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Realigning the Corporate-Stockholder Relationship: Facilitating Stockholder Communications During Active Proxy Solicitations

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NOTES

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I. INTRODUCTION

The bankruptcy of the Enron Corporation in December of 2001 "sent shock waves throughout the country" that forced both Wall Street and the average investor to rethink our system of corporate governance.[1] WorldCom, the second-largest long distance carrier in the United States, topped Enron by filing an even larger bankruptcy in 2002 with pre-petition assets estimated at a staggering $103,914,000,000.[2] Although these were two of the largest bankruptcy filings in United States history, Enron and WorldCom were merely the tip of the iceberg. Similar scandals at Adelphia Communications, Arthur Andersen, Global Crossing, HealthSouth, Qwest, Rite Aid, Tyco, and Xerox represent "a national deluge of corporate malfeasance."[3] "The particulars of each case are unique, but certain elements remain constant: massive accounting fraud, insider trading, influence-peddling, dubious tax avoidance scbemes, outrageous perks for insiders, and complicity by overcompensated directors."[4]

"Over half of American families now invest directly or indirectly in the stock market."[5] When companies such as Enron and WorldCom go bankrupt, it is the stockholders of these corporations who generally stand to lose the most as residual claimants of economically moribund corporations. "In the three years since the [Enron and Worldcom] scandals broke, nearly one thousand publicly held corporations restated their finances in order to stave off lawsuits, triggering a staggering *seven trillion* dollar devaluation in the stock markets."[6]

How, then, can our system of corporate governance be reformed—a system that has allowed officers and directors of corporations to perpetrate fraud so pervasive as to send some of America's largest corporations into bankruptcy? Although the public has looked largely to lawmakers to achieve corporate reform, other entities have undertaken reform as well. These reforms include increased scrutiny of corporate directors' actions,[7] bolstered requirements calling for boards of directors of companies listed on the

1. S. REP. NO. 107-70, at 2 (2002) (reporting on the role of the board of directors in Enron's collapse).

2. The Largest Bankruptcies 1980–Present, http://www.bankruptcydata.com/Research/15_largest.htm (last visited May 31, 2006).

3. Note, *Finding Strategic Corporate Citizenship: A New Game Theoretic View*, 117 HARV. L. REV. 1957, 1957 (2004).

4. Douglas Litowitz, *Are Corporations Evil?*, 58 U. MIAMI L. REV. 811, 811 (2004).

5. S. REP. NO. 107-70, *supra* note 1, at 2.

6. Litowitz, *supra* note 4, at 811 (emphasis added) (citing Bill Deener, *Cost to Stay Public Soars for Small Companies*, DALLAS MORNING NEWS, July 20, 2003, at D1 ("About $7 trillion in market capitalization is gone," said House of Representatives Financial Services Committee Spokesperson Peggy Peterson.)).

7. Jeffrey D. Hern, Comment, *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, 228–29 (2005).

NYSE and NASDAQ to be more independent,[8] and a higher degree of scrutiny from state agencies.[9] The reform has primarily focused on correcting loopholes exploited by companies like Enron and WorldCom to perpetuate fraud.[10] What the reform has not done, however, is change our system of corporate governance in a way that allows corporate constituencies to monitor or address wrongdoing by management *before* damage is done to a corporation.

True reform to our system of corporate governance is best directed at the state level: "In our federal system of corporate law, state governments set the rules governing the relationships among the primary participants in the corporate enterprise: directors, officers and investors."[11] States have the ability to enact statutes and develop common law that can be characterized as stockholder, management, or even creditor-friendly. Yet, perverse incentives may hamper states' efforts in achieving meaningful corporate governance reform.

Traditional scholarship asserts that our system of corporate governance is largely a product of competition between states that were either in a "race to the bottom"[12] or a "race to the top"[13] in terms of establishing systems of corporate governance designed to attract a greater number of corporate charters. These corporate charters are attractive to states because corporations pay franchise taxes and other fees to the states in which they incorporate, generating important tax revenue.[14] "Race to the bottom" theorists posit that our system of corporate governance is biased in favor of corporate management.[15]

8. *And Now, The Independent Director! Have Congress, the NYSE, and NASDAQ Finally Figured Out How to Make the Independent Director Actually Work?*, *in* Colloquium, *Developments & the Law: Corporations & Society*, 117 HARV. L. REV. 2181, 2195 (2004).

9. *See, e.g.*, Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1077 (2003) ("On December 20 2002, the SEC and New York Attorney General Eliot Spitzer announced that they had reached an agreement in principle with various SROs and state regulatory authorities to reform investment practices.").

10. *See* Erica Gann, Comment, *Judicial Action in Retrograde: The Case for Applying Section 804 of the Sarbanes-Oxley Act to All Fraud Actions Under the Securities Laws*, 72 U. CIN. L. REV. 1043, 1045 (2004) (citing the Sarbanes-Oxley Act and stating that it "sought to cover any possible legal loopholes that would permit corporate fraud").

11. Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 IOWA J. CORP. L. 625, 630 (2004).

12. For the classic formulation of the "race to the bottom" theory, see William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974).

13. For the traditional response to the "race to the bottom" theory, describing the "race to the top," see Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

14. William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303, 306 (1997) (stating that one of tbe reasons why states compete for corporate charters is to "produce[] franchise tax revenues").

15. Cary, *supra* note 12, at 670–72.

"Race to the top" proponents argue that the corporate-stockholder relationship is defined by the market, bringing the relationship into a natural equilibrium.[16]

Although this debate has ebbed and flowed, what is not debatable is where the vast majority of corporate charters are held. Delaware is the state of choice for incorporation, as shown by the fact that nearly 400,000 American corporations are chartered there.[17] 57.75 percent of all publicly-traded corporations and 59 percent of the Fortune 500 companies are incorporated in Delaware.[18] Because a significant number of the 42.25 percent of public corporations that are not incorporated in Delaware are chartered in the state where their headquarters are located, the true measure of Delaware's preeminence in corporate law should focus on the proportion of corporate charters Delaware captures from corporations which do *not* charter in their home state.[19] Delaware incorporates a commanding 85 percent of all such corporations.[20] "Delaware is thus a virtual monopoly in the out-of-state incorporations market. . . ."[21]

Further evidence of this "virtual monopoly" is the fact that the 15 percent of corporations which do incorporate outside the state of their headquarters, but do not incorporate within Delaware, actually do not concentrate in any one state.[22] Of the 216 Fortune 500 companies which incorporate outside of the state of their headquarters, no "state [other than Delaware] captures even 10 such corporations."[23] Non-Fortune 500 companies exhibit a similar incorporation pattern. For the non-Fortune 500 group, over a similar time period "Delaware capture[d] about 3744 out-of-state incorporations of publicly traded companies, [while] each other state attract[ed] fewer than 180 such incorporations."[24] Not only does Delaware dominate the market for out-of-state incorporations, but its

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16. Winter, *supra* note 13, at 256.

17. Marc Gunther, *Boards Beware!*, FORTUNE, Nov. 10, 2003, at 172, 176.

18. Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 568 (2002).

19. *Id.* at 568–74 (discussing the "home state" bias exhibited by many corporations and discussing possible reasons for it, including increased transaction costs for incorporating out of state and corporations' hopes to receive more favorable treatment in their home states).

20. *Id.* at 555–56.

21. *Id.* at 556.

22. *See* Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1573–74 (2002) (noting that "no state has had any meaningful success in attracting out-of-state firms going public" and stating that Delaware's most aggressive competitor, Nevada, failed to capture more than one percent of all firms that went public between 1990 and 1997).

23. Bebchuk & Hamdani, *supra* note 18, at 556 (citing Lucian A. Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 418 tbl. 13 (2003)).

24. *Id.*

market share is growing and this trend shows signs of continuing.[25] Whether it is a race to the top or a race to the bottom, Delaware is the clear winner in the race for corporate charters.

