move elsewhere.").

> the director failed to 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.[93]

The duty of loyalty can have a little more bite, but not much. While corporate law allows self-dealing transactions,[94] the duty of loyalty "mandates that the best interest of the corporation and its shareholders take precedence over any interest possessed by a director, officer, or controlling shareholder and not shared by the stockholders generally."[95] Savvy insiders, however, recognize the way around this duty: approval from an "independent" body—shareholders or the board, or even a committee composed of "disinterested" board members.[96] Some corporate codes even provide so-called "strong" safe-harbor statutes immunizing approved transactions from any fairness inquiry;[97] more importantly, jurisdictions such as Delaware that scrutinize such approved transactions for fairness despite the statutory language,[98] nonetheless employ a loose standard.[99] Much of this laxity is likely driven by the influence of Chicago School law and economics.[100]

Some will no doubt object to this characterization of the duty of loyalty, arguing that courts do scrutinize controlled transactions more rigorously.[101] Perhaps at the margins, but a skeptic might be forgiven here as well. Delaware courts, for instance, putatively ratchet up scrutiny by creating convoluted standards such as "intrinsic fairness"[102] or "entire

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93. Loewenstein, *Transformation*, *supra* note 67, at 377.

94. *See* Joseph T. Walsh, *The Fiduciary Foundation of Corporate Law*, 27 IOWA J. CORP. L. 333, 334 (2002) ("[T]he decisional law has recognized a relaxation of the rigor of trust law, primarily with respect to tolerance of self-dealing transactions.").

95. Cede & Co. v. Technicolor, 634 A.2d 345, 361 (Del. 1993).

96. *See, e.g.*, Walsh, *supra* note 94, at 334.

97. *See, e.g.*, REV. MODEL BUS. CORP. ACT. § 8.61(b)(3) (2002).

98. *See* DEL. CODE ANN. tit. 8, § 144(a)(3) (2004).

99. *See, e.g.*, Cooke v. Oolie, No. 11134, 1997 Del. Ch. LEXIS 92 (Del. Ch. June 23, 1997); *In re* Wheelabrator Techs., 663 A.2d 1194 (Del. Ch. 1995); Cookies Food Prods. v. Lakes Warehouse, 430 N.W.2d 447 (Iowa 1988).

100. Consider, for instance, Easterbrook and Fischel's somewhat startling claim that "if corporate law should forbid managers to divert corporate opportunities to themselves, they might respond by drawing higher salaries or working less hard to open up new business opportunities." Easterbrook & Fischel, *supra* note 8, at 1433.

101. *Cf.* Paula J. Dalley, *The Misguided Doctrine of Stockholder Fiduciary Duties*, 33 HOFSTRA L. REV. 176 (2004).

102. *See generally* Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

fairness."[103] These standards, though, are problematic on two dimensions. First, they are unnecessarily Byzantine: rather than requiring proof of causation as is done elsewhere, they shift the burden of proof to the defendant. Second and much more importantly, they have little bite. Predictably, their application has been lax,[104] permitting corporations to sidestep enhanced scrutiny by jumping through the requisite procedural hurdles—notably by structuring deals in ways that elude "fairness review,"[105] or establishing a special committee to approve the transaction.[106] Even if we assume, *arguendo*, that these standards are meaningful, they do cabin state corporate law to a remarkably narrow arena. As Robert Thompson reminds us:

> Delaware litigation is surprisingly limited in the types of issues resolved. The cases are overwhelmingly focused on acquisitions and, particularly, conflict of interest in acquisitions. This litigation pays some attention to conflicts of interest elsewhere and certain statutory cases, yet *the overall picture focuses on a few discrete areas of corporate governance that are more limited and occur more sporadically than might be expected for a plenary governance system.*[107]

Perhaps shockingly given its limitations, the duty of loyalty is nonetheless the strongest fiduciary duty.

Other duties—waste, candor, and good faith—are even weaker. Showing "waste" is an unusually difficult hurdle to clear, since plaintiffs must prove "an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."[108] The duty of candor (or disclosure)—which at least according to one Delaware case "obligates directors to provide the stockholders with accurate and complete information material to a transaction or other corporate event that is being presented to them for action"[109]—is unlikely to be an independent duty at all, since it derives merely "from the combination of the

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103. *See generally* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110 (Del. 1994).

104. *See generally* Schreiber v. Carney, 447 A.2d 17 (Del. Ch. 1982).

105. *See, e.g., In re* Siliconix, Inc., No. 18700, 2001 Del. Ch. LEXIS 83 at *24 (Del. Ch. June 19, 2001) (holding that minority freezeouts done via tender offer [are] not subject to "fairness" review).

106. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 709 n.7 (Del. 1983); *In re* W. Nat'l Corp., 2000 Del. Ch. LEXIS 82 (Del. Ch. May 22, 2000).

107. Thompson, *Challenges*, *supra* note 24, at 788 (emphasis added).

108. Glazer v. Zapata Corp., 658 A.2d 176, 183 (Del. Ch. 1993).

109. Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998).

fiduciary duties of care, loyalty, and good faith."[110] To boot, it is eclipsed by federal disclosure obligations under the securities laws.[111] Finally, what about the duty of good faith? Sean Griffith argues, for instance, that the duties of care and loyalty

> overlap as both seek to answer the fundamental question of whether a particular decision or a particular transaction are beneficial to the corporation. Whether the question is confronted from the angle of the duty of care or the duty of loyalty is just a difference in approach. To put it another way, the fundamental question underlying both duties really is good faith. Are the directors doing their best in acting for someone else? *Arguably, that is the only question in all of corporate law.* It is simply asked in different ways in different contexts.[112]

But Griffith's careful analysis reveals that while "the precise meaning of good faith remains unclear,"[113] "the emerging duty of good faith is best understood as a rhetorical device rather than a substantive standard."[114] Thus, to the extent that the duty of good faith can even be categorized as a separate duty, it too devolves into the procedural tricks of care and loyalty.[115] In addition, recent Delaware case law suggests that to be held liable, plaintiffs must show that defendants intentionally acted in bad faith.[116] Thus, to the extent an independent duty of good faith even exists, proving it is difficult.[117]

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110. *Id.* at 11.

111. For a discussion of the duty of disclosure, see Eric A. Chiappinelli, *The Moral Basis of State Corporate Law Disclosure*, 49 CATH. U. L. REV. 697 (2000); Lawrence A. Hamermesh, *Calling Off the* Lynch *Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087 (1996).

112. Griffith, *supra* note 90, at 47 (emphasis added). *But see* William A. Gregory, *The Fiduciary Duty of Care: A Perversion of Words*, 38 AKRON L. REV. 181, 183 (2005) ("Equating the duty of care with the duty of loyalty is bad law and worse semantics.").

113. Griffith, *supra* note 90, at 30.

114. *Id.* at 5.

115. *Cf. In re* Walt Disney Co., No. 15452, 2005 Del. Ch. LEXIS 113, at *169 (Del. Ch. Aug. 9, 2005) ("Decisions from the Delaware Supreme Court and the Court of Chancery are far from clear with respect to whether there is a separate fiduciary duty of good faith.").

116. *See id.* at *175 ("[T]he concept of *intentional dereliction of duty*, a *conscious disregard for one's responsibilities*, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith."). Indeed, if good faith were read broadly, it would eviscerate the exculpation provisions in Delaware § 102(b)(7) which does not protect defendants who either violate the duty of loyalty or act in bad faith. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2004).

117. Some scholars suggest building on the duty of good faith to fashion reforms in corporate law. Notably, Hillary Sale analogizes good faith to the scienter requirement in securities fraud cases and argues that the duty of good faith "holds considerable promise for creating incentives to instill effective corporate governance and preventing the kind of fiduciary abdication that has occurred." Sale, *supra* note 16, at 462.

Generalizing from an analysis of specific fiduciary duties, Delaware's opinions overall reveal two related and striking features: fuzzy standards prone to litigation, but ultimately ineffectual remedies. As Lucian Bebchuk and Assaf Hamdani note, "Delaware courts avoid providing bright-line guidance to corporate actors, relying instead on a set of loosely defined tests."[118] Marcel Kahan and Edward Rock point to the loose notion of stare decisis that such fuzzy standards enable:

> [T]he Delaware Supreme Court rarely overrules its own precedents. Instead, it tends to justify a ruling that is in tension with precedent (of which there have been a fair share) by explaining that general-sounding rules announced in earlier cases apply only to a much narrower set of circumstances or attributing any misunderstanding by lawyers or lower court judges to their failure to read supreme court precedent carefully.[119]

In such nimble and unconstrained hands, seemingly heightened scrutiny later gets interpreted as a more deferential standard.[120] As William Bratton and Joseph McCahery observe, the Delaware "courts garnered publicity in a handful of highly-publicized cases, ruling against management and announcing vague standards that held out the prospect of shareholder value enhancement. But in less well-publicized subsequent cases, they used the camouflage of complex facts to refrain from applying the standards in management-constraining ways."[121] These maneuvers feed weak remedies: injunctions are rare, monetary damages even rarer.[122] Predictably, "a characteristic style of Delaware law . . . [is the] denial of a preliminary motion coupled with strong criticism."[123]

The big picture that emerges, thus, is one filled with rhetoric but low on substance. Empirical evidence even suggests that investors "seem to consider the Delaware courts' decisions to be inconsequential as regards shareholders' wealth and, by implication, largely indeterminate

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118. Bebchuk & Hamdani, *supra* note 6, at 601; *see also* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1915 (1998).

119. Kahan & Rock, *supra* note 66, at 18-19.

120. *See supra* notes 101-06 and accompanying text. *Compare* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (articulating a "reasonable in relation to the threat posed" standard apparently somewhere between BJR deference and entire fairness) *with* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1385-86 (Del. 1995) (loosening the Unocal standard to something akin to BJR).

121. Bratton & McCahery, *Equilibrium*, *supra* note 15, at 62.

122. *See, e.g.*, *id.* at 63.

123. Rock, *supra* note 76, at 1103.

of the outcome of future cases."[124] As Edward Rock chronicles in his detailed study of how Delaware corporate law is actually created:

> the Delaware courts generate in the first instance the legal standards of conduct (which influence the development of the social norms of directors, officers, and lawyers) largely through what can best be thought of as "corporate law sermons." . . . *[W]e come much closer to understanding the role of courts in corporate law if we think of judges more as preachers than as policemen.*[125]

Rock argues "that we should understand Delaware fiduciary duty law as a set of parables or folktales of good and bad managers and directors, tales that collectively describe their normative role."[126]

The recent and eagerly anticipated *Walt Disney* case[127] provides a particularly vivid illustration of Rock's point. The case is interesting not so much for its predictable holding[128]—that the Disney board did not violate its fiduciary duties with respect to Michael Ovitz's $140 million severance package—but for its rhetoric.[129] The Chancery court did not find the duties of care,[130] loyalty,[131] or good faith[132] were violated because the Disney board was careful enough to jump through the requisite procedural hoops. Even more interesting is to dwell on how the opinion unravels into a morality tale. For example, the court teaches us that:

> Delaware does not—indeed, the common law cannot—hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices . . . . Indeed, other institutions may develop, pronounce and urge adherence to ideals of corporate best practices. But the development of aspirational ideals, however worthy as goals for

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124. Weiss & White, *supra* note 45, at 603.

125. Rock, *supra* note 76, at 1016 (emphasis added); *see also* Kamar, *supra* note 118, at 1942 (noting that Delaware judges "often take a preaching stance toward the business community").

126. Rock, *supra* note 76, at 1106.

127. *See In re* Walt Disney Co., No. 15452, 2005 Del. Ch. LEXIS 113 (Del. Ch. Aug. 9, 2005).

128. *See also* Jonathan Macey, *Delaware: Home of the World's Most Expensive Raincoat*, 34 HOFSTRA L. REV. 1131, 1132 & n.2.

129. For a similar example, see *In re* Caremark Int'l, Inc., 698 A.2d 959 (Del. Ch. 1996).

130. *See Disney*, 2005 Del. Ch. LEXIS 113, at *152 ("Obviously, it is in the shareholders' economic interest to offer sufficient protection to directors from liability for negligence, etc., to allow directors to conclude that, as a practical matter, there is no risk that, if they act in good faith and meet minimalist proceduralist standards of attention, they can face liability as a result of a business loss.").

131. *See id.* at *165 (finding that a transaction is apparently immunized from inquiry if it is putatively at "arms-length").

132. *See id.* at *169 ("Delaware law presumes that directors act in good faith when making business judgments.").

human behavior, should not work to distort the legal requirements by which human behavior is actually measured.[133]

The court then proceeds to apply this moral lesson to the case at hand:

> Eisner's actions in connection with Ovitz's hiring should not serve as a model for fellow executives and fiduciaries to follow. His lapses were many. He failed to keep the board as informed as he should have. He stretched the outer boundaries of his authority as CEO by acting without specific board direction or involvement. He prematurely issued a press release that placed significant pressure on the board to accept Ovitz and approve his compensation package in accordance with the press release. To my mind, these actions fall far short of what shareholders expect and demand from those entrusted with a fiduciary position. Eisner's failure to better involve the board in the process of Ovitz's hiring, usurping that role for himself, although not in violation of law, does not comport with how fiduciaries of Delaware corporations are expected to act.
>
> Despite all of the legitimate criticisms that may be leveled at Eisner, especially at having enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom, I nonetheless conclude, after carefully considering and weighing all the evidence, that Eisner's actions were taken in good faith. That is, Eisner's actions were taken with the subjective belief that those actions were in the best interests of the Company . . . .[134]

Tellingly, an enormous amount of ink is used chastising Mr. Eisner and the rest of the Disney board, while ultimately absolving them of any liability whatsoever.[135]

One troubling question remains: why go through all this trouble only to let managers off the hook? Rhetorical window-dressing serves at least three purposes: it obfuscates Delaware's influence, provides employment for its corporate service providers, and serves as a competitive weapon against other states. I explain each in turn.

First, opaque case law serves as a clever veneer. As Lucian Bebchuk and Assaf Hamdani observe, "the uncertainty of Delaware law disguises the extent to which Delaware's law favors managers over

133. *Id.* at *4-5.

134. *Id.* at *198-99.

135. *See id.* at *227-28.

shareholders."[136] It also renders the national political influence of a state with only 800,000 citizens less problematic:

> The public perception of Delaware's corporate law as technocratic and apolitical is important for Delaware as it helps fend off federal intervention.... Delaware has a legitimacy problem: why should a little state make the national rules of corporate law? By constructing law as technocratic and apolitical, Delaware defects attention from the democratic deficit of its corporate law, legitimizes its role as promulgator of the *de facto* national law, and reduces the likelihood of a populist challenge to its preeminence.[137]

Second, Byzantine fiduciary standards generate litigation, thereby creating work for a whole cottage industry of corporate service providers. Most obviously, both plaintiff and defense counsel benefit when there is litigation. As William Carney has argued:

> There are several reasons to believe that Delaware makes litigation more costly than elsewhere, thus imposing a higher litigation charge on Delaware corporations for the benefit of Delaware lawyers. First, Delaware increases litigation costs through the adoption of open legal standards (rather than bright-line property rules) and liberal rules about standing for derivative litigation.... Second, attorney fees for successful plaintiffs in derivative litigation are based on the results obtained rather than billable hours, opening up the possibility of premium billing for plaintiffs' lawyers.[138]

Even race to the top theorists admit that "the Wilmington Bar enjoys an unusually lucrative practice for a city of that size."[139] Jonathan Macey and Geoffrey Miller, in their interest group analysis of Delaware law, note how "Delaware lawyers have reputedly developed local

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136. Bebchuk & Hamdani, *supra* note 6, at 603. *Cf.* Gapper, *supra* note 21 ("It may be fair to say we are somewhat biased in favour of management, but we cannot go off in either direction." (quoting Delaware Vice Chancellor Leo Strine)).

137. Kahan & Rock, *supra* note 66, at 29; *see also* Bebchuk & Hamdani, *supra* note 6, at 603-04.

138. Carney, *supra* note 24, at 727; *see also* Bebchuk & Ferrell, *supra* note 61, at 1191 ("Delaware might purposely be maintaining a legal regime that encourages litigation. Delaware's corporate lawyers, an important interest group in Delaware, benefit from more, rather than less, litigation."); Bratton & McCahery, *Regulatory Competition*, *supra* note 66, at 1888-89 ("[T]he bar's interest diverges from the shareholders' even within the sphere of fiduciary enforcement, with the bar favoring a system that trades substantial money judgments to shareholders for substantial attorneys' fees."); Elliot J. Weiss & Lawrence J. White, *File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions*, 57 VAND. L. REV. 1797, 1857-60 (2004).

139. Winter, *supra* note 4, at 255.

counsel services into an art."[140] They also emphasize the creation of a broader network of service providers:

> The existing literature, almost without exception, views the "price" that Delaware charges for the incorporation privilege as the franchise fees extracted from state-chartered corporations . . . . The relevant literature fails to recognize that there is a second, very important, component of the charges that Delaware imposes on corporations. These are what might be called "indirect costs" of Delaware incorporation—the fees paid to lawyers, accountants, investment bankers, and corporation service companies as incidents of Delaware incorporation.[141]

A final advantage, as Ehud Kamar has noted, is that "legal indeterminacy accentuates Delaware's judicial advantage over other states. It does so by inducing litigation, and at the same time leaving more discretion to the courts in applying the law."[142] Moreover, "[w]hile substance can be emulated by other states, an indeterminate form is more difficult to copy and serves to accentuate the advantages that Delaware has over its rivals."[143] Delaware's ability to inhere to these advantages without stirring a public backlash is a testimony to its brilliance.

Whatever overall advantages might accrue to Delaware, the broader message cannot be ignored: state fiduciary duties are weak. Impressive-sounding obligations can be carefully skirted through clever process. As Vice Chancellor Leo Strine candidly admits, "Delaware corporate law generally permits corporate managers wide flexibility and errs on the side of managerial freedom."[144] Precious little is left of judicial review:

> Over time, state courts interpreted the [fiduciary] duties in a manner that left little substance. The business judgment rule and universal adoption of waiver of liability provisions all but eliminated causes of action for breach of the duty of care. The duty of loyalty, particularly self-dealing by officers and directors, could be validated through procedural mechanisms. With proper procedures, the fairness of the

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140. Macey & Miller, *supra* note 5, at 494.

141. *Id.* at 492.

142. Kamar, *supra* note 118, at 1932-33 (citation omitted).

143. *Id.* at 1946.

144. Leo E. Strine, Jr., *Delaware's Corporate-Law System: Is Corporate America Buying an Exquisite Jewel or a Diamond in the Rough? A Response to Kahan & Kamar's* Price Discrimination in the Market for Corporate Law, 86 CORNELL L. REV. 1257, 1279 (2001); *see also* Cary, *supra* note 3, at 670 ("[T]he judicial decisions can best be reconciled on the basis of a desire to foster incorporation in Delaware. It is not clear, however, that the revenue thermometer should replace the chancellor's foot."); Black, *supra* note 11, at 584 ("[S]ome judges, notably those in Delaware, actively try to foster a favorable business climate.").

transaction was not subject to judicial review. This approach allowed self-dealing by officers and directors almost without limits.[145]

Whether this stance is due to the judiciary's own shrewdness,[146] or can be ascribed to the environment in which it partakes,[147] is almost beside the point. The bottom line is that while the common law of fiduciary duties to corporations has immense pedagogical value in teaching us about the art of persuasion and rhetoric, it is much ado about very little. As William Bratton and Joseph McCahery succinctly put it: "the genius of Delaware lawmakers lies in their ability to generate a thick fiduciary law without at the same time imposing a significant compliance burden."[148]

Weak fiduciary duties parallel empty statutes: they create the veneer of regulation and substantive review, respectively, but ultimately provide an empty core upon which to base corporate governance and protect shareholders.[149] Implicitly, both take their cues from laissez-faire law and economics and espouse private ordering.[150] As Vice Chancellor Leo Strine observes, "[p]ut bluntly, while the Delaware Model relies upon governmental involvement, that involvement is limited to a (usually deferential) inquiry into the propriety of choices made in the first instance by the elected representatives of stockholders."[151] Of course, neither why nor how private ordering necessarily improves

145. J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 318-19 (2004). As one observer points out in his critique of agency law in the corporate context, "[f]or these modern princes, including corporate CEOs, the term quasi-principal may be coined to capture their double lives—agents for others (their corporations and shareholders) and de facto principals who hold vast authority and power." Eric W. Orts, *Shirking and Sharking: A Legal Theory of the Firm*, 16 YALE L. & POL'Y REV. 265, 282 (1998).

146. *See, e.g.*, Thompson, *Challenges*, *supra* note 24, at 783 ("[C]orporate law is made by knowledgeable jurists who are repeat players on these issues and have an appreciation for what works.").

147. *See, e.g.*, Black, *supra* note 11, at 585 ("[J]udges are bit players, cabined by their statutory authority and by political and economic forces beyond their control."); Macey & Miller, *supra* note 5, at 502 ("The bar and the judiciary are tied together through an intricate web of personal and professional contacts."); McDonnell, *Two Cheers*, *supra* note 66, at 134-35 ("[T]he milieu in which the typical Delaware judge has spent his career typically has been shaped by managerial interests, as is true for most corporate lawyers.").

148. Bratton & McCahery, *Equilibrium*, *supra* note 15, at 69.

149. *See supra* Part II.A.

150. *See, e.g.*, Easterbrook & Fischel, *supra* note 8, at 1442 ("Divergence between private and social interest is rare and does not appear to be at work in these examples.").

151. Strine, *supra* note 144, at 1278-79. Of course this perspective conveniently ignores the massive collective action problems inherent in shareholder voting.

social welfare is explained,[152] not to mention all the problems inherent in current conceptions of the shareholder franchise.[153]

In a monumental irony, the core of corporate law runs the risk of becoming irrelevant to debates on corporate governance. Bernard Black aptly observes that "appearances notwithstanding, state corporate law is trivial: it does not prevent companies—managers and investors together—from establishing any set of governance rules they want."[154] Irrelevance provides grist for the "race to the bottom" mill:

> At the state level, triviality analysis reinforces the concerns of race-to-the bottom proponents: don't bother, because the reforms won't work. Either the reforms will get watered down to a thin gruel in the legislative process, or they won't get adopted. Even if they get adopted somewhere, some enterprising state will let managers keep the flexibility they now have.
>
> The American Law Institute's Corporate Governance Project illustrates this dismal scenario. It was launched with great fanfare in 1978, with the goal of restating corporate law. . . . [Its controversial provisions] had some bite as first proposed, but after passing through a series of unpublished council drafts, they have been watered down to suggestions for tinkering at the margin. This predictable outcome reflects a vigorous lobbying effort by the practicing bar and the Business Roundtable.[155]

One might, of course, argue that positive law is not all that relevant since most insiders do seek to protect shareholders most of the time.[156]

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152. *See id.* at 1259 ("[R]educing the indeterminacy of Delaware corporate law . . . might also impair its central emphasis on corporate empowerment and private ordering, to the detriment of social welfare."). For a more pronounced belief in the virtues of private ordering, see Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961, 970 (2001) ("The provision of entire corporate law regimes through private vendors has several advantages over the present corporate law regime."). Unfortunately, study of welfare economics would suggest that private ordering does not necessarily coincide with social welfare. *See* Dibadj, *Weasel Numbers*, *supra* note 41.

153. *See infra* notes 257-62 and accompanying text.

154. Black, *supra* note 11, at 544. *Cf.* Weiss & White, *supra* note 45, at 602 ("But if investors do not find judicially-wrought changes in corporate law to be significant, we believe it is unlikely that investors consider differences between the corporate laws of different states to be much more important.").

155. Black, *supra* note 11, at 580; *see also* Cary, *supra* note 3, at 699 ("Managements want freedom from bothersome stockholders, government agencies, public opinion, and judicial review. This is also what most of the corporate bar would prefer: flexibility and certainty. This segment of the legal community is management-oriented; our principal clients are the companies that can afford us.").

156. *Cf.* Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055, 1087.

Unfortunately, however, the twentieth century reflected recurring crises in corporate governance.[157] As a fresh batch of scandals began rocking the corporate world in 2001,[158] state law was conspicuously absent:

> But where has Delaware been through all this? No bills have been introduced in Delaware's legislature; no hearings held by its committees; its law enforcement agents have taken no action; and its executives have staid mum. How is it that Delaware—the home of what has long been viewed as the *de facto* national corporate law—has sat on the sidelines?[159]

The problem, of course, is not confined to Delaware.[160] As Robert Thompson notes, "the response in state corporate law has been largely one of silence that has left any modifications in corporate governance to . . . other actors";[161] in the end, "no one thought that state law was the place to address these problems."[162] As Part III will explore, other players have stepped in to try to fill the gaps left by the empty core of state corporate law.

III. LAYERING

A. Understandable Bandages

Whenever scandals have shown corporate doctrine to be inadequate, policymakers have seemingly made a curious choice. Rather than reexamine why enabling statutes and standard fiduciary duties are inadequate, as Part II has tried to do, lawmakers have added a series of layers—bandages designed to stem blood from the most recent corporate impropriety or scandal. An analogy that might be useful is that of an

157. *See, e.g.*, Jeffrey D. Hurn, *Delaware Courts' Delicate Response to the Corporate Governance Scandals of 2001 and 2002: Heightening Judicial Scrutiny on Directors of Corporations*, 41 WILLAMETTE L. REV. 207, 209 (2005).

158. *See id.*

159. Kahan & Rock, *supra* note 66, at 1; *see also* Sale, *supra* note 16, at 456 ("In the post-Enron era, there has been considerable discussion about what went wrong at Enron and elsewhere and how to fix it. . . . [But the] State of Delaware, the mother of all corporate law, has been largely absent from the debate.").

160. As Stephen Bainbridge reminds us, "the two main poster-children for reform, Enron and WorldCom, were not Delaware corporations; they were incorporated in Oregon and Georgia, respectively." Bainbridge, *supra* note 44, at 30.

161. Robert B. Thompson, *Corporate Governance After Enron*, 40 HOUS. L. REV. 99, 102 (2003) [hereinafter Thompson, *After Enron*]; *see also* Loewenstein, *Transformation*, *supra* note 67, at 385 ("[S]tates seem to have abdicated their traditional role of defining the internal affairs of corporations, at least insofar as publicly-held corporations are concerned.").

162. Thompson, *After Enron*, *supra* note 161, at 107.

aging and unreliable computer operating system: rather than rethink core algorithms, a series of increasingly cumbersome patches must be downloaded. Eventually, the latticework of patches is likely to become so cumbersome that the end-user requires a new system, and a time of crisis ensues.

We have already visited some of this "layering" through Part II's discussion of state corporate law. Recall how when faced with the severe limitations of the duty of care and duty of loyalty, Delaware courts sometimes toy with the duties of candor or good faith,[163] or how, in the context of controlled transactions, the courts craft heightened standards of scrutiny,[164] only to be thwarted by the legislature's own new layer, antitakeover statutes.[165]

The bulk of the layering, however, has occurred at the federal level. The Sarbanes-Oxley Act of 2002 ("SOX"), of course, is the most prominent example.[166] But contrary to the conventional wisdom,[167] SOX is not a watershed: significant federal layering has been going on for decades.[168] As Mark Roe has shown in a series of articles, SOX is just the latest in an array of federal incursions, which include the Securities Act of 1933 and Exchange Act of 1934, the Williams Act, and the Foreign Corrupt Practices Act.[169] Roe concludes that

> [i]n nearly every decade of the twentieth century, the decade's major corporate law issue either went federal or federal authorities threatened to take it over—from early twentieth-century merger policy, to the 1930s securities laws, to the 1950s proxy fights, to the 1960s Williams Act, to the 1970s going-private transactions.[170]

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163. *See supra* notes 108-10 and accompanying text.

164. *See supra* notes 101-06 and accompanying text.

165. *See supra* notes 59-60 and accompanying text.

166. For a description of SOX, see Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915 (2003); Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1154 (2004).

167. *See, e.g.*, Joel Seligman, *A Modest Revolution in Corporate Governance*, 80 NOTRE DAME L. REV. 1159, 1168 (2005) ("[C]ontributions to corporate governance before the Enron-Sarbanes-Oxley period were minor, intermittent, and relatively ineffectual.").

168. Issues raised two decades ago seem remarkably analogous to today's problems. *See, e.g.*, Marc I. Steinberg, *Some Thoughts on Regulation of Tender Offers*, 43 MD. L. REV. 240, 250-58 (1984).

169. *See* Roe, *Delaware's Competition*, *supra* note 72, at 611-16; Roe, *Delaware's Politics*, *supra* note 5, at 2520-23; *see also* Bratton & McCahery, *Equilibrium*, *supra* note 15, at 44-57. Roe includes the antitrust laws, but I exclude them here given that they do not implicate, at least directly, the relationship between corporations and shareholders.

170. Roe, *Delaware's Politics*, *supra* note 5, at 2498.

The layers that Roe describes have arguably benefited shareholders. Other layers, notably the triad of securities reform statutes enacted from 1995 to 1998—the Private Securities Litigation Reform Act ("PSLRA"), the National Securities Market Improvement Act ("NSMIA"), and the Securities Litigation Uniform Standards Act ("SLUSA")[171]—have been even more pro-management than state securities laws.[172] And federal layering has not exclusively been through statutes and regulations. Federal courts, led by the U.S. Supreme Court, have played an important historical role in fashioning common law remedies, most famously through the federal common law[173] remedy of implied private rights of action for plaintiffs alleging fraud or misrepresentation.[174]

171. For a concise description of these laws, see Lander v. Hartford Life & Annuity Ins. Co., 251 F.3d 101, 107-09 (2d Cir. 2001).