Thus, in the wake of the recent wave of corporate scandals, not only should Delaware provide answers to the question of why the scandals occurred, but it should also provide long-term solutions to the problem. The lack of competition for out-of-state corporate charters, however, may mean that Delaware's legislature lacks the necessary incentives to innovate its corporate governance system. Notwithstanding this lack of incentives, recent scholarship has suggested two main vehicles through which corporate reform may be achieved. The first avenue focuses on reliance on Delaware itself, arguing that backlash from the wake of recent scandals is sufficient to prompt Delaware to make reforms in order to maintain dominance in the collection of corporate charters.[26] The second avenue relies on an increased form of competition between Delaware and the federal government to effectuate corporate reform.[27]

The scope of this Note is limited to first, evaluating corporate reform initiated by Delaware and, next, exploring another avenue for corporate reform which focuses on preventing corporate wrongdoing, rather than simply redressing it. Part II of this Note takes brief inventory of how Delaware is reacting to the corporate wrongdoing that began in 2001 and concludes that neither its judiciary, nor its legislature, is likely to make meaningful changes to its system of corporate governance. Part III will focus on how realigning the corporate-stockholder relationship may achieve corporate governance reform. Part IV will first evaluate a recent decision by Delaware's Chancery Court which had the opportunity to realign one narrow aspect the corporate-stockholder relationship through Delaware General Corporation Law (DGCL) section 220, and then present an alternative manner in which courts could review similar cases in the future. Part V will conclude by commenting on the feasibility of implementing the suggested change.

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25. Bebchuk & Cohen, *supra* note 23, at 386–87.

26. *See, e.g.*, Carl W. Mills, Note, *Breach of Fiduciary Duty as Securities Fraud:* SEC v. Chancellor Corp., 10 FORDHAM J. CORP. & FIN. L. 439, 464 (2005) (stating that despite the federalization of certain parts of corporate law, "Delaware remains in a position to play a significant role in the regulation of director conduct").

27. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003) (detailing how increased federalism of corporate law is creating a form of "competition" between the federal government and Delaware for control of America's system of corporate governance).

II. RELIANCE ON DELAWARE FOR CORPORATE REFORM

Any discussion of reform of Delaware corporate law requires an understanding of Delaware's unique position with respect to corporate law and the resulting advantages derived from hosting the corporate charters of so many U.S. corporations. No other state derives such a large proportion of its budgeted revenues from corporations chartered within its borders as does Delaware.[28] Consequently, any changes to the corpus of Delaware corporate law will most likely be tempered to ensure that current charters will not leave the state. If history is a guide, any changes to its law will also be fashioned such that new corporations will not be deterred from entering the state.[29]

At the very least, one must concede that Delaware is more than an impartial observer when it comes to the corpus of the corporate law which it promulgates. Critics assert that the "'public policy of the State' [is] to adopt legal rules that [corporate] managers desire[]."[30] Others argue that in order to maintain its legitimacy and preferred status as home to the largest corporations in the United States, the judiciary of Delaware must crack down on corporate mismanagement to protect stockholders.[31] An evaluation of changes that Delaware has made to its corporate law since 2001 demonstrates that Delaware has not made sufficient changes in its system of corporate governance to prevent corporate wrongdoing before it occurs.

A. Response of Delaware's Judiciary to Corporate Scandals After 2001

In reference to the Sarbanes-Oxley Act (the "Act") of 2002 [32], the Chief Justice of Delaware's Supreme Court, E. Norman Veasey, stated, "If we don't fix it, Congress will, but I hope they've gone as far as they're going to have to go."[33] There is perhaps no better evidence

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28. Michal Barzuza, *Price Considerations in the Market for Corporate Law,* 26 CARDOZO L. REV. 127, 159–60 (2004).

29. *See* Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency,* 15 DEL. J. CORP. L. 885, 890 n.11 (1990) (citing Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle,* 1 J.L. ECON. & ORG. 225 (1985), and stating that Delaware is one of the most responsive states in terms of incorporating changes into its corporate law that attract corporate charters).

30. Jones, *supra* note 11, at 630 (citing Cary, *supra* note 12, at 663).

31. *Id.* at 629 (stating that "[t]he realistic threat of federal preemption posed by Sarbanes-Oxley seems to have influenced Delaware's judiciary").

32. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 114 Stat. 745 (codified in scattered sections of 11, 14, 18, 28, and 29 U.S.C.).

33. Colloquium, *What's Wrong with Executive Compensation? A Roundtable Moderated by Charles Elson,* HARV. BUS. REV., Jan. 2003, at 68, 77 (quoting E. Norman Veasey, Chief Justice, Delaware Supreme Court).

than this statement to demonstrate that the Delaware judiciary is aware of the need to achieve corporate reform in the wake of recent corporate scandals. It is telling that the quote does not focus on the plight of the stockholder as much as it focuses on maintaining Delaware's "legitimacy and power in the realm of corporate law."[34] Since the Enron debacle of 2001, some have argued that Delaware's judiciary has made a noticeable shift in how it evaluates allegations of corporate malfeasance.[35] Scholars argue that the shift has been toward holding board members accountable for conduct detrimental to stockholders. This supposed shift is held out as evidence of reform to our system of corporate governance.

Specifically, *In re Walt Disney Company Derivative Litigation*[36] has been heralded by scholars as a paradigm shift by Delaware's judiciary—"a shift . . . from allowing independence [of board members] to enforcing oversight of their actions."[37] The case involved a stockholder action brought in response to a severance package given to the now-former president of the Walt Disney Company, Michael Ovitz.[38] After little more than a year of employment the board determined that Ovitz should no longer serve as president of the Walt Disney Company. As a result, he received a severance package allegedly valued at over $140 million.[39]

The decision to hire Ovitz was made "unilaterally" by Michael Eisner, Disney's CEO, who happened to be "a close friend [of Ovitz's] for over twenty-five years."[40] Prior to joining Disney, Ovitz had never held a position as "an executive for a publicly owned entertainment company," but was the founder and head of his own talent agency.[41] During the course of Eisner's pursuit of Ovitz for the position of president, Eisner sent Ovitz a letter setting out the material terms of Ovitz's prospective employment with the company.[42] Neither Disney's board of directors nor its compensation committee met to discuss hiring Ovitz as the new president of Disney before Eisner sent this letter.[43]

34. Jones, *supra* note 11, at 627.

35. *Id.* at 643 (stating that "Delaware's judiciary has taken the initiative to reform its state's corporate law in an effort to forestall further federal preemption").

36. 825 A.2d 275 (Del. Ch. 2003).

37. Hern, *supra* note 7, at 216.

38. *In Re Walt Disney Co.*, 825 A.2d at 278–79.

39. *Id.*

40. *Id.* at 279.

41. *Id.*

42. *Id.*

43. *Id.*

After Eisner sent the letter, Disney's board of directors failed to commit significant resources to deliberating over Ovitz's compensation package before approving it. Disney's compensation committee, which consisted of three board members, met for only one hour to discuss Ovitz's compensation package.[44] At this meeting, the directors also discussed two other subjects which dominated the conversation for nearly the entire meeting.[45] The committee did not even receive a copy of the draft agreement of Ovitz's employment contract prior to the meeting. Instead, the committee relied on an incomplete summary of the agreement that lacked pertinent data necessary to evaluate the fairness of Ovitz's employment contract.[46] Notwithstanding its lack of involvement and investigation, the compensation committee approved Ovitz's compensation package. Approval by the Disney board of directors came later that day without the availability of more detailed information providing the precise terms of Ovitz's employment contract.[47]

Despite alleging these seemingly damaging facts in their complaint, the plaintiffs' case was dismissed by Delaware's Chancery Court.[48] The dismissal was no shock, however, to commentators and those familiar with Delaware law. Board action with respect to executive compensation had long since fallen under the umbrella of the business judgment rule[49] and was well within the realm of decisions which courts allow board members to make under that doctrine.[50] Surprisingly, the Supreme Court of Delaware reversed and remanded the case on appeal with instructions for the Chancery Court to allow the plaintiffs to redraft portions of their initial complaint.[51]

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44. *Id.* at 280.

45. *Id.*

46. Hern, *supra* note 7, at 217 n.69:

> The summary did not include the following: Ovitz's exercise price for five million shares of stock options, any document showing the potential payout to Ovitz, any document showing the possible cost of Ovitz's severance package upon a non-fault termination, or any comparisons with employment agreements of similarly-situated executives in the entertainment industry.

47. *In re Walt Disney Co.*, 825 A.2d at 281.

48. In re Walt Disney Derivative Litig., 731 A.2d 342, 380 (Del. Ch. 1998).

49. The business judgment rule is perhaps best articulated in *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), where the Delaware Supreme Court stated that the business judgment rule is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."

50. *See, e.g.*, Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962) ("Where waste of corporate assets is alleged, the court['s examination] . . . is limited solely to discovering whether what the corporation has received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid.").

51. Brehm v. Eisner, 746 A.2d 244, 267 (Del. 2000).

Upon remand, the Chancery Court held that the plaintiffs' amended complaint was sufficient to withstand Disney's motion for dismissal, and the case was allowed to proceed to trial.

Scholars have used the *In re Disney* decision and others as evidence of a paradigm shift in Delaware's judiciary away from unflinching adherence to the principles of the business judgment rule, which defer overwhelmingly to management. Other cases that supposedly provide evidence of this shift include *In re Oracle Corporation*[52] and *In re Abbott Laboratories*,[53] both of which applied Delaware law.[54] In both cases, just as in *In re Disney*, the courts would not dismiss the plaintiffs' complaints on the pleadings alone.[55] At best, these cases *may* be evidence of a tightening of standards after the recent wave of corporate scandals. These cases cannot, however, be viewed as wholesale victories for the plaintiffs because each case simply allowed the proceedings to continue toward trial.[56]

Further proceedings in all three of these cases suggest that Delaware's judiciary has not made a meaningful shift in the level of scrutiny applied to alleged instances of corporate mismanagement. *In re Walt Disney* concluded in August of 2005, with the defendants prevailing on all counts.[57] The *In re Oracle* litigation also has arrived at its final resting place—summary judgment in favor of the CEO and CFO.[58] Although the final outcome is less clear, *In re Abbott* appears to be headed toward a similar result. In *In re Abbot*, just as in *In re Oracle*, after denying the defendant's initial motion for dismissal, the

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52. 325 F.3d 795 (7th Cir. 2003).

53. 824 A.2d 917 (Del. Ch. 2003).

54. *See* Hern, *supra* note 7, at 229; *In re Abbott Labs.*, 325 F.3d at 795; *In re Oracle Corp.*, 824 A.2d at 917 (applying Delaware law).

55. *In re Oracle Corp.*, 824 A.2d at 948; *In re Abbott Labs.*, 325 F.3d at 811.

56. *See* sources cited *supra* note 55.

57. In re Walt Disney Company Derivative Litig., No. Civ.A. 15452, 2005 WL 2056651, at *1 (Del. Ch. Aug. 9, 2005). The Court of Chancery made eight findings:

> (1) [Ovitz] did not breach duty of loyalty to corporation when president accepted non-fault termination package upon termination by [Eisner]; (2) termination of [Ovitz] and payment of non-fault termination benefits did not constitute waste; (3) [Eisner] acted in good faith and was not grossly negligent so as to breach his fiduciary duty of care when he negotiated with and hired [Ovitz]; (4) chairman of corporation's compensation committee was not grossly negligent and did not act in bad faith when he negotiated with and hired [Ovitz]; (5) compensation committee member who helped design compensation package and employment agreement did not breach fiduciary duty of care or act in anything other than in good faith; (6) board of directors was not under a duty to act with respect to termination of [Ovitz]; (7) general counsel acted in good faith when he advised [Eisner] with respect to termination; and (8) [Eisner] acted in accordance with his fiduciary duties and in good faith when he terminated [Ovitz].

Id.

58. 867 A.2d 904, 955 (Del. Ch. 2004).

court eventually decided the case in the defendant's favor on summary judgment.[59] On appeal, however, *In re Abbot* has been reversed and remanded and the district court will have the chance again to see the case proceed toward trial or end on summary judgment.[60] Proceeding toward trial has been a lengthy and expensive process as the defendant's various pretrial motions have slowed down the trial process. Motions for a rehearing,[61] bifurcation of discovery,[62] and a hearing to address objections to a magistrate judge's ruling compelling discovery of certain documents[63] have all been made by the defendants, slowing the process toward trial and increasing the cost of litigation for both parties. Although in all three of these cases the outcome has been favorable to the plaintiffs at some intermediate point, if history is any guide, the ultimate outcomes will be uniformly disappointing. Thus, the practical effect of courts denying initial motions to dismiss has been that the plaintiffs have paid more lawyers' fees for unfavorable results. Winning a few minor battles simply cannot be seen as a true shift in paradigm when the outcome of the war remains the same.

1. Institutional Constraints of the Judiciary

Early speculation that the above cases were strong evidence of a shift in Delaware's judiciary toward a more stockholder-friendly model of corporate governance was misplaced. There is simply no hard evidence that Delaware's judiciary is, already has, or is poised to, increase its scrutiny of decisions made by corporate boards in the wake of recent corporate mismanagement. Continued stockholder abuse[64] by corporate managers suggests that any changes which have been made so far are insufficient to root out corporate wrongdoing. This failure, however, may not be the fault of the judiciary itself, but rather, of the paradigm within which the judiciary works.

The judiciary is the final arbiter of disputes. It inherently lacks the ability to prospectively change the rules which apply to our

59. *In re Abbott Labs.*, 325 F.3d at 798–99.

60. *Id.* at 811.

61. In re Abbott Labs. Derivative S'holders Litig., No. 01-1952, 2003 U.S. App. LEXIS 10628, at *1 (7th Cir. May 27, 2003).

62. In re Abbott Labs. Derivative S'holders Litig., No. 99 C 7246, 2003 U.S. Dist. LEXIS 16032, at *2 (N.D. Ill. Sept. 8, 2003).

63. In re Abbott Labs. Derivative S'holders Litig., No. 99 C 7246, 2004 U.S. Dist. LEXIS 5451 (N.D. Ill. March 29, 2004).

64. *See supra* note 3 and accompanying text.

system of corporate governance due to the doctrine of ripeness.[65] A prospective solution is necessary to stop corporate wrongdoing at its earliest stages before stockholders are defrauded and lose the value of their investments. Even if the judiciary (which oversaw the system of corporate governance that allowed for the Enron and WorldCom debacles),[66] could be trusted to achieve meaningful reform, it could not achieve this without first allowing more wrongs to occur. Reliance on the judiciary as a vehicle for achieving corporate reform is simply inefficient.

Reliance on a reactionary judiciary to achieve corporate governance reform would create other problems as well. *Ex ante* certainty would be undermined if judicial opinions, which should achieve finality and thus certainty for our system, change at the demands of the public or other constituencies.[67] Delaware has not always been a perfect model of *ex ante* certainty, and the tendency of Delaware courts to change their interpretations of the law has led some scholars to suggest that Delaware law is indeterminate in certain areas. For example, one such scholar suggested that "Delaware courts are famous for announcing new standards of conduct, while claiming that such standards have always existed."[68] Evidence that Delaware courts do not produce perfect *ex ante* certainty, however, does not mean that Delaware would not be harmed if the judiciary further exacerbated this problem.

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65. *See* Gene R. Nichol, Jr., *Ripeness and the Constitution*, 54 U. CHI. L. REV. 153, 153, 155, 161 (1987) (elaborating on the "case or controversy" requirement in Article III of the Constitution and explaining that the ripeness doctrine is essentially part of "actionability analysis"—that is, a determination of "whether a litigant has stated a claim on which relief can be granted"); *see also* Harold J. Krent, Laidlaw*: Redressing the Law of Redressability*, 12 DUKE ENVTL. L. & POL'Y F. 85, 92–93 (2001) (noting that "causation and redressability constitute independent requirements a litigant must meet to satisfy standing under Article III"). Properly understood, the doctrine of ripeness simply restricts parties from filing claims when they have not yet suffered a concrete harm.

66. Although neither Enron nor WorldCom were incorporated within the state of Delaware, any argument that Delaware's system of corporate governance is not implicated by the scandals would ignore the reality of our national system of corporate governance. Virtually all states have established enabling statutes that follow Delaware's lead, and most other state courts look to Delaware for legal precedent with respect to corporate law. Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85, 87 (1990) (referring to Delaware law as "our national corporate law"); Jones, *supra* note 11, at 654 n.200.