172. For a discussion of the differences between state corporate and state securities laws, see David L. Ratner, *The SEC at Sixty: A Reply to Professor Macey*, 16 CARDOZO L. REV. 1765, 1769 (1995).

173. The term "federal common law" is used "to refer to any rule of federal law created by a court (usually but not invariably a federal court) when the substance of that rule is not clearly suggested by federal enactments—constitutional or congressional." Martha A. Field, *Sources of Law: The Scope of Federal Common Law*, 99 HARV. L. REV. 883, 890 (1986). As Field points out, "the only limitation on courts' power to create federal common law is that the court must point to a federal enactment, constitutional or statutory, that it interprets as authorizing the federal common law rule." *Id.* at 887. A tenable argument can be made that an enactment is not even needed. *See id.* at 946; *see also* Louise Weinberg, *Federal Common Law*, 83 NW. U. L. REV. 805, 835 (1989).

174. The landmark case is *Borak*, where the Court implied a private right of action under SEC Rule 14a-9 for false or misleading proxies. *See* J.I. Case, Co., v. Borak, 377 U.S. 426, 432 (1964); *see also* Henry J. Friendly, *In Praise of* Erie—*And of the New Federal Common Law*, 39 N.Y.U. L. REV. 383, 413 (1964) ("[S]ignificant steps toward the development of a federal common law of corporate responsibility have already been taken by implying causes of action from and filling interstices in laws administered by the SEC."). Beginning in the early 1970s, however, implied rights of action have become less expansive. *See, e.g.*, Cort v. Ash, 422 U.S. 66 (1975) (espousing a narrower purview for federal common law based on federalism concerns); Santa Fe Indus. v. Green, 430 U.S. 462 (1977). For a critique of the federal common law in the context of Rule 10b-5, see Edward A. Fallone, *Section 10(b) and the Vagaries of Federal Common Law: the Merits of Codifying the Private Cause of Action under a Structuralist Approach*, 1997 U. ILL. L. REV. 71 (1997); *see also infra* Part IV.B.2.

Figure 1: The Layers of Corporate Law

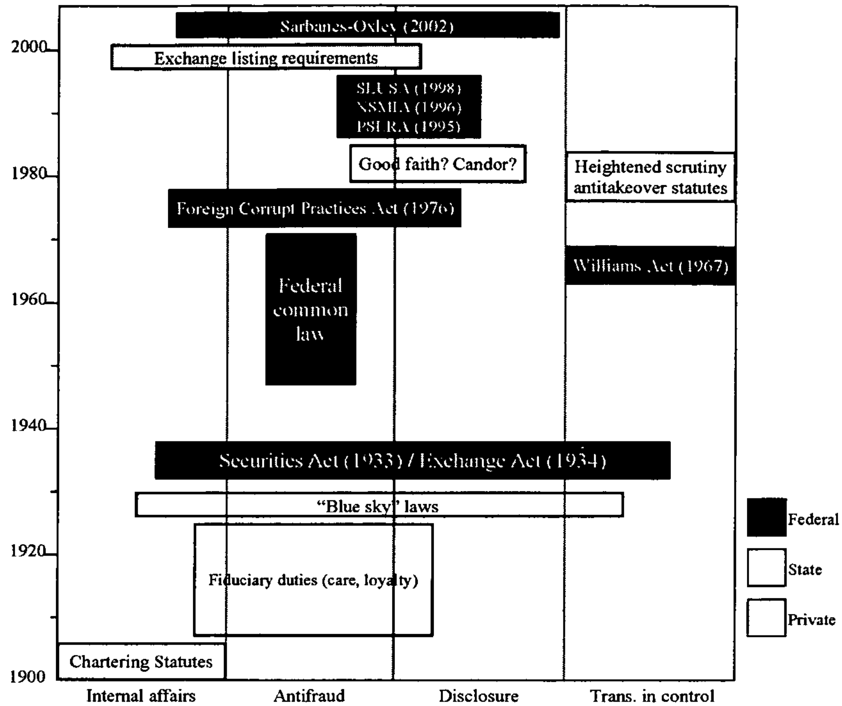

Figure 1 presents a stylized overview of the layers that have accumulated over the past century. Corporate law is broadly defined and divided into three general categories: internal affairs, antifraud, and disclosure. Additionally, a special category for transactions in control is added to capture developments such as the Williams Act, heightened state fiduciary duties, and state antitakeover statutes.

While readers might quibble with my placement of various elements, at least I hope they will agree that corporate law is scattered. At one level, this dispersion is understandable. After all, a series of layers has been added to bandage an ailing state system. As Robert Thompson points out, "[m]assive additions to federal statutes and regulations, and important governance modifications by self-regulatory organizations, such as the New York Stock Exchange's changes to its listing requirements, have completely overshadowed any response of state law, the traditional source of corporate law in the United States."[175]

175. Thompson, *After Enron*, *supra* note 161, at 100; *see also* Loewenstein, *Transformation*, *supra* note 67, at 363 ("[S]tate law is nearly irrelevant in affecting the corporate governance of

Even Delaware judges, generally hostile to SOX,[176] acknowledge that "it would smack of hypocrisy for us to fail to acknowledge the substantial integrity-generating potential of these initiatives."[177]

B. Cross-currents

So why not leave things this way? Why should federal intervention through the securities laws not serve as a proxy for corporate governance, as some scholars seem to suggest?[178] The problem is straightforward: existing securities laws operate through different mechanisms to serve different purposes.

Federal securities laws are reactive and focused on disclosure. Congress acts "on a fire patrol basis"[179] where "the fire alarm is a scandal or bad economic performance."[180] Securities law, at least in part, is public administrative law;[181] state corporate law is "judge-made and privately enforced."[182] Moreover, federal securities laws are ostensibly focused on disclosure, not governance per se.[183] While disclosure can

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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."). *Cf.* Black, *supra* note 11, at 565 ("[F]ederal rules are an important source of nontrivial corporate law."); Roe, *Delaware's Competition*, *supra* note 72, at 625 ("Today takeover law is perhaps the last important domain of corporate law where states have nearly full authority."); Herbert Hovenkamp, *The Classical Corporation in American Legal Thought*, 76 GEO. L.J. 1593, 1688 (1988).

176. *See, e.g.*, Leo Strine, *Sarbanes-Oxley's Creeping Intrusion*, FIN. TIMES, July 6, 2005, at 21.

177. William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections from Two Residents of One Small State*, 152 U. PA. L. REV. 953, 957 (2003).

178. *See, e.g.*, Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 863 (2003) ("[F]ederal securities fraud litigation operates much like state fiduciary duty litigation in policing corporate governance.").

179. Bratton & McCahery, *Equilibrium*, *supra* note 15, at 44.

180. Roe, *Delaware's Politics*, *supra* note 5, at 2530.

181. *See, e.g.*, *id.*; Donald C. Langevoort, *Seeking Sunlight in* Santa Fe's *Shadow: The SEC's Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449, 486 (2001).

182. Kahan & Rock, *supra* note 66, at 27.

183. As Mark Loewenstein sums up:

> [I]t 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.

Loewenstein, *Transformation*, *supra* note 67, at 357; *see also* Richard C. Breeden, *Observations on the Role of the SEC in Corporate Governance and Corporate Charity*, 41 N.Y.L. SCH. L. REV.

help lower agency costs,[184] it is quite a leap to argue, as Mark Roe has, that "[t]o compel disclosure of an act is to control that act."[185] Indeed, as Robert Thompson and Hilary Sale note, disclosure can be a mixed blessing:

> Although, in general terms, disclosure is a good thing, it is not necessarily entirely good or a good regulatory mechanism for corporate governance claims. First, disclosure is an indirect way to regulate managerial behavior. As discussed above, disclosure is, at best, a monitor of what managers say, not what they do. The two may be linked only at the margin. Second, disclosure can, as the recent cycle reveals, create pressure for more disclosure—truthful or not. Disclosure then is a double-edged sword. Truthful disclosures work to decrease informational asymmetries. Fraud increases them.[186]

Even assuming the disclosed information is truthful, it can lead to information overload—"the risk that investors will actually make less accurate decisions in the face of more information as they adopt less complicated decision strategies in an effort to simplify their investment decisions."[187]

Perhaps more importantly, federal securities regulation is often focused on gatekeepers—outside directors, lawyers, accountants, investment bankers, and the like—rather than squarely on corporate insiders. While SOX does impose some duties on managers, notably the certification of financial statements and financial controls[188]—it relies primarily on gatekeeper reform by regulating the composition of audit

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1179, 1182 (1997) ("Actually, most of what the SEC does as regulation is really done in the form of disclosure.").

184. *See, e.g.*, Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995).

185. Roe, *Delaware's Competition*, *supra* note 72, at 615; *see also* Thompson, *Challenges*, *supra* note 24, at 789 ("[D]isclosure has emerged as a key mechanism of corporate governance, a trait primarily associated with federal law.").

186. Thompson & Sale, *supra* note 178, at 909; *see also* Romano, *supra* note 4, at 226.

187. Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 484 (2003).

188. William Bratton and Joseph McCahery argue that even this aspect is not new:

> SOX requires that the CEO and CFO certify public reports, making them responsible for the maintenance of the firm's internal controls system, along with accompanying criminal penalties. While these go to internal affairs, the affairs they address long have been federalized. Moreover, the integrity of the disclosure system still stands out as the ultimate goal. In effect, the federal government, having instituted the mandatory system, reacts to successive compliance failures by reaching further and further back to cover the internal processes that generate the mandated reports.

Bratton & McCahery, *Equilibrium*, *supra* note 15, at 48-49.

committees, accounting regulators, and the like.[189] For example, Jill Fisch and Kenneth Rosen provide an insightful critique of section 307 of the Sarbanes-Oxley Act (requiring lawyers to report up evidence of corporate wrongdoing to corporate leaders) based on the near futility of looking "to private service providers from outside of the organization to transform corporate governance."[190] Gatekeepers, of course, are not the focus of state corporate law. In sum, as Robert Clark has observed, "the SOX-related reforms were not based on a policy decision to effect a major 'paradigm shift' in the allocation of law making authority between the federal government and the states."[191]

C. *Status Quo as Symbiosis*

If a desire to usurp state corporate law does not explain the layers, then what can? A number of distinguished academics have suggested that the mere threat of federal intervention serves as a check on Delaware's power. Most prominently, Mark Roe argues that "Delaware's freedom to act and its limits are not determined solely, and perhaps not even primarily, by its strength vis-à-vis other states, but by the line demarcating where the federal authorities leave it alone and where they do not."[192] Yet, as Roberta Romano points out, "Roe does not identify instances of a chilling or formative effect that the federal securities laws have had on the subsequent development of Delaware (or other states') law, whether substantive or procedural."[193] Indeed, Romano's observation seems consistent with my analysis above.

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189. For a description of the changes wrought by SOX, see Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*, GA. ST. UNIV. L. REV. (forthcoming 2006) [hereinafter Clark, *Morality Tale*], *available at* http://ssrn.com/abstract=808244 (classifying reforms as "audit-related changes," "board-related changes," and "disclosure enhancements and accounting rule changes"); *see also* Romano, *supra* note 4, at 214-16.

190. Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 VILL. L. REV. 1097, 1131 (2003). Needless to say, gatekeeper reform should not be ignored. *See, e.g.*, John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 201 (2004). Nonetheless such reforms are tangential to core corporate governance.

191. Clark, *Morality Tale*, *supra* note 189, at 30; *see also* Loewenstein, *SEC*, *supra* note 23, at 801 ("The near void in corporate governance standards that state law has created has not been filled by the federal government."); Johnson & Sides, *supra* note 166, at 1152.

192. Roe, *Delaware's Politics*, *supra* note 5, at 2499; *see also* Roe, *Delaware's Competition*, *supra* note 72, at 592. For similar arguments, see Bebchuk & Hamdani, *supra* note 6, at 558 ("Our weak-competition account suggests that the greatest threat confronting Delaware is not competition from other states but the possibility that the federal government will intervene in a way that would undermine Delaware's position.").

193. Romano, *supra* note 4, at 226.

A more Machiavellian reasoning emerges: layering, while perhaps well-intentioned, ends up obfuscating the underlying emptiness of basic state corporate law. Consider as a starting point that federal regulation does not affect Delaware's franchise fees, and by simple virtue of its national application, does not disrupt the equilibrium among states.[194] In fact, the federal government can even help maintain the status quo in state corporate law by serving as a buffer that deflects attention away from what the states, most prominently Delaware, are not doing:

> Delaware may favor federal intervention to the extent that it makes the corporate law system as a whole less scandal prone and reduces the chances of populist backlash against Delaware as principal regulator. Thus, the relationship between federal and state regulation in corporate law is, in our view, more symbiotic and less antagonistic than generally presumed.[195]

William Bratton and Joseph McCahery agree that a symbiotic relationship has emerged between Delaware and the putative federal incursions:

> The federal government is the bad cop. Its mission is to make sure that firms tell the truth about themselves. It performs the mission with a massive, mandatory apparatus peopled by prosecutors with political aspirations and greedy plaintiff's lawyers, imposing fines and large money judgments and occasionally sending miscreants to jail. Delaware is the good cop. It arbitrates between shareholder and management interests, making sure never to chill risk taking. It articulates governance standards in a dialogue with the actors it regulates. It only polices when forced. Even then it chooses its techniques with care, sometimes enjoining a transaction but almost never imposing a money judgment. Its mandarin case law is conversant with financial technicalities and full of procedural nuance.[196]

For our purposes, the more important point is that layers hide the hollowness of basic corporate law. The layers—the bandages—shift attention away from the underlying problem: the empty core.[197] Unless

194. *See* Bratton & McCahery, *Equilibrium*, *supra* note 15, at 37 ("National intervention has impacted neither the basic terms of the state settlement nor Delaware's rent flows, once again implying a cooperative strategy.").

195. Kahan & Rock, *supra* note 66, at 12.

196. Bratton & McCahery, *Equilibrium*, *supra* note 15, at 2.

197. *Cf.* Thompson, *Challenges*, *supra* note 24, at 800 ("When the corporate scandals of the post-bubble economy were revealed, the major competitors to Delaware in regulating corporate governance, i.e., Congress, the stock exchanges and the SEC, responded in a more dramatic fashion.

systemic reform occurs, the next scandal will bring yet another reactive bandage, thereby setting the stage for future scandals. The perennial vicious cycle will continue.