67. *See, e.g.*, Peter J. Henning, *Corporate Law After the Eighties: Reflections on the Relationship Between Management, Shareholders, and Stakeholders*, 36 ST. LOUIS U. L.J. 519, 524–25 (1992) (discussing the trend of Delaware courts during the 1980s and stating that the judiciary began the decade by questioning the breadth of the business judgment rule as it applied to managerial choices, yet later eroded stockholders' "protection from management's defensive tactics aimed at defeating hostile offers and preventing future unwanted advances").

68. Jones, *supra* note 11, at 645, 645 n.126.

Reliance on the judiciary for corporate reform essentially transforms judges into legislators. Notwithstanding one commentator's observation that there are "extremely and unusually close links between the Delaware Legislature and the judiciary," the line between the two should not be further blurred.[69] Allowing judges to assume a legislative role is unsound because the judiciary is insulated from the political process. The judiciary is an anti-majoritarian body and is appointed, rather than elected.[70] It is fundamental to our system of government that the people of our nation elect those who make the law.[71] This is true at both the national and state levels where the political process serves as a check on the powers of our lawmaking bodies. To entrust the judiciary with the task of reforming our system of corporate governance is to entrust it with a task for which it is ill-equipped and not intended to fulfill. Additionally, changes made by the judiciary which are initiated due to popular pressure could easily be reversed when the political winds subside. It follows that reform involving the judiciary should be limited to instances when the court's actions are benign, removing obstacles or interpreting existing statutes in a manner that will allow other corporate actors to act as permanent checks to corporate wrongdoing. Such change would not rely on the judiciary to *make* law, only to enforce it.

B. Response of Delaware's Legislature to Corporate Scandals After 2001

To date, Delaware's legislature has done very little to prevent the reoccurrence of the abuses that caused the Enron and WorldCom scandals. The largest change to corporate law instituted by Delaware's legislature was a series of laws passed in 2003 that expanded the Chancery Court's jurisdiction to assist some classes of plaintiffs in bringing actions against officers of corporations.[72] A simple channeling of more lawsuits into the judiciary, however, cannot achieve meaningful corporate reform because simply allowing more lawsuits to begin suffers from the same procedural and institutional defects described in the previous section. The new laws further

69. Rafael A. Porrata-Doria, Jr., *The Proposed Pennsylvania Business Corporation Law: A Horse Designed by Committee*, 59 TEMP. L.Q. 437, 442 (1986).

70. Randy J. Holland & David A. Skeel, Jr., *Deciding Cases Without Controversy*, 5 DEL. L. REV. 115, 121 (2002).

71. *See* Sosa v. Alvarez-Machain, 542 U.S. 692, 750 (2004) (Scalia, J., concurring).

72. Jones, *supra* note 11, at 644 n.115 (citing 18 CORP. COUNS. WKLY. 185, 185–86 (June 18, 2003)).

entrench a reactionary system designed to punish past deeds and only theoretically to deter future ones; the laws fail to provide a corporate constituency with the ability to prevent mismanagement as it occurs. In short, Delaware's legislature has taken a passive role, bolstering the judiciary's ability to hear cases while leaving in place the legal framework which led to corporate disasters.

III. INCREASED STOCKHOLDER OVERSIGHT

Structural deficiencies of the judiciary and lack of action by Delaware's legislature should prompt corporate reformers to seek alternative avenues of change. Because of the lack of permanence of common law and the prevalence of corporate lobbyists who could erect barriers to new legislation,[73] true corporate reform is most likely to occur only in the absence of continued reliance on the judiciary or massive new legislation. Such reform remains necessary despite passage of the Sarbanes-Oxley Act because the Act is deficient in the same way as the modestly changed Delaware corporate law. Specifically, the Act fails to alter the corporate-stockholder relationship and focuses reform on increased monitoring and enhanced punishment for abuse of that relationship.[74] Generally speaking, recent reform both from Delaware and the federal government is not a step in a new direction, but more of the same. Instead of altering pecuniary incentives for the stockholder and the manager, recent reforms introduce a larger role for government monitoring of private interests, seeking to appease the stockholder by appearing to frighten the corporate manager into compliance with the law.

Unfortunately, these reforms address only one side of the equation, wholly ignoring the potential role of the stockholder in corporate monitoring. Instead of untying the hands of stockholders who are prevented, often statutorily, from monitoring corporate management, reforms such as Sarbanes-Oxley and recent Delaware legislation[75] have only increased the "surveillance and control of the market and the firm by government in the name, and on behalf, of the

73. *See, e.g.*, Steven P. Croley, *Public Interested Regulation*, 28 FLA. ST. U. L. REV. 7 (2000) (discussing the general workings of government regulation and the role interest groups play in shaping most legislation).

74. *See* Sarbanes-Oxley Act of 2002, *supra* note 32, at tits. I, II, and IV (discussing the enhanced disclosure requirements); *id.* at tits. III, VII, IX, and XI (discussing enhanced "responsibilities" and new liability attached to corporate wrongdoing).

75. *See* Sarbanes-Oxley Act of 2002, *supra* note 32; *see also* Jones, *supra* note 11, at 644 n.115 (citing 18 CORP. COUNS. WKLY. 185, 185–86 (June 18, 2003)).

private stakeholders traditionally charged with the development and protection of their economic arrangements."[76]

Our system of corporate governance should not continue to substitute government oversight (federal or state) for stockholder oversight since it is the stockholder who suffers discrete and personal harm from corporate mismanagement. The corporate-stockholder relationship's equilibrium, as it existed prior to Sarbanes-Oxley and the recent changes to Delaware law, allowed for some of the most far-reaching corporate scandals in modern times.[77] Yet, neither federal nor state government reform has directly altered the nature of the relationship. At best, recent reforms alter the corporate-stockholder relationship indirectly by increasing penalties for abuse of the relationship. Corporate scandals subsequent to recent legislation[78] suggest that only minimal protection is afforded to stockholders through the indirect realignment of their relationship with corporate management.

A new direction should be explored to achieve corporate reform: realignment of the corporate-stockholder relationship by taking some of the responsibility for monitoring corporate management from the government and placing it with stockholders. The effectiveness of changing this relationship lies in the ability to harness stockholders' existing incentives. Because stockholders have unique and personal financial interests at stake in a given corporation, their interests are best served by protecting the intrinsic value of the individual corporations in which they hold stock. An approach allowing stockholders to tighten corporate governance for individual corporations has the potential to do what modern reform has failed to do: establish a system of corporate governance that stops corporate wrongdoing in its infancy before it can destroy a corporation.

Realigning the actual corporate-stockholder relationship will also internalize the costs of monitoring corporate management to those persons who decide it is in their best interests to do so. Internalization of costs would not be a goal of restructuring the corporate-stockholder relationship, but an added benefit. The real goal would be to increase the probability of preventing corporate mismanagement by moving from a model dominated by government monitoring to a model that includes increased stockholder oversight.

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76. Larry Catá Backer, *Surveillance and Control: Privatizing and Nationalizing Corporate Monitoring After Sarbanes-Oxley*, 2004 MICH. ST. L. REV. 327, 328.

77. *See supra* note 3 and accompanying text.

78. *Id.*

A. *Increased Monitoring Through Disclosure and Sharing of Information*

In an article exploring shareholder monitoring of corporate management, Professor Randall Thomas stated that "two predicates to effective shareholder monitoring are that dispersed investors have information about the companies they invest in and that they can communicate this information to other investors so that they can act collectively."[79] Corporate managers who are hostile toward stockholders seeking information from the corporation, however, have too many tools to prevent the disclosure of corporate information.[80] Use of these tools exposes the relative inequality in bargaining power that exists between corporate management and its stockholder constituency. Although it is necessary and desirable for corporations to deny stockholder access to some types of information (such as, trade secrets),[81] expanded access to corporate information for stockholders is a necessary predicate to effective monitoring of corporate management. Expanded access to corporate records may be achieved either by enlarging the actual set of documents that a stockholder may review or by facilitating disclosure of information to stockholders who have the right to review corporate records. The remainder of this Note focuses on taking one modest step toward accomplishing the latter method.