IV. DELAYERING

Existing strands of corporate law scholarship, while descriptively brilliant, too often provide precious few workable suggestions for reform. Even ignoring for a moment the implausible assumptions of "race to the top" theorists and the unwieldy proposal of "race to the bottom" advocates, the race debate is somewhat moot: corporate law has reached an equilibrium and is no longer racing anywhere. For their part, deconstruction theorists, much like the critical legal scholars of the 1970s and 80s,[198] provide vague bromides that are not actionable. For instance, we are cautioned to "understand the corporation in terms of the capitalist political economy . . . by asking whether and in what sense we thought prices in a given market were, or could be, truthful"[199] or to "Improve the Regulatory System. . . . Strengthen Political Democracy. . . . Create a Robust Public Sphere. . . . Challenge International Neoliberalism."[200] How all of this is to come about, let alone what the proposals even mean, is left as an exercise for the reader. More subtly, interdisciplinary analysis predicated on public choice or industrial organization, for all of its valuable insight, remains too often curiously agnostic and descriptive.[201] As Roberta Romano writes, the "normative implications of the theses that no states compete and that federal supremacy trumps state competition rationalizes the status quo, a federal securities regime, with corporate law left to the states."[202]

By contrast, Part IV will try to offer suggestions for policy reform as a starting point for debate. It draws on two emerging paradigms in regulatory theory and applies them to corporate law: substantively, confining regulation narrowly only to "bottleneck" elements within a system; and procedurally, experimenting with cooperative federalism as an alternative to either dual or preemptive federalism. I argue that reforming corporate law requires targeting the "bottleneck":

The *Business Roundtable* responded more than Delaware; even the American Bar Association Task Force responded more than Delaware.").

198. *See* Dibadj, CLE, *supra* note 39.

199. Westbrook, *supra* note 7, at 126-27.

200. Bakan, *supra* note 7, at 161-64.

201. *See, e.g.*, Bratton & McCahery, *Equilibrium*, *supra* note 15, at 3 ("For us it suffices that the system is consensual, responsive, and monitored at the national level.").

202. Romano, *supra* note 4, at 229.

reinvigorating core fiduciary duties by resetting judicial "standards of review" to match "standards of conduct," while at the same time focusing on the behavior of officers not just boards of directors. Finally, the institutional approach proposed is one where the federal government would set minimum standards, but implementation would occur through state courts through a "reverse-*Erie*" principle. Minimalism is the order of the day—policymakers must delayer corporate law to make it meaningful.

A. Revitalizing the Core

I begin by discussing regulatory theory, then analogize to corporate governance. Advances in the theory of economic regulation suggest that effective interventions cannot consist of broad "command and control" edicts that try to micromanage an industry. Stephen Breyer's path-breaking book, *Regulation and Its Reform*, suggests the metaphor of "less restrictive alternatives"[203] and lays out "a framework that sees classical regulation as a weapon of last resort and looks for less restrictive ways to deal with problems thought to call for regulation."[204] The locus of attention in regulatory circles has thus moved away from setting retail rates and controlling the entry and exit of players,[205] toward improving the narrow regulation of bottlenecks where incumbents can abuse their power. In telecommunications, for example, the bottleneck is the last mile of cable or copper wire going into subscribers' homes; in the electricity and natural gas industries, transmission and local distribution facilities are the bottleneck.[206]

How does any of this relate to delayering corporate law? The layers of corporate law in Figure 1 above—notably the federal securities laws—too often represent a "command and control" vision. SOX, with all of its complexities, in many ways represents the apotheosis of this way of thinking. By contrast, if we analogize corporate "insiders" of corporate law to the "incumbents" in regulatory theory, new insights emerge. One might specifically ask what "least restrictive alternatives" are available to regulate corporations? To the extent that regulation is

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203. STEPHEN BREYER, REGULATION AND ITS REFORM 341 (1982).

204. *Id.* at 368.

205. The paradigmatic historical examples are the transportation, energy, and telecommunications sectors. *See* REZA DIBADJ, RESCUING REGULATION (forthcoming).

206. *See id.*

about government intervention in private contractual arrangements,[207] the question becomes even more pointed: where and how should policymakers place mandatory rules on insiders?

State corporation statutes could be selectively redesigned to have more bite without creating heavy-handed micromanagement of corporations.[208] But such an approach is likely to meet stiff resistance—the enabling approach is simply too ingrained. A more realistic option for statutory reform, drawing on recent work in behavioral economics,[209] would be to think carefully about where defaults are set. At least, as Jeffrey Gordon suggests, "legislation that relaxes mandatory rules should always require an affirmative shareholder decision to 'opt in' to the change rather than merely permitting shareholders to 'opt out.' This will prevent management from extracting more from the legislative process than it could obtain from the charter amendment process."[210] While thinking carefully about defaults would be a positive step, the bulk of real reform is unlikely to lie in elaborate statutes.

Rather, the "least restrictive alternative" lies in the "protean concept"[211] of fiduciary duty. The rhetoric of contractarianism has masked just how important these duties are.[212] As Jeffrey Gordon argues, "parties taking into account the insiders' power and positional advantage would pick a standard of fairness or good faith as measured ex post and that this radically undermines the case for opting out of fiduciary duties."[213] It is important to emphasize that fiduciary obligations must be made mandatory:

> More specifically, since insiders have substantial control over the amendment process, they are continually tempted to relax fiduciary

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207. *See, e.g.*, David P. Baron, *Design of Regulatory Mechanisms and Institutions*, *in* HANDBOOK OF INDUSTRIAL ORGANIZATION 1349 (Richard Schmalensee & Robert D. Willig eds., 1989).

208. For a discussion of the possible use of regulations implemented through state agencies, see *infra* Part IV.B.

209. *See, e.g.*, Russell Korobkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 VAND. L. REV. 1583 (1998). *Cf.* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 594 (2003) ("The somewhat surprising answer we derive from contract theory is that most state-created defaults will be useless or inefficient.").

210. Gordon, *supra* note 76, at 1555. *Cf.* Black, *supra* note 11, at 568-69.

211. Allen, Jacobs & Strine, *supra* note 90, at 861-62.

212. For a thoughtful discussion of the misleading facade of contract in the context of corporate law, see Brudney, *supra* note 74, at 1410.

213. Gordon, *supra* note 76, at 1594. Gordon adds that "because fiduciary duty rules exist in large measure to protect shareholders from risks against which they cannot diversify, the ex post private wealth maximization criterion, which depends on diversification, is unsatisfactory." *Id.* at 1596.

> standards that govern their behavior and expose them to liability. A mandatory rule eliminates this threat of opportunism while leaving recourse to the legislative process to modify duties—to innovate—where appropriate. Further, a stable conception of fiduciary duty develops only through applying a single standard across a great range of cases. Such a baseline represents a valuable public good, since the verbal formulas and the standards would vary considerably in the absence of a mandatory rule.[214]

Or as Ian Ayres frames it, courts can "provide a unique source for providing non-trivial defaults."[215] We need to make fiduciary duties simpler and stronger. Below, I outline a start.

1. Matching "Standards of Review" to "Standards of Conduct"

Fortunately, there is an elegant way to approach the problem. As Melvin Eisenberg describes, "standards of review in corporate law pervasively diverge from . . . standards of conduct."[216] The BJR is perhaps the canonical doctrinal example. As Delaware judges admit:

> Where the business judgment standard applies, a director will not be held liable for a decision—even one that is unreasonable—that results in a loss to the corporation, so long as the decision is rational. In this review context, *the business judgment standard ("rationality") diverges from, and becomes more lenient than, the normative standard of expected conduct ("reasonableness").*[217]

A characteristic of "standards of review" is that they focus on procedure. As Eisenberg recounts, "a director or officer will not be liable for a decision that resulted in a loss to the corporation, even if the decision is unreasonable, as long as the conditions of the business-judgment rule have been met and the decision is rational."[218] Sean Griffith is thus quite correct to point out that "[t]here is a difference . . . between corporate *law* and corporate *governance*, a difference that is protected by the principle of judicial restraint underlying the business judgment rule."[219]

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214. *Id.* at 1594; *see also* Thomas Lee Hazen, *The Corporate Persona, Contract (and Market) Failure, and Moral Values*, 69 N.C. L. REV. 273, 318 (1991).

215. Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391, 1415 (1992).

216. Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 438 (1993).

217. Allen, Jacobs & Strine, *supra* note 90, at 868 (emphasis added).

218. Eisenberg, *supra* note 216, at 443; *see also id.* at 440-41.

219. Griffith, *supra* note 90, at 18.

Yet it is precisely this difference that makes for weak corporate law. The justifications for this divergence emerge as articles of faith rather than through analysis. Delaware judges argue that the policy underlying deferential scrutiny "reflects the concern that directors will be too inhibited in their decision making if they risk being held liable for decisions that involve ordinary negligence."[220] Even eminent thinkers seem to agree with this conventional wisdom. For example, after a thoughtful discussion of the differences between "standards of conduct" and "standards of review," Melvin Eisenberg nonetheless posits that "utilizing standards of review that were fully congruent with the relevant standards of conduct would impose greater costs than the costs of letting some persons who violated their standards of conduct escape liability"[221] and that "in the case of business decisions it may often be difficult for factfinders to distinguish between bad decisions and proper decisions that turn out badly."[222] Yet no evidence is offered as to why corporate decisions should be granted such deference.

Indeed, the burden should be on those arguing for a divergence between "standards of review" and conduct in corporate law—as Eisenberg himself admits, "[i]n many or most areas of law, these two kinds of standards tend to be conflated."[223] Why should corporate law be any different? Perhaps only because, unwittingly or not, we have made a fetish of the corporation. The idea that judges somehow are not qualified to judge "care" and "loyalty" is difficult to stomach: courts delve into the most difficult and delicate areas of our lives—how we reproduce, raise our children, and even die, to name just a few—yet somehow, corporations are magically off limits. The laxity of fiduciary duties is perhaps best captured in a humorous passage from Edward Rock's account of how state corporate law is actually made: "As one experienced Wall Street transactional lawyer put it in private conversation, 'We're not afraid of what the Delaware courts say. We're afraid of what the press says.'"[224] With lax fiduciary duties, savvy practitioners have recognized that courts have effectively exited the scene.

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220. Allen, Jacobs & Strine, *supra* note 90, at 892. *Cf. In re* Walt Disney, Co. 2005 Del. Ch. LEXIS 113, at *6 (Del. Ch. Aug. 9, 2005) ("But the essence of business is risk—the application of informed belief to contingencies whose outcomes can sometimes be predicted, but never known.").

221. Eisenberg, *supra* note 216, at 467-68.

222. *Id.* at 444. Eisenberg, however, does admit that the "concept of gross negligence . . . is notoriously ambiguous." *Id.* at 448.

223. *Id.* at 437.

224. Rock, *supra* note 76, at 1067-68.

In the end, the explanation for the special disjunction between "standards of review" and "standards of conduct" does not derive from any serious argument that such divergence leads to better law. The current sad state of affairs is likely more about the influence of interest groups:

> [I]t is hard to see what makes corporate managers such delicate beings that they require an exemption from the ordinary rules of the game. The point must be that the exemption has been purchased, and solicitude is expected within the state equilibrium. The system appears to satisfy management, which is happy to pay attorneys to churn litigation that rarely entails more substantial costs in terms of money judgments or lost deals. Clearly the lawyers are also satisfied. For shareholders, the system remains problematic even in the era of shareholder capitalism.[225]

To get beyond the realpolitik of the status quo, I propose a simple and intuitive reform: make "standards of review" congruent with "standards of conduct." This would not only accord with the vast body of doctrine outside corporate law, but would also make judicial review simpler and more meaningful at the same time. Perhaps most surprisingly of all, an influential group of current and former Delaware judges might perhaps be willing to meet such a proposal at least partway:

> [T]he creation of more, rather than fewer, standards of review tends to create a false sense of doctrinal safety, encouraging boards to act in ways that, although enabling their actions to fall into the right categorical box, does not necessarily create the result most genuinely protective of the interest of stockholders.[226]

Unsurprisingly, however, the new standards these judges advocate are themselves convoluted.[227] I propose doing away with this complexity,

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225. Bratton & McCahery, *Equilibrium*, *supra* note 15, at 64. *Cf.* Gevurtz, *BJR*, *supra* note 90, at 336 ("The obstetrician dealing with a difficult labor, the trial lawyer planning strategy, or just the automobile driver attempting a left turn into a busy thoroughfare must exercise judgment. So must we all. . . . [T]here is simply no call for treating business judgments by corporate directors any differently than any other judgment.").

226. Allen, Jacobs & Strine, *supra* note 90, at 869.

227. The following illustrative passage should make the point:

> We also would alter the current "reasonableness" standard slightly, by retaining the existing two-step test as part of a broader, unitary inquiry into whether the board-adopted defensive measures taken as a whole, were reasonable in light of the objective circumstances facing the board. Under that approach, a board's failure to pass the "threat" prong of the *Unocal* analysis would not automatically doom a defensive measure to invalidation. This more flexible analytical framework would enable a board action to pass muster under *Unocal*, even if the board failed to conduct a sufficient

and finding congruence. Eisenberg, despite his legitimization of "standards of review," does provide a wonderful summary of what standards of conduct in corporate law should be:

> Despite the welter of standards in corporate law, certain organizing themes emerge. *The standards of conduct are relatively simple.* In all areas, directors and officers must act in good faith and in the interest of the corporation. In addition, where officers or directors are engaged in disinterested conduct they should act reasonably, and where they are engaged in self-interested conduct they should act fairly.[228]

Those who oppose courts from screening for these standards of conduct will need to argue that courts should not hold corporate "insiders" to a reasonable level of care and loyalty—the way judges generally hold citizens in society. After the facile bromides of the Chicago School of law and economics have worn off, it would be a difficult argument to make with a straight face.

Another advantage of my approach is that it is easily communicable and focuses attention of basic agency law. Specifically, it shines a light on the fact that corporate law "has relaxed—*without either explanation or justification*—the fiduciary strictures imported from trusts and agency so as to permit direct and indirect self-dealing and other diversionary transactions"[229] to rely instead on "the *imagery* of contract and consent."[230] This point cannot be overemphasized. As Justice Harlan Stone reflected in the wake of excesses of the 1920s:

> I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that "a man cannot serve two masters. . . . Yet those who serve nominally as trustees, but relieved, by clever legal devices, from the obligation to protect those whose interests they purport to represent, corporate officers and directors who award themselves huge bonuses from corporate funds without the assent or even the knowledge of their stockholders, reorganization committees created to serve interests of others than those whose

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> "threat" analysis. The primary virtue of our suggested approach is that it avoids the need for a wholly new second-step inquiry into whether a less-than-optimally informed board nonetheless acted "fairly."

Id. at 893-94. In addition to being difficult to follow, the judges' suggestions for reform still present a predictable divergence between standards of conduct and standards of review. *See, e.g.*, *id.* at 865.