Legislation aimed at realigning the corporate-stockholder relationship by increasing stockholder access to corporate information would probably be met with stiff resistance from corporate interest groups. In order to minimize institutional resistance from such interest groups, therefore, expanding stockholder access to corporate information would be best accomplished through the judiciary. Yet, for the same reasons discussed above, change accomplished via the judiciary would suffer from the same defects inherent in any common law doctrine: namely, lack of certainty with regard to the permanence of changes.[82] This concern could be mitigated if the judiciary were to rest its decision to increase stockholder access to corporate

79. Randall S. Thomas, *Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information*, 38 ARIZ. L. REV. 331, 331 (1996).

80. *Id.* at 332 (stating that corporate managers "can cut off [shareholder] access to certain information" when management is hostile to the ideas that shareholders are proposing).

81. *Id.* at 364 n.177 (noting that an examination of the history of shareholder access to corporate information makes it clear that "the corporation's interests in preserving trade secrets and other valuable information from disclosure to competitors suggest that some mechanism must be incorporated to stop rogue shareholders from blackmailing and harassing the company").

82. *See supra* note 68 and accompanying text.

information on the plain meaning of the text of a statute already designed to allow stockholder access to certain corporate information. The concern of non-permanency would be mitigated to the extent that the statutory language employed has not yet been interpreted by the judiciary.

B. Delaware General Corporate Law Section 220

Delaware General Corporate Law Section 220 ("section 220"), entitled "Inspection of Books and Records," is the principal statute with which Delaware's judiciary determines the breadth of a stockholder's access to corporate information. Section 220 allows stockholders "to obtain two types of information from recalcitrant managers: the corporation's stocklist and its books and records."[83] Access to a stocklist is essential for stockholder-to-stockholder communication because it is the vehicle that allows stockholders to identify and communicate with one another; thus, it enables collective action. Access to books and records is the primary vehicle used by a stockholder "seeking to uncover corporate mismanagement or fraud [who] may need access to the company's internal files" to obtain such information.[84] Books and records obtained pursuant to section 220 are vital in enabling stockholders to effectively monitor corporate management. Indeed, one scholar noted the Supreme Court's suggestion that "corporate frauds may only be discoverable through the examination of corporate records by shareholders."[85]

A stockholder in a corporation, however, does not have *carte blanche* to inspect all the books or records of a corporation pursuant to section 220. Stockholders seeking corporate books and records bear the burden of proving that they are entitled to the documents they desire to inspect.[86] "This burden is not insubstantial, and 'mere curiosity or a desire for a fishing expedition will not suffice.'"[87] Stockholders must demonstrate that they have a "proper purpose" in order to avail themselves of section 220, which means "a purpose reasonably related to such person's interest as a stockholder."[88] "In determining the scope of inspection relief, the overriding principle is

83. Thomas, *supra* note 79, at 332.

84. *Id.* at 333.

85. *Id.* at 333 n.10 (citing Guthrie v. Harkness, 199 U.S. 148, 155 (1905)).

86. *See, e.g.*, Thomas & Betts Corp. v. Leviton Mfg. Co., 681 A.2d 1026, 1031–32 (Del. 1996).

87. Mattes v. Checkers Drive-In Rests., Inc., C.A. No. 17775, 2001 Del. Ch. LEXIS 47, at *13 (Del. Ch. Mar. 28, 2001) (quoting Sahagen Satellite Tech. Group, LLC. v. Ellipso, Inc., 791 A.2d 794 (Del. Ch. 2000)).

88. Del. Code Ann. tit. 8, § 220(b) (2006).

that only those records that are 'essential and sufficient' to the shareholder's purpose will be included in the court-ordered inspection."[89] Although courts have used section 220 to allow independent stockholder investigation into potential mismanagement in limited circumstances,[90] the judiciary's use of section 220 seems to be focused on its usefulness in the context of litigation.

Notwithstanding section 220's potential use as a mechanism to discover and rectify corporate fraud independent of litigation, Delaware's courts seem to view section 220 as little more than a tool for drafting a well-pleaded complaint. Delaware's supreme court has stated that "[s]tockholders have a right to at least a limited inquiry into books and records when they have established some credible basis to believe that there has been wrongdoing. In fact, a Section 220 proceeding may serve a salutary mission as a prelude to a derivative suit."[91] Again, section 220's use seems litigation-focused. Section 220 is often referred to as merely a "tool at hand" to be utilized to meet the heightened pleading requirements of Court of Chancery Rule 23.1, applicable to derivative actions.[92] Delaware courts refer plaintiffs to section 220 after determining that their pleadings were insufficient with such frequency that the Supreme Court of Delaware has stated that it is the public policy of the state "to encourage stockholders to utilize Section 220 before filing a derivative action . . . ."[93]

The judiciary's hope that section 220 will be utilized to craft well-pleaded complaints is understandable. Yet, in their exuberance to see that section 220 is employed to this end, Delaware courts have inadvertently and unnecessarily limited the scope of its application. Courts focus too much on its usefulness to solve the problem of remedying complaints that are not well-pleaded and ignore other potential uses of section 220 that may be equally as valuable to stockholders.

The statutory language of section 220 is broad enough to allow courts to moderate an imbalance in the corporate-stockholder

89. Helmsman Mgmt. Servs., Inc. v. A & S Consultants, Inc., 525 A.2d 160, 167 (Del. Ch. 1987) (quoting Neely v. Okla. Publ'g Co., No. 5293 (Del. Ch. Aug. 15, 1977), *reprinted in* 3 DEL. J. CORP. L. 126, 139, 142 (1977)).

90. *See, e.g.*, Nodana Petroleum Corp. v. State *ex rel.* Brennan, 123 A.2d 243 (Del. 1956) (affirming a decision granting a stockholder the right to investigate a company's books and records to uncover potential improprieties of management).

91. Sec. First Corp. v. U.S. Die Casting & Dev. Co., 687 A.2d 563, 571 (Del. 1997) (footnote omitted).

92. Disney v. Walt Disney Co., 857 A.2d 444, 448 (Del. Ch. 2004).

93. Freund v. Lucent Techs., C.A. No. 18893, 2003 Del. Ch. LEXIS 3, at *13 (Del. Ch. Jan. 9, 2003) (citing Grimes v. Donald, 673 A.2d 1207, 1218 (Del. 1996); Scattered Corp. v. Chi. Stock Exch., 701 A.2d 70, 78 (Del. 1997)).

relationship. Just as stockholders have the right to sue a corporation, they also have the right to sell their stock or to use their voting power.[94] Relegating the role of section 220 to serve only as a pleading tool is unnecessarily restrictive because it does not further the stockholder's rights to sell or vote. Still, even when courts recognize a stockholder's right to inspect books and records independent of litigation, the courts fail to recognize the breadth of that interest. Certainly a stockholder may have an interest in maintaining the value of his or her investment. Just as certainly, stockholders may accomplish this by using their power to vote. Courts seem to forget that stockholders could benefit from using section 220 in a manner that does not involve the courtroom. If Delaware courts began construing section 220 in a manner that enabled stockholders to gain information about corporations so that they could exercise their rights to sell or vote, section 220 would have greater potential to protect the value of stockholder investments. It could actually be used as a tool to stop corporate mismanagement.

C. Would Stockholders Use Section 220 to Monitor Corporate Managers?

A broader application of section 220 is premised upon the assumption that stockholders will capitalize on enhancements in their ability to monitor corporate managers. Today, institutional stockholders hold a majority of the shares in most large public companies.[95] "This concentrated ownership gives [institutional investors] significant potential power over these corporations" and additional incentive to monitor corporate management.[96] Still, recent scholarship casts doubt on the ability, and perhaps the desire, of institutional investors to become "corporate watchdogs." A major reason for this is that they may "not want the constraints that would undoubtedly come with an increased role in managerial monitoring."[97] One example of a constraint that an institutional investor may want to avoid is the potential of being labeled an insider which would preclude it from freely trading on a corporation's stock. Although this

94. Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue*, 62 LAW & CONTEMP. PROBS., Summer 1999, at 215, 215–16.

95. Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 91 n.52 (2003) ("[I]nstitutions own approximately sixty-six percent of the outstanding shares of S&P 500 companies as of January 2003.").