228. Eisenberg, *supra* note 216, at 467 (emphasis added).

229. Brudney, *supra* note 74, at 1434 (emphasis added).

230. *Id.* (emphasis added).

securities they control, financial institutions which, in the infinite variety of their operations, consider only last, if at all, the interests of those whose funds they command, suggest how far we have ignored the necessary implications of that principle.[231]

Justice Stone's words are at least as relevant today as they were in 1934.[232] It would be difficult to argue that the perpetrators in the recent corporate scandals were either careful or loyal.[233] As Robert Thompson and Hillary Sale summarize, "[t]oday's federal securities fraud claims are largely efforts to recover from what could be care claims at state law."[234] Only it is worse. The layers of Figure 1, through the artificial sense of security they convey, make it easier to lose sight of Justice Stone's central point: corporate insiders are agents for shareholders. Layers might provide temporary comfort, but they will not solve the problem.[235]

Finally, I am sympathetic to the observations of Delaware Chancellors William Chandler and Leo Strine who point out that the 2002 corporate reforms such as SOX, "suffer from the rapidity of their enactment and a tendency to deal with many issues somewhat superficially and sporadically, rather than with one or two issues deeply and coherently."[236] The most important item—one we should ponder "deeply and coherently"—is to return to fundamental principles of agency law and reform fiduciary duties under state corporate law.[237]

231. Harlan F. Stone, *The Public Influence of the Bar*, 48 HARV. L. REV. 1, 8-9 (1934).

232. On the importance of agency law to corporations, see generally Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187 (2003) [hereinafter Langevoort, *Candor*].

233. *See, e.g.*, Kahan & Rock, *supra* note 66, at 25 (noting how looting at Tyco represents a "classic self-dealing transaction by a corporate fiduciary").

234. Thompson & Sale, *supra* note 178, at 904.

235. In a paper analyzing the most recent federal reforms, Robert Clark has a section tellingly entitled "The Vast Territory of Unchanged Corporate Governance." Clark, *Morality Tale*, *supra* note 189, at 28. Clark adds that the "first [unchanged area] is substantive corporate law concerning self-dealing, related party transactions, the setting of executive compensation, and the extraction of private benefits from management positions and controlling relationships." *Id.* at 29.

236. Chandler & Strine, *supra* note 177, at 957.

237. Some might be tempted to argue that fiduciary duties are a bit quaint in an era increasingly dominated by institutional shareholders. Quite the opposite is true. A pioneer in the world of investment funds, John Bogle, warns that:

> [T]he radical change from an ownership society dominated by individual investors to an intermediation society dominated by professional money managers and corporations has not been accompanied by the development of an ethical, regulatory and legal environment that requires trustees and fiduciaries, as agents, to act solely and exclusively in the interests of their principals.

John C. Bogle, *Individual Stockholder, R.I.P.*, WALL ST. J., Oct. 3, 2005, at A16.

2. Officers, Not Just Directors

It is imperative that these revamped duties should apply squarely to officers, not just directors. State law, particularly in Delaware, clings stubbornly to the fiction that directors run corporations.[238] As the Chancery Court bluntly states, "[a] fundamental precept of Delaware corporation law is that it is the board of directors, and neither shareholders nor managers, that has ultimate responsibility for the management of the enterprise."[239] Or, put simply in Robert Thompson's words: "Director centrality is the Rule #1 in understanding Delaware law."[240] Of course, anyone who has had even a passing encounter with an actual corporation recognizes how management-centered and hierarchical firms are. Too often, the board occupies little more than a ceremonial position.[241] To their credit, Chandler and Strine admit that "several of the most prominent of the corporate scandals have involved (apparently) serious breaches of fiduciary duty by corporate officers and executives who were not directors."[242] Their corporate law, however, has precious little to say on this account.

State laws do two things to exacerbate the situation: they emphasize the board's managerial role over its monitoring role, and make a fetish of the outside director. First, as Robert Clark has pointed out, the board's principal function, at least according to the fiction in Delaware law, is to manage, not to monitor.[243] This is nonsensical.[244]

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238. *See* DEL. CODE ANN. tit. 8, § 141(a) (2004) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.").

239. Grimes v. Donald, 1995 Del. Ch. LEXIS 3, at *25 (Del. Ch. Jan. 12, 1995); *see also* Chandler & Strine, *supra* note 177, at 1002 (exposing the trend in Delaware toward boards composed of independent directors to the exclusion of manager-directors).

240. Thompson, *Challenges*, *supra* note 24, at 781; *see also* Thompson & Sale, *supra* note 178, at 868.

241. *See generally* JAY W. LORSCH, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS (1989).

242. Chandler & Strine, *supra* note 177, at 1003.

243. *See* Clark, *Morality Tale*, *supra* note 189, at 22 ("[T]he classic statement of the directors' role, in section 141(a) of the Delaware General Corporation Law, declares that the business of a corporation is to be managed by or under the direction of the board of directors. The managerial role is highlighted in the definitional description of the board. The monitoring role gets no such billing.").

244. Delaware courts try to reconcile this by pointing to the board's ability to delegate. *See, e.g.*, Grimes, 1995 Del. Ch. LEXIS 3, at *25-26:

> Of course, given the large, complex organizations through which modern, multi-function business corporations often operate, the law recognizes that corporate boards, comprised as they traditionally have been of persons dedicating less than all of their attention to that role, cannot themselves manage the operations of the firm, but may satisfy their

Second, obsessing over the role of independent directors is prone to make things worse. Put bluntly, independent directors may "lack the will, time and/or the incentives"[245] to monitor corporations. They may also lack the expertise, or belong to a tightly knit community of like-minded directors who enjoy interlocking directorships and have a strong interest in maintaining the hospitable ties to management that acquiescence affords.[246] In Gerald Frug's deconstruction of the stories woven to give legitimacy to bureaucracy,[247] he humorously exposes the unrealistic expectations traditional corporate governance structures place on what even the best-intentioned outside director might actually be able to accomplish:

> Into the chaos of the world of the expertise model, [theorists who legitimize bureaucracy] insert a figure truly worthy of comic-book adventure stories: Super-Expert.... In corporate law... he could assume a position within the bureaucracy itself by becoming a so-called "independent" or "outside" director of the company. In such a role, he would be responsible for monitoring the activities of the pseudo-experts—the "inside" directors and the corporate executives—either on issues within his special area of expertise or on matters considered particularly suspect.... To bring a truly outside perspective to bear on corporate transactions, an outside director would have to be fully insulated from the vision of the world that renders inside directors' self-approval of their own activities suspect. To possess this kind of objectivity, Super-Expert might have to come from Krypton.[248]

> obligations by thoughtfully appointing officers, establishing or approving goals and plans and monitoring performance.

Naturally, this begs the question as to why boards are given power, but not the concomitant liability that goes with exercising it.

245. Loewenstein, *Transformation*, *supra* note 67, at 376.

246. As an expert on organizational behavior reminds us:

> Many sociological governance studies in the past ten years have concerned the impact of interlocking boards of directors, in which individual directors serve on two or more boards at once. The cumulative findings of this literature provide a compelling critique of the shareholder value approach, in which directors are dutiful agents of their shareholder principals disciplined by the operations of a market for corporate directors.

Gerald F. Davis, *New Directions in Corporate Governance*, 31 ANN. REV. SOCIOL. 143, 151 (2005) (citations omitted).

247. *See* Gerald E. Frug, *The Ideology of Bureaucracy in American Law*, 97 HARV. L. REV. 1276 (1984).

248. *Id.* at 1328-29.

Recent corporate scandals have borne out Frug's critique.[249] As Mark Loewenstein sums up, 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."[250] Indeed, to the extent that some of the layers of federal law in Figure 1 have bite, it is in part because they focus on what officers, not just directors, are doing.[251] By analogy to the language of the regulatory theorist, officers constitute the incumbent's "bottleneck."

My point is straightforward: if the law wants to make corporations accountable to its shareholders, then it should focus on the individuals who actually manage the corporations—the officers.[252]

3. An Emphasis on Shareholders

Some readers, who might otherwise be sympathetic to my argument, will no doubt protest that the reforms I propose do not go far enough. In particular, what about stakeholders other than shareholders?[253] There is no question that corporations need to recognize that employees, customers, communities, and the environment are a part of the mix.[254] But at this stage in corporate law's development, focusing doctrine on stakeholders rather than shareholders is only likely to make matters worse. One might argue, as mainstream shareholder rights advocates are wont, that it would be impossible to try to optimize among constituents once non-shareholders are thrown into the mix. My argument, however, is much more fundamental. First, shareholder primacy does not necessarily equate to a contractarian vision for corporate law.[255] In fact, this Article has argued precisely the opposite:

249. *See, e.g.*, Robert Frank & Elena Cherney, *Paper Tigers: Lord Black's Board: A-List Cast Played Acquiescent Role*, WALL ST. J., Sept. 27, 2004, at A1.

250. Loewenstein, *Transformation*, *supra* note 67, at 375.

251. *See, e.g.*, Thompson & Sale, *supra* note 178, at 905 ("[T]he federal focus on the behavior of officers is much more in line with the reality of modern corporate America.").

252. New research even challenges the commonly held notion that boards emerged for good economic reasons; rather, their evolution may be traced simply to the path of historical events. *See* Franklin A. Gevurtz, *The European Origins and the Spread of the Corporate Board of Directors*, 33 STETSON L. REV. 925 (2004).

253. *See, e.g.*, Greenfield, *End of History*, *supra* note 38, at 1421 ("[S]hareholder primacy within corporate law . . . only works . . . if the nonshareholder stakeholders have some comparative advantage in the legislature or regulatory agencies.").

254. For example, the composition of the typical board of directors could be altered to include these constituencies. *See* Dibadj, *Reconceiving the Firm*, *supra* note 55, at 1524-28.

255. Some commentators seem to conflate the two. *See, e.g.*, Greenfield, *End of History*, *supra* note 38, at 1419-21.

the hollow core of contractarianism denigrates shareholders by unwittingly acquiescing to corporate insiders. Second, corporate law already allows wide management discretion—notably under the BJR[256]—and the results have been, to put it kindly, less than stellar. Too much discretion is the problem, not the solution. Delayering and focus go hand in hand.

My suggestions for reform thus emerge within a broader argument that corporate law needs to emphasize shareholder rights.[257] As students of corporate law know, shareholders can only do three things to protect themselves: sell, vote, and sue.[258] Regrettably, by the time shareholders find out it is time to sell, it is often too late.[259] Voting rights, as Delaware judges themselves admit, are notoriously ineffectual.[260] Prominent scholars, such as Lucian Bebchuk, while pointing out that such weak voting rights do not reflect the natural order of things,[261] have already proposed eminently reasonable electoral reforms.[262] Within this larger taxonomy, this Article focuses on the right to sue: providing shareholder protection through more meaningful fiduciary duties. In other words, my proposal dovetails with those of other commentators advocating greater shareholder rights. Our goals are congruent and our mechanisms complementary.

256. *Cf.* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 770 (2005) ("[T]he business judgment rule makes plain that the duty of care cannot be enforced in a way that would bar managers from exercising discretion to sacrifice corporate profits in the public interest.").

257. Clark, *Morality Tale*, *supra* note 189, at 41 ("[S]ome of the strongest evidence of good effects for shareholders has to do with shareholder rights, not board independence.").

258. *See, e.g.*, Thompson, *Challenges*, *supra* note 24, at 781.

259. Consider, for example, the shareholders of Enron, WorldCom, Tyco, and the like, who suffered dramatic losses in the wake of the most recent corporate scandals.

260. *See* Chandler & Strine, *supra* note 177, at 999 ("As of now, incumbent slates are able to spend their companies' money in an almost unlimited way in order to get themselves elected. As a practical matter, this renders the corporate election process an irrelevancy, unless a takeover proposal is on the table and a bidder is willing to fund an insurgent slate.").

261. *See* Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 842 (2005) [hereinafter Bebchuk, *Shareholder Power*] ("[T]he considerable weakness of shareholders in U.S. companies is not a necessary consequence of the dispersion of ownership. This weakness is at least in part due to the legal rules that insulate management from shareholder intervention.").

262. *See, e.g.*, *id.* at 836 ("I present the case for allowing shareholders to initiate and vote to adopt changes in the company's basic corporate governance arrangements."); *see also* Bratton & McCahery, *Regulatory Competition*, *supra* note 66, at 1926 ("We propose a federally mandated privilege of direct shareholder access to amend the corporate charter at the annual meeting of shareholders, with cost-shifting to be effectuated through access to the proxy statement for the making of proposals.").

B. *Institutional Approaches*

The remaining question concerns how to implement a revitalization of corporate law's core. Once again building on new research in regulatory theory, my goal will be to find a middle ground between "'preemptive federalism' that relies primarily or exclusively on federal courts or administrative agencies to develop unitary and pinpointed federal policies . . . [and] 'dual federalism' that leaves the states as autonomous actors separated from the federal government."[263] I discuss why neither dual nor preemptive federalism will provide a lasting fix before proposing a new version of cooperative federalism.

1. Dual Federalism

Within a dual federalist conception, two things could happen: either Delaware, the de facto state corporate law, decides to reform itself, or other states could react with stiffer regulation of out-of-state corporations. Each scenario might appear tempting at first glance.

First, Delaware could move on its' own. Its lawmakers could recognize that its laws, modeled on antiquated law and economics,[264] are becoming increasingly irrelevant to corporate governance.[265] More and more commentators could realize that its statutes suffer from the "democratic deficit" that Kahan and Rock describe,[266] and that its fuzzy case law induces litigation with very little remedy.[267] Even Delaware's judges might be beginning to feel a little self-conscious.[268] In short, increasing numbers of people could realize that Delaware corporate law is a brilliantly marketed business concerned primarily with maximizing

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263. Philip J. Weiser, *Federal Common Law, Cooperative Federalism, and the Enforcement of the Telecom Act*, 76 N.Y.U. L. REV. 1692, 1693 (2001) [hereinafter Weiser, *Telecom Act*].

264. For a discussion of the difficulties of displacing the conventional wisdom in law and economics, see Ugo Mattei, *The Rise and Fall of Law and Economics: An Essay for Judge Guido Calabresi*, 64 MD. L. REV. 220 (2005).

265. *See supra* note 158 and accompanying text; *see also* Thompson & Sale, *supra* note 178, at 905 ("Delaware conceded much more of corporate governance than it may have anticipated when it forwent the affirmative use of disclosure obligations or, through the exculpation clause, the affirmative regulation of managerial care."); *cf.* Langevoort, *Candor, supra* note 232, at 1226 ("Federal statutes, particularly the federal securities laws and ancillary criminal laws, like conspiracy and mail and wire fraud, are the big weapons.").

266. *See supra* note 135.

267. *See supra* notes 119-22 and accompanying text.

268. *See, e.g.*, Chandler & Strine, *supra* note 177, at 1001 ("It will not surprise legal scholars that Delaware's common law was perhaps slower than ideal in adapting to the new realities, which seem to many to cry out for a deeper and more skeptical judicial inquiry.").

its own profits rather than providing shareholder protections.[269] As Robert Thompson summarizes:

> Is there a downside to a status quo response in Delaware? There is, if Delaware's response would halt the intrusions from these other sources. Two facts are relevant. First, the New York Stock Exchange is not likely to have the same role in corporate governance that it held in the last year. Technological changes and market shifts have dulled both its incentives and ability to make corporate governance rules. Second, the SEC is at the edge of its statutory authority. Congress is not likely to revisit the question in the near term. Timely action by Delaware can apply new pressure on the SEC and the NYSE to retreat from the questionable authority they now seek to apply. Delaware, as it has done before, should consider a more proactive approach that would make Congress, the NYSE, the SEC, and the courts more comfortable in foregoing additional regulation and adhering to the traditional division of corporate governance.[270]

Even a casual glance at the business press will show the corporate miscreant of the day being paraded in front of a courthouse in lower Manhattan. Delaware is missing.

Assuming Delaware wishes to address its absence, it could change a few things. Its current emphasis is on private enforcement, ex post, through common law.[271] As Mark Roe points out, "[n]o regulatory agency makes forward-looking rules in Delaware"[272]—"[y]et the state could adopt another lawmaking strategy: it could use a regulatory agency with proactive, anticipatory rulemaking authority—one that uncovered problems, that investigated firms, their managers, and their owners, and that, like the SEC, often restricted the activities of firms, managers, and owners prospectively."[273] Indeed, I have suggested a similar mechanism in the context of antitrust.[274] But core corporate law

269. *Cf.* Bratton & McCahery, *Equilibrium*, *supra* note 15, at 68 ("Delaware being a business, only a threat to the state equilibrium matters to its bottom line."); Kahan & Rock, *supra* note 66, at 31 (noting that the "extra-cameral activities by members of the Delaware judiciary . . . help *market Delaware law* to the legal community" (emphasis added)).

270. Thompson, *Challenges*, *supra* note 24, at 801; *cf.* Bratton & McCahery, *Equilibrium*, *supra* note 15, at 50 ("Delaware does run a risk here. Future cumulative SOX-type mandates could so hard wire governance processes that firms decide that the choice of state of incorporation is irrelevant and stop paying Delaware's premium price.").

271. As Kahan and Rock observe, "[t]his focus on private enforcement is distinctive both from the international and the national perspective." Kahan & Rock, *supra* note 66, at 25.

272. Roe, *Delaware's Politics*, *supra* note 5, at 2501; *see also* Kahan & Rock, *supra* note 66, at 24 ("Delaware has no regulatory agency that enforces its corporate law.").

273. Roe, *Delaware's Politics*, *supra* note 5, at 2527.

274. *See* Dibadj, *Saving Antitrust*, *supra* note 39.

is different.[275] Much like torts or contracts, it requires a broader balancing of social impact rather than becoming immersed in technical details as in competition policy.[276] Moreover, it would stretch the imagination to believe that Delaware would have the political will to establish and support such an agency.[277] A less drastic step, but nonetheless one that would acknowledge corporate law as a form of public law, would be for Delaware to enforce its corporate laws using a prosecutor. Currently, Delaware "does not enforce corporate norms through criminal proceedings; and even though the Attorney General has some civil enforcement powers with respect to for-profit corporations, these powers are virtually never exercised."[278]

Interestingly, the prosecutorial route is one mechanism that Attorneys General in some other states—most notably Eliot Spitzer in New York—have followed as a proxy to enforcing corporate law.[279] But would states be willing to go further? This question depends in large part on what conception one has of the internal affairs doctrine—the "continued applicability of the internal affairs rule is, of course, the life-blood of Delaware."[280]

At first glance, the doctrine seems to impose a barrier to the regulation of out-of-state corporations. As the U.S. Supreme Court has described:

> The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors,

275. Mark Roe analogizes Delaware to a federal administrative agency. *See* Roe, *Delaware's Politics*, *supra* note 5, at 2542 ("Instead of seeing Delaware as solely the upshot of a market of competing states, we also see it as like a federal agency—captured by its interest groups—that can only move as far as Congress allows.").

276. *See* Dibadj, *Saving Antitrust*, *supra* note 39, at 788-89.

277. *Cf.* Loewenstein, *Transformation*, *supra* note 67, at 376 ("If not independent directors, one might ask, who? The only other candidates are governmental regulators, a solution no one embraces because of the fear that government has neither the resources nor the expertise to monitor corporate governance.").

278. Kahan & Rock, *supra* note 66, at 24; *see also* Roe, *Delaware's Politics*, *supra* note 5, at 2501 ("No Delaware prosecutor scrutinizes corporate America to throw wrongdoers in jail . . . .").

279. *See, e.g.*, Roe, *Delaware's Politics*, *supra* note 5, at 2528 ("Corporate and financial prosecutions emerge in big states, like New York (think of N.Y. Attorney General Eliot Spitzer's recent prosecutions) . . . not in Delaware.").

280. Kahan & Rock, *supra* note 66, at 33.

> and shareholders—because otherwise a corporation could be faced with conflicting demands.[281]

Upon deeper scrutiny, however, the internal affairs doctrine reveals itself not to present an insurmountable block. To begin with, it is not a constitutional imperative.[282] Moreover, the guidance provided by the Restatement of Conflict of Laws provides space to regulate:[283]

> The local law of the state of incorporation will be applied to determine . . . [issues involving the rights and liabilities of a corporation] except in the unusual case where, with respect to the particular issue, some other state has a more significant relationship to the occurrence and the parties, in which event the local law of the other state will be applied.[284]

Comment g seems to allow even more leeway, observing that "[s]tatutes in a number of states forbid regulation of the internal affairs of foreign corporations. . . . *On the other hand, statutes in other states specifically provide for such regulation.*"[285] As Bernard Black notes, "[a]t the state level, the best prospect for manager constraining rules is laws whose force depends on contacts with the state other than incorporation."[286] David Skeel observes that "[i]f choice of law were based not on the state of incorporation, but on some other factor such as

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281. Edgar v. MITE Corp., 457 U.S. 624, 645 (1982). Richard Buxbaum's historical analysis suggests that:

> The internal affairs doctrine—that the internal affairs of a corporation normally should be governed by the law of the state of incorporation—began as a forum derogation concept. Early courts, called on to provide relief to some shareholders (or creditors) of a foreign corporation, understandably were unsure whether their jurisdictional reach was broad enough to guarantee that they could grant complete rather than partial or, worse, inconsistent relief.

Richard M. Buxbaum, *The Threatened Constitutionalization of the Internal Affairs Doctrine in Corporation Law*, 75 CAL. L. REV. 29, 43-44 (1987).

282. *See, e.g.*, Arthur R. Pinto, *The Constitution and the Market for Corporate Control: State Takeover Statutes after* CTS Corp., 29 WM. & MARY L. REV. 699, 764-65 (1988) ("Although the [United States Supreme] Court historically has deferred to the law of the state of incorporation on issues involving internal affairs, that does not mean that the Court has established a constitutional requirement under the commerce clause mandating that the law of the state of incorporation be applied on all corporate governance issues.").

283. Of course, states could choose not to abide by the Restatement and return to more basic conflict of laws principles.

284. RESTATEMENT (SECOND) OF LAW, CONFLICT OF LAWS § 302(2) (1971).

285. *Id.*, Comment g (Reporter's Note) (emphasis added). The major states that already attempt to regulate out-of-state corporations are New York and California. For a negative view of these attempts, see Carney, *supra* note 24, at 759 ("Statutes that preclude vigorous competition, such as those of New York and California that reduce the benefits of migration by regulating pseudo-foreign corporations, are the real problem.").

286. Black, *supra* note 11, at 580. *Cf.* Kahan & Rock, *supra* note 66, at 33.

the firm's principal place of business, corporate managers would lose much of their incentive to shop for the optimal corporation law regime, and the competition for charters would break down."[287]

Notwithstanding these arguments, states themselves are unlikely to bolster regulation. Delaware is unlikely to budge: it has too much invested in its existing legal infrastructure, fuzzy case law and all. And it is too busy enjoying rents derived from the current equilibrium. The recent *Disney* case[288] only confirms this pessimism. For their part, other states—New York's Eliot Spitzer notwithstanding—generally lack incentives to move in a systemic fashion.[289] It is thus no coincidence, as Part II has described, that state corporate laws have descended into an equilibrium that protects the interests of managers to the detriment of shareholders.[290] Dual federalism has gotten us into this mess and is unlikely to get us out.

2. Preemptive Federalism

Preemptive federalism is happening to some extent—visually, it is depicted in the dark grey layers in Figure 1 above. Given state corporate law's empty core, it is natural to want the federal government to step in to protect shareholders.[291] As one might expect, federal preemption is the solution of "race to the bottom" theorists.[292] Additionally, there is virtually no question, given the Commerce and Supremacy clauses, that the federal government has constitutional authority to override the state law of corporations.[293] The more interesting question, however, is

287. Skeel, *supra* note 62, at 521.

288. *See supra* notes 126-33.

289. As Marcel Kahan and Ehud Kamar observe, "[o]ther than Delaware, states do not gain significant financial benefits from competing. Even if they attracted a substantial number of public corporations, they would neither earn meaningful additional franchise taxes under their current tax structures nor profit significantly from an increase in legal business." Kahan & Kamar, *supra* note 6, at 748. In addition, "state lawmakers pursue political goals rather than economic profits." *Id.*

290. *Cf.* Black, *supra* note 11, at 586 ("The chartermongering race, whether to the top, the bottom, or somewhere in between, is essentially over. All that's left is incremental change to respond to changing circumstances. . . . [T]he difference between most state laws are small.").

291. *See supra* Part III; *see also* Steinberg, *supra* note 168, at 257 ("The expansive construction given by many courts to the business judgment rule, in conjunction with state anti-takeover statutes that protect incumbent management, strongly suggest that any meaningful shareholder protection and reforms in the tender offer area must come from existing federal law and the implementation of further Congressional and SEC action.").

292. *See, e.g.*, Cary, *supra* note 3. *Cf.* Bainbridge, *supra* note 44, at 30 ("The basic case for federalizing corporate law rests on the so-called 'race to the bottom' hypothesis.").

293. *See, e.g.*, Bainbridge, *supra* note 44, at 26 ("No one seriously doubts that Congress has the power under the Commerce Clause, especially as it is interpreted these days, to create a federal law of corporations if it chooses."); Kahan & Rock, *supra* note 66, at 7.

whether preemptive federalism is even good policy, and if so, whether it can be implemented more simply than via contorted layers?[294]

Two new mechanisms would be available to the federal government: chartering and federal standards.[295] Federal chartering would be simplest,[296] and unlike simply preempting certain state laws,[297] would disrupt Delaware's rent flows from franchise fees.[298] For their part, new federal standards could take two different forms. The first would revolve around the SEC by extending securities laws—either to provide greater regulation of specific areas such as takeovers,[299] or more broadly to expand the federal common law centered around proxy regulation and securities fraud. A second option, not as dependent on the SEC, would be to create new federal fiduciary standards and enforce them in federal courts.[300] For example, Lucian Bebchuk suggests the need for direct federal intervention

> with respect to issues that are significantly redistributive, including self-dealing, taking of corporate opportunities, and insider trading . . . [,] issues that directly implicate the strength of market discipline, including the regulation of corporate takeover and proxy contexts . . . [and] issues that involve potential transfers between

294. *Cf.* Thompson & Sale, *supra* note 178, at 909 ("The remaining question for further discussion, then, is whether the disclosure approach is sufficiently efficacious, and if not, whether we should recognize the strong role of federal law in monitoring corporate governance and reformulate it to do so in a more direct fashion.").

295. Some commentators suggest other tentative possibilities. *See, e.g.*, Michael Abramowicz, *Speeding Up the Crawl to the Top*, 20 YALE J. ON REG. 139, 189-205 (2003) (arguing that federal law could impose caps on the number of firms per state, subsidize firms or states to innovate in corporate law, and even provide intellectual property protection for innovations in corporate law).

296. Of course, there are variations, such as offering federal incorporation as an option. *See, e.g.*, Bebchuk & Hamdani, *supra* note 6, at 613.

297. *See, e.g.*, Roe, *Delaware's Politics*, *supra* note 5, at 2518 ("[I]f Congress federalizes a law, Delaware need not lose tax revenues.").

298. *Cf.* Griffith, *supra* note 90, at 66 ("As long as Delaware's franchise fees are safe, state legislators are less likely to be sensitive to the incremental federalization of corporate law."); Bratton & McCahery, *Equilibrium*, *supra* note 15, at 65 ("And, despite its entry into internal affairs, SOX in no way impairs the charter market or Delaware's rent flows.").

299. *See, e.g.*, Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 115-16 (2001) ("[A] mandatory federal process rule would enable shareholders to decide to have their corporation opt into the optional federal takeover regime even against the wishes of the corporation's managers.").

300. *See, e.g.*, Cary, *supra* note 3, at 701 (advocating "minimum corporation law provisions which shall be applicable to companies doing business in interstate commerce and construed by federal judicial standards. Uniformity is of the essence."); Bebchuk, *Federalism*, *supra* note 27, at 1484 ("[W]e should consider expanding federal law to govern—or at least set minimum standards for—managers' fiduciary duties, the fiduciary duties of controlling shareholders in freezeouts and allocation of opportunities, and the various aspects of takeover bids and proxy contests now governed by state law."); Brown, *supra* note 145, at 376-78.

> public shareholders and a dominant shareholder, including going-private freezeouts, parent-subsidiary mergers, and the allocation of opportunities between parent companies and subsidiaries.[301]

While such proposals are well-intentioned and elegant, they face institutional roadblocks, since neither the SEC, nor the federal courts, nor even Congress has the capacity to manage corporate governance.

To begin with, implementation would be difficult without specific Congressional authorization. The SEC is at the limits of the powers delegated to it.[302] Controversies related to Rule 14a-8 "precatory" shareholder town hall meeting proposals,[303] and Rule 19c-4 "one share, one vote" rights[304] reflect the precariousness of its mandate in the realm of corporate governance. The regulatory tap-dance is perhaps most contorted when the SEC is relegated to exerting its influence indirectly by having the stock exchanges implement what the Commission would be precluded from doing directly.[305] As a former Chairman of the agency somberly warns, "the SEC tiptoes in the corporate governance area, with

301. Bebchuk, *Federalism*, *supra* note 27, at 1484. In addition, Bebchuk notes that "state competition may well produce socially undesirable results whenever a corporate law issue involves significant externalities . . . [such as] the regulation of takeovers and proxy contests, the protection of creditors, disclosure regulation, and the protection of constituencies other than providers of capital." *Id.* at 1494.

302. *See, e.g.*, Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 VAND. L. REV. 1129, 1131 (1993) ("The statutory language and legislative history are ambiguous as to whether the SEC is authorized to enact rules with a substantive effect on corporate governance or simply to implement disclosure requirements.").

303. *See, e.g.*, Bebchuk, *Shareholder Power*, *supra* note 261, at 846 ("[U]nder state corporate law, directors have discretion whether to follow precatory proposals that receive substantial or majority support, and directors' freedom to disregard such resolutions is protected under the business judgment rule."); Thompson, *Challenges*, *supra* note 24, at 798; Fleischer, *supra* note 3, at 1159.