96. *Id.* at 91.

97. *Id.* at 78.

notion has analytical weight, many institutional investors invest in corporations with views towards the long-term performance of a corporation's stock,[98] rebutting the notion that liquidity is a major concern.

Institutional investors that hold their investments for long-term gains can only be made better off by expanded access to corporate information. Greater access increases their ability to monitor corporate management. The fact that *some* institutional investors value the liquidity of a portion of their holdings is no excuse to deny *all* institutional investors expanded access to corporate books and records. Critics may also point to the historical reluctance of institutional stockholders to perform monitoring activities[99] as evidence that these stockholders are not interested in, or capable of, an increased monitoring role. Such criticism, however, is inherently flawed—it is much like looking at a dog in a cage and concluding that the dog does not want to get out because it is not actively trying to break free. While some dogs may be happy to stay in their cages, others forego the wasted energy of attempting to break out because they are smart enough to realize they are hopelessly boxed in. Understanding the restraints that currently bind stockholders who seek to monitor corporate management could explain their perceived reluctance to monitor corporate management. A particularly strong restraint placed on stockholders relates to inter-stockholder communication.

Improvement in the way that stockholders communicate with each other is not easy to achieve. In fact, there have been no real changes since 1992, when "the SEC adopted a wide range of proxy rules and other amendments designed to enhance shareholder communications, both amongst shareholders and between shareholders and companies."[100] The SEC's changes have had a limited impact on stockholder communications.[101] The lack of further innovation to increase the ability of institutional stockholders to communicate with one another, especially with respect to sharing information obtained pursuant to section 220, could explain the

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98. *See* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 468 n.73 (1991).

99. Thomas J. André, Jr., *Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany*, 73 TUL. L. REV. 69, 147 (1998) (stating that institutional investors rarely use the avenues available to them to affect the governance of corporations, especially to replace a board of directors).

100. Lipton & Rosenblum, *supra* note 95, at 91.

101. Bernard S. Black, *Next Steps in Proxy Reform*, 18 J. CORP. L. 1, 9 (1992) (stating that the 1992 amendments to proxy rules are "limited in scope" and affect only certain classes of stockholders).

reluctance of institutional investors to involve themselves in monitoring corporate management. Without the ability to share information discovered pursuant to section 220 with other stockholders, investors are often left powerless to effectuate changes necessary to rectify corporate wrongdoing if it is discovered.

If an institutional investor obtains information pursuant to section 220 that would be useful in making a determination that a certain board member should be replaced, that investor is placed in a difficult position under the current framework. Unless that single investor holds a majority of the voting power in the corporation, the investor must be able to communicate that information to other stockholders in order for the information to be of value. In the absence of a mechanism allowing such communication, the incentives of a stockholder to monitor corporate management are eviscerated and a stockholder's best option may be to sell his or her investment in a corporation upon discovery of the mismanagement. Yet, inability to sell one's stock attaches once one acquires material inside information.[102] Furthermore, an institutional investor may also have pecuniary disincentives to dump large blocks of stock in a short period of time because such action may trigger a fire-sale, which will in turn diminish the value of its holdings in the company that it was unable to sell initially.

Significant restrictions on the ability of stockholders, including institutional stockholders, to communicate information obtained from a corporation with each other prevent effective corporate monitoring. These restrictions are an unnecessary obstacle built into our system of corporate governance that tilts the balance in the corporate-stockholder relationship too far in management's favor. The remainder of this Note will suggest one way in which our system of corporate governance may be reformed in order to realign a portion of the corporate-stockholder relationship by removing barriers to certain stockholder communication.

IV. DELAWARE'S OPPORTUNITY TO INCREASE STOCKHOLDER MONITORING

Increased stockholder access to corporate records and increased stockholder input in management functions is by no means a novel

102. *See* Lacey S. Calhoun, *Moving Toward a Clearer Definition of Insider Trading: Why Adoption of the Possession Standard Protects Investors*, 32 U. MICH. J.L. REFORM 1119, 1121 (1999) (reviewing when liability attaches under SEC Rule 10b-5 and stating that "an insider selling stock in his corporation is liable under the possession standard [of 10b-5] if he is shown simply to have possessed material inside information at the time of [a] trade").

solution to reforming our system of corporate governance.[103] In fact, one recent rule proposal by the SEC[104] contemplated increased stockholder input by including board election contests in a corporation's proxy.[105] This proposal was met with stiff resistance. After the SEC announced the proposed change, the public commenting period was dominated by negative input from powerful lobbying forces.[106] Commentators also mostly disapproved.[107] Major arguments against allowing stockholders to hold election contests through a company's proxy include: (1) costs to the corporation (both temporal and pecuniary) associated with contested elections; (2) deterrence of qualified individuals from serving on boards; (3) questionable character and qualifications of stockholder nominees; and (4) the possibility of "balkanizing" the board.[108] Though allowing for board election contests is analytically distinct from allowing section 220 to be used in conjunction with a proxy solicitation, the structural similarity between the two proposed reforms means that some of the criticisms leveled against the proposed rules change may also be leveled against the proposal outlined in this Note.

Proposals seeking to achieve corporate governance reform through a realignment of the corporate-stockholder relationship should be structured to avoid costing corporations on their bottom line and eroding the quality or effectiveness of board members. In light of these concerns, one way to achieve corporate governance reform is by providing corporate stockholders with a tool allowing them to communicate with each other during the proxy solicitation process. Such a tool could be used to share information gleaned from a corporation as a result of a stockholder's right to inspect the books and

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103. *See, e.g.*, Thomas, *supra* note 79, at 331 (focusing on reforming inspection statutes, especially for institutional shareholders); John A. Matheson & Brent A. Olson, *Corporate Cooperation, Relationship Management, and the Trialogical Imperative for Corporate Law*, 78 MINN. L. REV. 1443, 1446 (1994) (discussing ways to reform the structure of corporate governance so as to include shareholder input into important management functions).

104. Proposed Rule: Security Holder Director Nominations, Sec. & Exch. Comm. (proposed Oct. 14, 2003) (to be codified at 17 C.F.R. pts. 240, 249, and 274), *available at* http://www.sec.gov/rules/proposed /34-48626.htm.

105. Lipton & Rosenblum, *supra* note 95, at 67.

106. *See, e.g.*, Letter from Jerry W. Powell, Compass Bancshares Inc., to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm. (Dec. 18, 2003), http://www.sec.gov/rules/proposed/s71903/compassbanc122203.htm (last visited May 31, 2006); Letter from Michael J. Holliday, N.Y. State Bar Ass'n, to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm. (June 13, 2003), http://www.sec.gov/rules/other/s71003/scrblsnysba061303.htm (last visited May 31, 2006).

107. *See* Usha Rodrigues, *Let the Money Do the Governing: The Case for Reuniting Ownership and Control*, 9 STAN. J.L. BUS. & FIN. 254, 267 (2004) (collecting and discussing the major criticisms of the proposal).

108. *See id.*

records of a corporation under section 220. A recent case from the Chancery Court of Delaware provided the judiciary with an opportunity to realign this very narrow aspect of the corporate-stockholder relationship in exactly such a manner.[109] Unfortunately, when faced with an opportunity to shift the balance of the corporate-stockholder equilibrium, the Court of Chancery decided to make it even more difficult for stockholder constituencies to prevent corporate wrongdoing through the use of section 220.

A. Disney *Case Study*

In a branch of the well-known Disney litigation[110] ("*Disney*"), Delaware's Chancery Court was presented with a plaintiff's request to apply section 220 in a slightly non-traditional manner.[111] Roy E. Disney, the plaintiff, was unhappy with certain decisions made by the board of directors with respect to the severance package given to Disney's former president, Michael Ovitz.[112] Out of his concern over the severance package, Mr. Disney sought access to corporate books and records pursuant to section 220 "to investigate possible mismanagement, waste of corporate assets, improper influence or conduct, improper conflicts of interest between directors and officers and the Compensation Committee and lack of due care."[113] Although the Walt Disney Company did not object to Mr. Disney's purpose for seeking the requested information, it insisted "that Mr. Disney agree to a form of confidentiality agreement that would permit the Company to designate broad categories of non-public information as 'confidential' and would prohibit [him] from publicly disseminating any 'confidential' information."[114] This prohibition was categorical and applied to the general public and stockholders alike.

Mr. Disney objected to the breadth of the proposed confidentiality agreement and initiated litigation when the parties could not agree on its scope.[115] Thereafter, the parties came to an understanding "that did not limit the Company's ability to designate documents as 'confidential,'" but "permitted Mr. Disney to challenge the Company's designations" in the Court of Chancery if the parties

109. In Re Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003).

110. *Id.*

111. Disney v. Walt Disney Co., 857 A.2d 444, 445 (Del. Ch. 2004).

112. *See id.*

113. *Id.*

114. *Id.* at 446.

115. *Id.*

could not resolve their disagreements.[116] Acquiescing to this confidentiality agreement was the only way that Mr. Disney could obtain access to Disney's books and records without continuing lengthy and costly litigation focused on the scope of the confidentiality agreement.

Not surprisingly, prior to Mr. Disney's inspection, the Disney Company designated nearly two hundred of the six hundred pages it produced pursuant to section 220 as "confidential."[117] Items which were deemed confidential included "performance evaluations, documents reflecting the board's deliberative process and non-public financial targets established for a tax-qualified compensation plan."[118] Mr. Disney objected to the company's designation of many of these documents as confidential. To obtain relief, he applied to the Court of Chancery which ruled that Mr. Disney was not entitled to relief from the confidentiality agreement.[119] While reviewing Mr. Disney's case the court purportedly set out a new standard for reviewing claims for "relief from a Section 220 confidentiality agreement in the context of an active proxy solicitation."[120] After stating that the court was not aware of a decision discussing the standard to apply in such a situation, the court stated:

> [I]t can be assumed that the burden on the [party seeking to cancel the confidentiality agreement] would be heavy. For example, the person seeking relief will be required to show a likelihood that disclosure of information designated "confidential" is needed to prevent the corporation's proxy materials from being false and misleading in some material respect, or equally compelling circumstances.[121]

In pronouncing this standard, the Chancery Court essentially held that a stockholder seeking to cancel a confidentiality agreement entered into pursuant to section 220 must meet a hurden strikingly similar to the one applied to stockholders who seek to penalize a corporation for violation of Rule 14a-9 of the Securities Exchange Act of 1934 ("Rule 14a-9" or "14a-9").[122] Rule 14a-9 states that no proxy solicitation shall be made which is "false or misleading with respect to any material fact . . . ."[123] In essence, the court decided that for a stockholder to share information obtained pursuant to section 220 with any party, *even a similarly situated stockholder who is*

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116. *Id.*
117. *Id.*
118. *Id.*
119. *Id.* at 449.
120. *Id.*
121. *Id.*
122. 17 C.F.R. § 240.14-a-9 (2006).
123. *Id.*

presumably entitled to the same information, the stockholder must first show that the information obtained pursuant to section 220 is sufficient to prove a violation of securities law.

The *Disney* court announced a tremendously strict standard for canceling a section 220 confidentiality agreement to share information during an active proxy solicitation. As such, it missed an opportunity to achieve meaningful reform to our system of corporate governance by failing to move the corporate-stockholder relationship into more of a balanced state. Moreover, the court ignored the potential role of institutional investors in today's market and their ability to serve as a check on corporate mismanagement if able to effectively communicate with one another.

B. Rule 14a-9's Application to Section 220 Confidentiality Agreements

Rule 14a-9 under the Securities Exchange Act of 1934 states, in part:

> No solicitation subject to this regulation shall be made by means of any proxy statement . . . containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading . . . .

Under this rule, the corporation, as the issuer of the proxy, is directly liable for materially misleading proxy statements.[124] A statement is considered material if "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[125] "Individual directors can also be liable personally if they participated sufficiently" in drafting the proxy statement.[126] To recover damages under 14a-9, a plaintiff must make a very difficult showing of causation: the misleading statement in the proxy must "link[] a directors' proposal with the votes legally required to authorize the action proposed."[127]

There are at least two major problems with applying the 14a-9 standard to a stockholder seeking to cancel a confidentiality agreement entered into pursuant to section 220. First, doing so restricts the scope of what a stockholder may share with another stockholder to information related to what the corporation included

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124. Gould v. Am. Hawaiian S.S. Co., 331 F. Supp. 981, 998 (D. Del. 1971).

125. *See* TSC Indus., Inc., v. Northway, Inc., 426 U.S. 438, 449 (1976).

126. Arnold v. Soc'y for Sav. Bancorp, Inc., 678 A.2d 533, 539 (Del. 1996) (citing Salit v. Stanley Works, 802 F. Supp. 728, 733 (D. Conn. 1992); Wilson v. Great Am. Indus., Inc., 855 F.2d 987, 995 (2d Cir. 1988)).

127. Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991).

within its proxy statement. In other words, because the corporation controls what it puts in its proxy, the corporation would also control when a stockholder could use information obtained pursuant to section 220 to alert other stockholders to corporate wrongdoing. Second, due to the remedial framework of 14a-9, the standard simply does not allow a stockholder to disseminate information he or she knows is misleading to other stockholders before they are deceived by a misleading proxy statement.

There are a host of issues a stockholder could uncover pursuant to section 220 which would never find their way into a corporation's proxy statement because the subject matter is simply not pertinent to a stockholder vote. The power to set compensation levels,[128] among other things,[129] is within the authority of the board of directors and is generally not subject to stockholder approval. Mishandling of activities that do not require stockholder approval may be relevant to a stockholder's decision to exercise his right to elect certain board members or acquiesce to a proxy solicitation. Because information germane to board actions, which do not require a stockholder vote, would not appear on a proxy solicitation, applying a 14a-9-like standard is inapposite. Since corporations have total control over the subject matter of a proxy solicitation, they can dictate when and if potentially negative information uncovered via section 220 will be disseminated to other stockholders. For example, if a corporation solicited proxies for an election of its board of directors, and, pursuant to section 220, a stockholder uncovered negative information about a board member's actions, the corporation could effectively block dissemination of that information by refusing to include in the proxy a misleading statement related to the wrongdoing. Under the framework set up in *Disney*, the information could not be disclosed to other stockholders through cancellation of a confidentiality agreement because the information would not satisfy 14a-9's requirements. This would be true even if the negative information were undisputed by the corporation.

Another reason why a 14a-9-like standard should not be applied to section 220 confidentiality agreements lies in a fatal procedural deficiency. On its face, rule 14a-9 is remedial in nature[130] and gives stockholders an implied cause of action against corporate

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128. Haber v. Bell, 465 A.2d 353, 359 (Del. Ch. 1983) (stating that "generally directors have the sole authority to determine compensation levels and this determination is protected by the presumption of the business judgment rule") (citations omitted).

129. *See generally* DEL. CODE ANN. tit. 8, §§ 122–123 (2006) (setting forth general and specific powers of a corporation).

130. *TSC Indus.*, 426 U.S. at 448.

managers or boards of directors when these managers or directors use their positions to issue false or misleading proxy statements. 14a-9 is a tool fashioned with the express purpose of remedying damages already caused by a false or misleading proxy solicitation. As a pragmatic reality, any remedial tool is incapable of preventing harm prospectively. Although a stockholder could possibly obtain an injunction to stop a proxy solicitation after he had received it, this would require litigation. Worse still, the 14a-9-like standard leaves stockholders powerless to stop the dissemination of false information because they have no opportunity to review a corporation's proxy statement before it is sent to stockholders.

The court in *Disney* did not elaborate on the possible justifications for the stringent standard of review applied when stockholders seek to cancel a confidentiality agreement entered into pursuant to section 220 in the context of an active proxy solicitation. Application of the standard seems to be based on several false premises. First, it seems that the court applied general contract principles which require mutual agreement on the part of the contractors in order to modify a contract.[131] Although the rule is sound in the abstract, it ignores the realities stockholders face when entering confidentiality agreements pursuant to section 220.