304. The landmark case is *Business Roundtable v. SEC*, where the U.S. Court of Appeals for the D.C. Circuit held that "[b]ecause the rule directly controls the substantive allocation of powers among classes of shareholders, we find it in excess of the Commission's authority under § 19 of the Securities Exchange Act of 1934." Bus. Roundtable v. SEC, 905 F.2d 406, 407 (D.C. Cir. 1990). The court added that "[i]f Rule 19c-4 were validated on such broad grounds, the Commission would be able to establish a federal corporate law by using access to national capital markets as its enforcement mechanism." *Id.* at 412.

305. *See, e.g.*, Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325, 338-39 (2001) ("[S]tock exchange listing standards operate as a bridge between state and federal law with respect to corporate governance, but their legal status is uncertain."); Thompson, *Challenges*, *supra* note 24, at 793 ("The current set of regulations differs from the historic NYSE listing standard and has much more of the appearance of an indirect way for the SEC to operate in a manner that a federal appellate court in the Business Roundtable case said the federal agency could not."). *Cf.* Bainbridge, *supra* note 44, at 28 (criticizing "the troubling expansion of stock exchange listing standards that displace state corporate law").

an omnipresent shadow of doubt surrounding the question of the breadth of the SEC's own mandate."[306]

More broadly, the federal government—beginning as early as the late 1970s—has been increasingly solicitous of federalism issues in corporate governance. Examples include gradual acceptance of state antitakeover statutes under a less rigorous dormant commerce clause analysis,[307] and a careful carve-out for derivative actions based on state fiduciary duty claims in SLUSA.[308] This direction is consistent with a general movement, at least since *Cort*,[309] to cabin federal common law as it relates to corporate governance. As the Supreme Court cautioned in the landmark case of *Santa Fe Industries v. Green*,[310] "[a]bsent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."[311]

306. Breeden, *supra* note 183, at 1182.

307. *Compare* Edgar v. MITE Corp., 457 U.S. 624, 644 (1982) (appellant "argues that Illinois seeks to protect resident security holders and that the Act merely regulates the internal affairs of companies incorporated under Illinois law. We agree with the Court of Appeals that these asserted interests are insufficient to outweigh the burdens Illinois imposes on interstate commerce.") *with* CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 86 (1987) ("The longstanding prevalence of state regulation in this area suggests that, if Congress had intended to pre-empt all states laws that delay the acquisition of voting control following a tender offer, it would have said so explicitly."). Of course, there were differences in the structure of the Illinois and Indiana statutes, but it is important to note that Justice White, who authored the *MITE* opinion, dissented in *CTS*. For more discussion of these statutes, *see, e.g.*, Robert A. Prentice, *The Role of States in Tender Offers: An Analysis of* CTS, 1988 COLUM. BUS. L. REV. 1 (1988); *Pinto*, *supra* note 282.

308. *See, e.g.*, Kahan & Rock, *supra* note 66, at 10 (noting that SLUSA "which in effect deprived state courts of jurisdiction over securities class actions for misrepresentations or deceit and eliminated the states' ability to apply their own securities laws on misrepresentations or deceit in class actions, contains the so-called 'Delaware carve-out' which specifically exempts actions for misrepresentations based on the corporation law of a company's state of incorporation from its provisions"); Bratton & McCahery, *Equilibrium*, *supra* note 15, at 55 ("But before passage, a Delaware-oriented carve-out was added in the Senate, assuring that state litigation in respect of fiduciary duty would be unaffected."); Jennifer O'Hare, *Director Communications and the Uneasy Relationship Between the Fiduciary Duty of Disclosure and the Anti-Fraud Provisions of the Federal Securities Laws*, 70 U. CIN. L. REV. 475, 476 (2002).

309. *See* Cort v. Ash, 422 U.S. 66 (1975).

310. 430 U.S. 462 (1977).

311. *Id.* at 479; *cf. Cort*, 422 U.S. at 84 (1975) ("Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."); Gaines v. Haughton, 645 F.2d 761, 779 (9th Cir. 1981) ("[W]e hold that director misconduct of the type traditionally regulated by state corporate law need not be disclosed in proxy solicitations for director elections. This type of mismanagement, unadorned by self-dealing, is simply not material or otherwise within the ambit of the federal securities laws."). The retrenchment of federal common law has continued and is not limited to the

Of course, Congress could act directly and boldly, as some prominent commentators have suggested.[312] While this would avoid the prudential considerations discussed above, it brings with it its own host of problems. As one scholar observes, "[c]orporate law would be just one issue out of a huge agenda for the U.S. Congress, whereas Delaware's very success in the state competition makes corporate law a much more central concern to Delaware politicians. The same also holds true for Delaware judges versus federal judges."[313] Assuming, *arguendo*, that Congress would be able to act on an ongoing basis, it is unclear whether its drafting of statutes would necessarily be to shareholders' benefit. Any federal statute that seeks to be comprehensive will likely descend into complexity in order to satisfy various interest groups.[314] As Mark Roe posits, "if Congress made most corporate law directly, America's corporate law would look more like the tax code than current corporate law."[315] In addition to the complexity issue, preemptive federalism would either help shareholders, or further entrench managers, depending on the political vagaries of the day. The Williams Act arguably benefited incumbent management, and the PSLRA, NSMIA, SLUSA are all examples of federal laws effectively meant to preempt more generous state securities laws.[316] Not to mention that federal oversight of corporate accounting—the root of many of the recent corporate scandals—has been lax.[317] Perhaps most amusingly, it is important to remember that while corporate interest groups do clamor for "states' rights" when federal laws do not suit them, they are also not ashamed to turn around and argue for federal preemption in the face of

corporate arena. *See, e.g.*, O'Melveny & Myers v. FDIC, 512 U.S. 79 (1994); Kamen v. Kemper Fin. Servs., 500 U.S. 90 (1991). As one commentator has observed, the Supreme Court "altered dramatically the balance between state and federal power during the 1990s: by restricting the federal common law making powers of the federal courts." Paul Lund, *The Decline of Federal Common Law*, 76 B.U. L. REV. 895, 899 (1996).

312. *See, e.g.*, Seligman, *Minimum Corporate Standards*, *supra* note 74, at 972-73.

313. McDonnell, *Two Cheers*, *supra* note 66, at 124. *Cf.* Skeel, *supra* note 62, at 515; Romano, *supra* note 4, at 229.

314. *See, e.g.*, Kahan & Kamar, *supra* note 6, at 743-44 ("Like noncompeting states, Congress would likely be amenable to lobbying by campaign contributors. As a result, it would likely play to corporate managers, subject to occasional corrective legislation following financial debacles.").

315. Roe, *Delaware's Politics*, *supra* note 5, at 2515.

316. *See, e.g.*, Bratton & McCahery, *Equilibrium*, *supra* note 15, at 51. *Cf.* Marc I. Steinberg, *The Emergence of State Securities Laws: Partly Sunny Skies for Investors*, 62 U. CIN. L. REV. 395 (1993).

317. *See, e.g.*, Kahan & Kamar, *supra* note 6, at 744 ("[M]embers of Congress opposed by an overwhelming margin a proposal by the Financial Accounting Standards Board to require companies to account for stock options as an expense—until, that is, a series of major financial scandals changes the political calculus somewhat.").

inconvenient state laws.[318] Smart Delaware judges have been quick to pounce on this inconsistency.[319]

Given the limitations on Congress as a decision-making body and on the federal courts as enforcers of corporate law, perhaps the most workable approach under a preemptive federalist model would be for Congress to draft some broad mandates, and then delegate expanded responsibilities to the SEC as its expert agency. This is possible and certainly more feasible than Congress trying to do things directly, but it would vastly expand the Commission's duties and require a rethinking of how the agency operates. After all, at least prior to the most recent spate of corporate scandals, the SEC was not always a paragon of performance.[320] As one article in the *Wall Street Journal* asks, "[h]ow did the SEC's staff of more than 3,000 allow Mr. Spitzer's investor-protection staff of 84 to grab the enforcement torch?"[321]

In sum, Congress, the federal courts, and the SEC—even in careful combination and with the best of intentions[322]—could not manage corporate governance by themselves. A new approach would be vastly preferable.

3. Cooperative Federalism

Ideally, we would like the best of both worlds: some kind of federal intervention to force the states out of their equilibrium, while at the same time not requiring the vast federal machinery—Congress, SEC, and the courts—to supervise corporate governance on an ongoing basis. The

318. The pattern, of course, extends beyond corporate law. *See, e.g.*, Robert M. Ackerman, *Tort Law and Federalism: Whatever Happened to Devolution?*, 14 YALE J. ON REG. 429, 447 (1996); Jonathan Peterson, *Lenders Target State Laws: An Industry that Makes Home Loans to People With Poor Credit Wants Uniform Federal Rules that Could Undo Tougher Consumer Protections*, L.A. TIMES, Dec. 28, 2005, at A1; David Rogers, *Missouri Lawmaker Lends Movers a Hand*, WALL ST. J., Nov. 30, 2005, at A4.

319. *See, e.g.*, Strine, *supra* note 144, at 1273 ("In 1998, corporate America persuaded Congress to restrict the ability of shareholder plaintiffs to bring disclosure class actions in the federal courts and to preempt most state regulation of corporate disclosures in such lawsuits.").

320. *See, e.g.*, Kahan & Rock, *supra* note 66, at 35 (noting how Eliot Spitzer was "visibly on the ball while the Securities and Exchange Commission was asleep"); Alan R. Palmiter, *The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation*, 45 ALA. L. REV. 879, 883 (1994) (lamenting "the SEC's erratic and desultory performance" in the context of Rule 14a-8).

321. Mark Maremont & Deborah Solomon, *Behind SEC's Failings: Caution, Tight Budget, '90s Exuberance*, WALL ST. J., Dec. 24, 2003, at A1; *see also* Jesse Eisinger, *SEC Screwdriver Joins Spitzer Hammer as Hedge-Trimmer*, WALL ST. J., Oct. 27, 2004, at C1.

322. *Cf.* Robert B. Thompson, *Protecting Shareholder Rights to Vote, Sell, and Sue*, 62 LAW & CONTEMP. PROBS. 215, 222 (1999) ("Congress has repeatedly refused to enact a federal incorporations act, and federal courts often have restricted the reach of federal securities laws, citing a desire to preserve federalism and traditional state regulation of corporate matters.").

notion of cooperative federalism, again drawn from regulatory theory, provides at least a promising beginning to addressing the conundrum.

Philip Weiser, a leading commentator on cooperative federalism in the regulatory arena, provides a compelling description of the idea:

> In contrast to dual federalism, cooperative federalism envisions a sharing of regulatory authority between the federal government and the states that allows states to regulate within a framework delineated by federal law.... Significantly, these programs neither leave state authority unconstrained within its domain, as would a dual federalism program, nor displace such authority entirely with a unitary federal program, as would a preemptive federalism.... By crafting a middle ground solution between the extremes of dual federalism and preemptive federalism, Congress continues to outstrip existing constitutional rhetoric, which envisions a separation that does not exist in practice.[323]

While cooperative federalism has yet to be discussed in the context of corporations, the reasons behind its emergence in the regulatory arena offer a striking parallel to the current problems in corporate law:

> Under the cooperative federalism model, certain choices are removed from the state level to ensure that the state does not compromise—for whatever reason—on issues of national importance. Thus cooperative federalism schemes define the terms of competition between the states so that they do not deviate from basic federal policy goals, underinvest in goods and services that would benefit neighboring states, or engage in a "race to the bottom."[324]

Cooperative federalism has been used in a variety of regulatory contexts: environmental law, telecommunications, and social services, to

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323. Philip J. Weiser, *Towards a Constitutional Architecture for Cooperative Federalism*, 79 N.C. L. REV. 663, 664-65 (2001) [hereinafter Weiser, *Constitutional Architecture*]; *see also* Harold J. Krent, *Congressional Delegations of Administrative Authority Outside the Federal Government*, 85 NW. U. L. REV. 62, 67 (1990) ("The most familiar consist of congressional delegations of authority to states and state officials to implement and help enforce federal regulatory schemes.").

324. Philip J. Weiser, Chevron, *Cooperative Federalism, and Telecommunications Reform*, 52 VAND. L. REV. 1, 32-33 (1999) (emphasis added) [hereinafter Weiser, Chevron]. As Weiser elaborates:

> there are at least three related reasons why the federal government has decided to promote diversity in federal regulatory regimes: (1) to allow states to tailor federal regulatory programs to local conditions; (2) to promote competition within a federal regulatory framework; and (3) to permit experimentation with different approaches that may assist in determining an optimal regulatory strategy.

Weiser, *Telecom Act*, *supra* note 263, at 1698. All of these reasons are eminently applicable to corporate law.

name a few.[325] In their usual incarnation, cooperative federalism programs "set forth some uniform federal standards—as embodied in the statute, federal agency regulations, or both—but leave state agencies with discretion to implement the federal law, supplement it with more stringent standards, and, in some cases, receive an exemption from federal requirements."[326] This framework can potentially bring challenging constitutional issues to the fore. In *AT&T v. Iowa Utilities Board*,[327] which interpreted the 1996 Telecommunications Act, Justice Scalia went out of his way to mention that the Court's opinion assumes the following:

> [A] scheme in which Congress has broadly extended its law into the field of intrastate telecommunications, but in a few specified areas (ratemaking, interconnection agreements, etc.) has left the policy implications of that extension to be determined by state commissions, which—within the broad range of lawful policymaking left open to administrative agencies—are beyond federal control. *Such a scheme is decidedly novel, and the attendant legal questions, such as whether federal courts must defer to state agency interpretations of federal law, are novel as well.*[328]

While federal deferrals to state agencies have been found constitutional,[329] the important question that Justice Scalia puts forth seems to revolve around whether *Chevron* deference should be granted to state agencies; or, put differently, whether state agencies should be permitted to create federal common law.[330]

The institutional approach I advance for corporate law, however, carefully avoids this issue. I propose that Congress craft a short statute that does two things: (i) as a baseline, requires that "standards of review" match "standards of conduct" for both directors and officers—thereby

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325. *See, e.g.*, Robert L. Fischman & Jaelith Hall-Rivera, *A Lesson for Conservation from Pollution Control Law: Cooperative Federalism for Recovery under the Endangered Species Act*, 27 COLUM. J. ENVTL. L. 45 (2002); Weiser, Chevron, *supra* note 324; Sheryll D. Cashin, *Federalism, Welfare Reform, and the Minority Poor: Accounting for the Tyranny of State Majorities*, 99 COLUM. L. REV. 552 (1999). *See generally* Weiser, *Constitutional Architecture*, *supra* note 323, at 664-65.

326. Weiser, *Telecom Act*, *supra* note 263, at 1696.

327. 525 U.S. 366 (1999).

328. *Id.* at 385 n.10 (emphasis added).

329. *See, e.g.*, FERC v. Mississippi, 456 U.S. 742 (1982).

330. For differing viewpoints, compare Weiser, *Constitutional Architecture*, *supra* note 323, at 719 ("[O]ur constitutional commitment to federalism and effective governance justifies state agency administration of federal law not subject to federal agency review.") with Reza Dibadj, *Competitive Debacle In Local Telephony: Is the 1996 Telecommunications Act to Blame?*, 81 WASH. U. L.Q. 1, 58-59 (2003).

enhancing the duties of care and loyalty; and (ii) replaces state court standards for dismissal with federal standards less favorable to defendants.[331] Implementation, however, would be left to state courts, not federal courts or state agencies.

The constitutional underpinnings of the approach rely on the "reverse-*Erie*" principle articulated by the U.S. Supreme Court in *Testa v. Katt*[332]—simply put, state courts have an obligation to enforce federal law.[333] More specifically, Supreme Court precedent has repeatedly confirmed Congress's right to create a federal claim to be litigated exclusively in state courts.[334] Even Justice O'Connor's opinion in *New York v. United States*,[335] which held, under an anti-commandeering principle, that "the Constitution simply does not give Congress the authority to require the States to regulate,"[336] nonetheless was very careful to observe that "[f]ederal statutes enforceable in state courts do, in a sense, direct state judges to enforce them, *but this sort of federal 'direction' of state judges is mandated by the text of the Supremacy Clause.* No comparable constitutional provision authorizes Congress to command state legislatures to legislate."[337] One federal judge puts it

331. *Cf.* Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 61-62 (1993) ("The federal fiduciary duty cause of action Congress could enact would be litigated in federal court and would expressly prohibit federal courts from deferring to special litigation committees in suits properly alleging the misconduct of any member of the board of directors."); Seligman, *Minimum Corporate Standards*, *supra* note 74, at 973 ("The new federal rule would be procedural. It would substitute for the special litigation committee the well-established federal courts' standard for dismissals of nonmeritorious suits."). By contrast, my approach centers around state, not federal, courts.

332. 330 U.S. 386 (1947).

333. *See id.* at 389 ("For we cannot accept the basic premise on which the Rhode Island Supreme Court held that it has no more obligation to enforce a valid penal law of the United States than it has to enforce a penal law of another state or a foreign country."); *see also* Friendly, *supra* note 174, at 407 ("Just as federal courts now conform to state decisions on issues properly for the states, state courts must conform to federal decisions in areas where Congress, acting within powers granted to it, has manifested, be it ever so slightly, an intention to that end.").

334. *See* Shoshone Mining Co. v. Rutter, 177 U.S. 505, 513 (1900) ("[T]he mere fact that a suit is an adverse suit authorized by the statutes of Congress is not in and of itself sufficient to vest jurisdiction in the Federal Courts."); Matsushita Elec. Indus. Co., Ltd. v. Epstein, 516 U.S. 367, 385 (1996) ("[E]ven when exclusively federal claims are at stake, there is no 'universal right to litigate a federal claim in a federal district court.'" (citation omitted)); Verizon Md. Inc. v. Pub. Serv. Comm'n of Md., 535 U.S. 635, 644 (2002).

335. 505 U.S. 144 (1992).

336. *Id.* at 178.

337. *Id.* at 178-79 (emphasis added).

succinctly: "[n]o constitutional impediment prevents Congress from creating a federal right that can only be vindicated in state courts."[338]

Beyond its overarching constitutionality, there is also specific precedent in the regulatory context for my approach. The Telephone Consumer Protection Act of 1991,[339] which authorizes a plaintiff to file suit "if otherwise permitted by the laws or rules of court of a State . . . in an appropriate court of that State,"[340] provides a useful analogy. As the U.S. Court of Appeals for the Fourth Circuit stated in upholding the statute, "[w]e today reach the somewhat unusual conclusion that state courts have exclusive jurisdiction over a cause of action created by federal law."[341] The court remarked that "[b]ecause federal-question jurisdiction ultimately depends on an act of Congress, the scope of the district courts' jurisdiction depends on that congressional intent manifested in the statute."[342]

My approach thus differs from that of scholars who typically suggest creating a right in federal court to litigate based on state fiduciary standards.[343] I suggest precisely the opposite: creating a right to litigate in state court based on federal fiduciary standards.

Such a construct presents a number of advantages. First, it maintains the existing infrastructure of state courts as a forum to resolve corporate law disputes. By tweaking substantive standards, the existing judicial machinery—notably Delaware's—could now be used to benefit shareholders, not just to generate litigation.[344] A side-benefit is that it relieves the already overburdened federal courts from the frontlines of

338. William G. Bassler, *The Federalization of Domestic Violence: An Exercise in Cooperative Federalism or a Misallocation of Federal Judicial Resources*, 48 RUTGERS L. REV. 1139, 1186 (1996); *see also* Ackerman, *supra* note 318, at 446.

339. Pub. L. No. 102-243, 105 Stat. 2394 (1991).

340. 47 U.S.C. § 227(b)(3) (2004).

341. Int'l Sci. & Tech. Inst. v. Inacom Commc'ns, 106 F.3d 1146, 1150 (4th Cir. 1997). The Second, Third, Fifth and Eleventh Circuits have agreed with the Fourth Circuit. *See* Chair King, Inc. v. Houston Cellular Corp., 131 F.3d 507 (5th Cir. 1997); Erienet, Inc. v. Velocity Net, Inc., 156 F.3d 513 (3d Cir. 1998); Nicholson v. Hooters of Augusta, Inc., 136 F.3d 1287 (11th Cir. 1998); Foxhall Realty Law Offices, Inc. v. Telecomms. Premium Servs., 156 F.3d 432 (2d Cir. 1998).

342. *Inacom*, 106 F.3d 1146 at 1153-54.

343. A leading advocate of such an approach is Joel Seligman. *See, e.g.*, Seligman, *Minimum Corporate Standards*, *supra* note 74, at 973 ("Congress should enact a federal cause of action based on existing state corporate law fiduciary standards. . . . This cause of action would be litigated in federal court. . . . The fiduciary standards applied by federal courts would remain state corporate law.").

344. As just one example, if "standards of review" are upped to "standards of conduct" then Delaware could not fashion an opinion as in *Disney*, see *supra* notes 126-33.

policing corporations.[345] Indeed, one of the problems emanating from SOX is the burden on the federal government and the accompanying ambiguity as to the role of the states in the implementation.[346]

Second, it does not lock in the states to a national corporate law regime, but only sets a minimum federal floor for fiduciary obligations. As this upsets the existing equilibrium, those states that might be serious about offering greater shareholder protections would be free to do so, provided they not be allowed to contract out of the federal statute.[347] A related benefit is that allowing an interpretative role for state courts allows state doctrine to evolve, thereby avoiding the "vestigialization"[348] of state law that accompanies preemptive federalism, as has happened in bankruptcy[349] and securities regulation.[350] It goes without saying that a belief in devolving some power to the states does not necessarily equate to conservative laissez-faire economics.[351]

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345. Interestingly, it appears to be for this reason that William Cary reluctantly seems to acknowledge that there might be a role for state courts as a fallback option. *See* Cary, *supra* note 3, at 704-05. Of course, I propose cooperative federalism because it is good policy; alleviation of the burden on federal courts is only an incidental benefit. *Cf.* Barry Friedman, *Under the Law of Federal Jurisdiction: Allocating Cases Between Federal and State Courts*, 104 COLUM. L. REV. 1211, 1222-23 (2004).

346. As William Chandler and Leo Strine point out:

> Because the [2002 federal] Reforms address boardroom practices traditionally governed by state law but do not, in themselves, constitute a comprehensive body of substantive corporation law, the Reforms will inevitably begin to influence state law adjudication. One of the important factors supporting this intuition is that Congress and the Exchanges did not supply forums for the resolution of implementation disputes at the instance of stockholders.

Chandler & Strine, *supra* note 177, at 982. *Cf.* Johnson & Sides, *supra* note 166, at 1225.

347. *Cf.* Carney, *supra* note 24, at 717 ("Though the constraint of competition is not perfect, it probably curbs management rent-seeking more effectively than an alternative such as federalizing corporate law, and certainly produces greater innovation."); McDonnell, *Two Cheers*, *supra* note 66, at 139 ("Full-fledged nationalization would lose the gains from diversity and experimentation. Full-fledged devolution to the states would eliminate the check on excessive managerialism that the various federal actors provide."); 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, 708 (2003) ("[C]ompetition among states for corporate charters may be one way of slowing down the process of locking into a particular corporate law regime.").

348. Skeel, *supra* note 62, at 474.

349. *See id.* at 474-75 n.7 ("[A]fter the separation of state corporate law and federal corporate bankruptcy, the interaction between these two areas of law is based upon the remnants of what might otherwise have been a cohesive, integrated policy.").

350. *See supra* note 110; Langevoort, *Candor*, *supra* note 232, at 1208 ("The question of why an intra-corporate duty of candor has not evolved as a legal doctrine has another answer: the federal securities laws have made it less necessary because it has created a strong enough obligation of candor to the marketplace.").

351. The mantra among traditional law and economics commentators is to argue for less government, not necessarily for states' rights if it does not suit their agenda. *See, e.g.*, A.C. Pritchard, *Constitutional Federalism, Individual Liberty, and The Securities Litigation Uniform*

Third, and perhaps most excitingly, thinking about cooperative federalism as it relates to corporate governance can offer a fresh perspective on the intersection of federalism and corporate law. The underlying, perhaps counterintuitive, premise is that state courts would be articulating federal common law.[352] One issue would be how the federal statute should manage appeals—the United States Supreme Court would have the final say,[353] but to what extent should a state court's decision be reviewable by a federal appellate court? Will resistance develop to state court articulation of federal common law? Might more complex forms of "multijurisdictional" adjudication emerge?[354] To what extent might congressional delegations to state actors be in tension with Article II's mandate that the executive should "execute" federal laws?[355] Could mandating state courts to follow federal procedures for dismissal of suits in turn be subject to an anti-commandeering argument?[356]

Future research might include these questions, and no doubt many more. As the Supreme Court observed in *New York*, "the task of ascertaining the constitutional line between federal and state power has

Standards Act of 1998, 78 WASH. U. L.Q. 435, 439-40 (2000) ("I conclude that the Uniform Act is consistent with principles of constitutional federalism because its preemption results in less, rather than more, government interference with private conduct.... [T]he Uniform Act enhances individual liberty because eliminating state regulation enhances individuals' choices.").

352. *See, e.g.*, Field, *supra* note 173, at 890 n.30 ("Because federal common law applies in state as well as federal court..., an argument can be made that it should apply in the first instance in state court, just as in federal district court. In theory a state judge would recognize federal common law if she believed the United States Supreme Court would recognize it. And the contention that it is applicable would be reviewable by the United States Supreme Court, whether it prevailed below or not." (citation omitted)).

353. Interestingly, new empirical research suggests the Supreme Court is showing declining interest in hearing business law cases. *See* E. Thomas Sullivan & Robert B. Thompson, *The Supreme Court and Private Law: The Vanishing Importance of Securities and Antitrust*, 53 EMORY L.J. 1571 (2004) (noting how the U.S. Supreme Court is showing a declining tendency to adjudicate private law disputes, notably in the securities regulation and antitrust arenas).

354. Different portions of a case could be reviewed in different court systems. Some forms of multijurisdictional adjudication already exist; for example, federal certification of state law questions or federal collateral review of state decisions through habeas corpus petitions. Friedman suggests an integrated state and federal adjudication process, whereby individual cases could have separate issues decided by the appropriate court through sequencing or reference. *See* Friedman, *supra* note 345, at 1272, 1274.

355. *See, e.g.*, Evan Caminker, *States in a Federal System: The Unitary Executive and State Administration of Federal Law*, 45 KAN. L. REV. 1075 (1997); *see also* Weiser, *Constitutional Architecture*, *supra* note 323, at 707 ("Constructing a constitutional architecture for cooperative federalism requires a new vision not only of federal-state relations, but also of the nature of separation of powers law.").

356. *See* Seligman, *The New Corporate Law*, *supra* note 331.

given rise to many of the Court's most difficult and celebrated cases."[357] My goal here is simply a small beginning to a new conversation about the intersection of federalism and corporate governance. As Judith Resnik notes, we should "aspire to a conversation within law that relies less on preexisting categories and that searches among evolving practices to learn something new about federalism in the United States."[358]

V. CONCLUSION

The great irony is that over the past century, lawmakers have used everything but core corporate law to stem scandal and improve corporate governance—securities law, criminal law, and exchange listing requirements, to name a few.[359] To become relevant again, corporate law must first be delayered and simplified. Simply using temporary bandages in reaction to scandal only leads to recurring problems.[360]

Rather than these baroque facades, minimalism should be the order of the day. Indeed, lost amid this sea of reform is one basic and surprisingly overlooked fact: the traditional base of corporate law—fiduciary obligations—has been eviscerated. The rhetoric of corporate law cleverly sets its "standards of review" well below desirable "standards of conduct." Seemingly impressive obligations such as the duty of care and the duty of loyalty are thus enfeebled to become very weak checks on managers. The result has been state common law that overwhelmingly defers to management interests. An analogous problem is the fixation that corporate doctrine has on directors, when in reality, the modern corporation is run by its officers. Simply put, "standards of review" must become congruent with "standards of conduct" in corporate law, like they are in other areas of law. And these standards must squarely apply to officers.

Arguably an even more interesting question becomes how to elicit these reforms. Federalization of corporate law is too crude a method. Indeed, preempting state laws often has, at best, mixed results. Maybe states themselves will one day realize that contractarian corporate law is unworkable, as evidenced by endless cycles of corporate scandal. Or

357. New York v. United States, 505 U.S. 144, 155 (1992).

358. Judith Resnik, *Federalism's Options*, 14 YALE J. ON REG. 465, 473 (1996).

359. *See, e.g.*, Leonard Orland, *Corporate Misconduct vs. Criminal Behavior*, N.Y. TIMES, Dec. 21, 2004, at A29.

360. *Cf.* Ackerman, *supra* note 318, at 447 ("Many a redundant statute is enacted because there is a political itch that needs to be scratched. In such cases, what is needed is not more law, but more effective enforcement of existing law.").

perhaps at least states other than Delaware will pay less deference to the "internal affairs" doctrine and regulate corporations incorporated out-of-state more aggressively. These possibilities, while theoretically attractive, are unlikely given states' vested interests in maintaining the current system. No one wants to move first.

The approach I have proposed is one of cooperative federalism: the federal government would impose minimum fiduciary standards, but allow individualized implementation at the state level. Analogizing to existing paradigms where federal legislation has been left to implementation by state agencies, I suggest under a reverse-*Erie* analysis, that state courts interpret these federal minimum standards. The articulation of federal common law by states courts, in and of itself, engenders a series of exciting questions for future debate.

In sum, existing attempts to reform corporate law have merely added unnecessary layers to doctrine and created a welter of confusing standards that conflate corporations and securities regulation. A better approach would be to reinvigorate fiduciary obligations within the framework of cooperative federalism.

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