As the *Disney* case illustrates, stockholders often enter into confidentiality agreements as a result of a gross imbalance in bargaining power.[132] Stockholders acquiesce to overbroad confidentiality agreements because without entering a confidentiality agreement, corporations may deny access to the records altogether, unless stockholders sue to enforce such a right. Asymmetrical information between a corporation and its stockholders works against a stockholder's willingness to spend the time and money necessary to bring litigation. The corporation possesses all company information and is therefore best able to judge the relative value of that information. Consequently, corporations can accurately estimate what it is worth to protect certain information and make litigation decisions accordingly. Corporations naturally will refuse to allow inspection of books and records under section 220 unless a stockholder acquiesces to a confidentiality agreement broad enough to allay any concerns the corporation may have about revealing potentially

131. *See, e.g.*, Christine Jolls, *Contracts as Bilateral Commitments: A New Perspective on Contract Modification*, 26 J. LEGAL STUD. 203, 204 (1997) ("The prerogative of contractors to modify their original contract by mutual agreement is an article of faith for contract law.").

132. Disney v. Walt Disney Co., 857 A.2d 444, 446 (Del. Ch. 2004) (detailing Mr. Disney's litigation, which was dropped in order for him to gain access to books and records pursuant to section 220).

damaging information. Thus, corporations may conceal information that reveals corporate mismanagement by constraining the dissemination of such information to other stockholders. Essentially, confidentiality agreements force each individual stockholder to incur the costs of discovering the information.

If a stockholder cannot share information obtained via section 220 with other stockholders so as to bring about collective action, the stockholders' power to use their vote to make changes to a corporation is nullified; the stockholders' only remaining options are to sue or sell their holdings in the corporation. The high burden *Disney* placed on a stockholder seeking to cancel a confidentiality agreement entered into pursuant to section 220 will discourage stockholders from correcting problems they may discover within a corporation and encourages these same investors to simply sell their stock to other investors. Such a course of action allows corporate mismanagement to continue unchecked even after its discovery.

It is true that a stockholder may litigate the scope of the confidentiality agreement, but the costs of such litigation serve as a natural deterrent to such action.[133] This is especially true because the stockholder does not know what information may or may not be available for inspection. But, as the court stated in *Disney*, a court determining whether a confidentiality agreement should be honored will "begin[] its analysis with the presumption that the production of nonpublic corporate books and records to a stockholder making a demand pursuant to section 220 should be conditioned upon a reasonable confidentiality order."[134]

Although the presumption is a sound one, the court in *Disney* seems to start from the presumption that the confidentiality agreement was reasonable, rather than the presumption that the agreement *should be* reasonable.[135] This ignores the reality of the stockholder's choice when entering the agreement: agree to the corporation's terms or face the costs of litigation. As such, if stockholders agree to a confidentiality agreement without first litigating its scope, they run the risk of a court treating the confidentiality agreement as if it were a contract entered into willingly by equal parties. Just as the court did in *Disney*, a court may start with the presumption that the confidentiality agreement is reasonable and consequently require the party seeking to cancel the contract to justify the cancellation. Such a standard of review allows corporations

133. *Id.* at 449.
134. *Id.* at 447.
135. *See id.* at 449.

to benefit from their greater bargaining power and full access to asymmetric information and works against collective action. Again, "two predicates to effective shareholder monitoring are that dispersed investors have information about the companies they invest in and that they can communicate this information to other investors so that they can act collectively."[136] When a 14a-9-like standard is applied to determine whether a section 220 confidentiality agreement can be cancelled, the latter predicate is undermined and collective action is made nearly impossible without resorting to litigation. In establishing this standard, the court in *Disney* ignored section 220's capacity to move toward a system of corporate governance where stockholders have the ability to monitor corporate governance.

C. *An Alternative View of Section 220 Confidentiality Agreements*

As noted above, when a court reviews a confidentiality agreement entered into under section 220 in the context of an active proxy solicitation, the court presumes the agreement was entered into pursuant to a reasonable confidentiality order.[137] A court could just as easily presume that a corporation's protection from dissemination of non-public information will not be diminished if a stockholder shares information obtained pursuant to section 220 with other stockholders in certain situations. For example, if the stockholder who obtains information pursuant to section 220 shares that information only with similarly situated stockholders agreeing to be bound by the same confidentiality agreement, the corporation's protection should not be compromised. This is so because similarly situated stockholders possess the same pecuniary incentives to prevent corporate mismanagement. In effect, a court could read an implied waiver into the confidentiality agreement entered into by the corporation, which is justified because a corporation should not be able to treat similarly situated stockholders differently with respect to the dissemination of section 220 information. Determining if one stockholder is similarly situated to another, then, would become a task of great importance.

There are various measurements a court could use to determine whether one stockholder is similarly situated to another. Most obviously, a court could compare the amount or value of stock that each stockholder possesses. If the stockholders possess an amount within a specified range, the court could conclude that they are similarly situated. Another way for a court to determine which

136. Thomas, *supra* note 79, at 331.

137. *Disney*, 857 A.2d at 449.

stockholders should be able to enter the same confidentiality agreement would be by setting an ownership floor—a minimum amount of stock a party must own to be privy to any information obtained pursuant to section 220. An additional requirement could be comparison of the ratio of the value that the stock in question represents to each stockholder's entire portfolio of assets. This requirement would ensure that large institutional investors whose stake in a given corporation may be insignificant as to them actually possess similar pecuniary incentives as the stockholder who entered into the original confidentiality agreement pursuant to section 220.

As an alternative to reading an implied waiver into a confidentiality agreement, courts could conclude that any confidentiality agreement which does not contain a clause allowing for stockholders to share information obtained pursuant to section 220 with similarly situated investors (who are willing to enter the same confidentiality agreement) is sufficient evidence, or at the very least strong evidence, to rebut the presumption that the agreement was reasonable.[138] A court that took this approach would give the stockholder a better chance to prevail in a suit to set aside a confidentiality agreement entered into pursuant to section 220. This approach makes more sense than presuming that all section 220 confidentiality agreements are reasonable because it takes into account the inequality in bargaining power inherent in the corporate-stockholder relationship.

Trade secrets, corporate strategies, management practices, and the like are all important pieces of information that could damage a corporation if parties inimical to the well being of the corporation were to obtain them. None of these interests would be implicated by a stockholder sharing evidence of corporate mismanagement obtained pursuant to section 220 with another stockholder during an active proxy solicitation for the purpose of collective action against a board member. Allowing increased stockholder communication during an active proxy solicitation would be an extremely powerful tool in the hands of stockholders because it would allow them to withhold votes from board members who are implicated in mismanagement. Such a change would transform section 220 from a means of drafting a well-pleaded complaint into a tool useful to stop corporate mismanagement when it is discovered and to prevent it from perpetuating.

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138. *Id.* at 449 (stating that courts begin their review of requests to set confidentiality agreements aside with the presumption that the agreement is reasonable).

V. CONCLUSION

Our current system of corporate governance is in need of reform. Current legal scholarship is focused on reforming our system through reliance on (1) Delaware's judiciary or legislature, or (2) a new system of corporate federalism. Such avenues of reform are less efficient than those that empower corporate stockholders to root out corporate wrongdoing. One way of empowering stockholders would be to change the standard of review applied when a stockholder seeks to share information obtained pursuant to section 220 with other stockholders during an active proxy solicitation. Because such a change would involve overturning only one portion of a recent judicial opinion, implementing the reform is pragmatic and somewhat insulated from the political pressures applied to Delaware's governmental institutions. Further, such a move has the potential to shift the balance in the corporate-stockholder relationship to achieve a system that more closely resembles an equilibrium, in turn possibly preventing corporate wrongdoing *before* it destroys a corporation.

Delaware should empower stockholders to police corporate management by allowing stockholders to share information obtained pursuant to section 220 with other stockholders during an active proxy solicitation if the stockholders are: (1)similarly situated and (2) agree to enter the same confidentiality agreement with the corporation as the stockholder who petitioned the corporation for access to books and records under section 220. This change would help prevent corporate malfeasance by enabling stockholders to monitor corporate management and share information with other stockholders when it matters most—when a stockholder is about to yield their voting rights to another party. It is precisely during an active proxy solicitation, where collective action is most likely to occur, that our system of corporate governance should encourage dissemination of information to stockholders to which they are statutorily entitled.

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