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## Symbiotic Federalism and the Structure of Corporate Law

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# Symbiotic Federalism and the Structure of Corporate Law

Marcel Kahan\* & Edward Rock\*\*

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## INTRODUCTION

Enron. Worldcom. Adelphia. Global Crossing. Tyco. Corporate scandals have made the front pages. Congress has gotten in the act. Members have held numerous hearings, given speeches, and, ultimately, passed the Sarbanes-Oxley Act.<sup>1</sup> The Securities and Exchange Commission ("SEC") has been busy writing regulations and leaning on the stock exchanges to modify their listing requirements, all in order to restore "investor confidence." Federal prosecutors have indicted executives of Enron, Worldcom, and Adelphia and their minions in the auditing and investment banking industries.<sup>2</sup> State officials have also been active. Several states have passed statutes that resemble or go beyond the strictures of Sarbanes-Oxley.<sup>3</sup> Robert Morgenthau, the Manhattan District Attorney, has indicted the CEO and other officers of Tyco.<sup>4</sup> And New York Attorney General Eliot Spitzer has vastly increased his political standing by taking on the brokerage houses, perhaps following in the footsteps of Rudolf Giuliani, another renowned prosecutor of corporate criminals.<sup>5</sup> The leaders of corporate America have been galvanized to action, forming committees and task forces, issuing reports, and giving speeches.

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 stayed 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?

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1. Sarbanes-Oxley Act of 2002, 116 Stat. 745 (codified as amended at 15 U.S.C. §§ 7201 et seq. (2005)).

2. Editorial, "*Perp Walks*" and Watchdogs Can Thwart Corporate Crime, USA TODAY, July 9, 2004, at 10A.

3. Deborah Solomon, *Zealous States Shake Up Legal Status Quo*, WALL ST. J., Aug. 28, 2003, at A4 (noting that at least 20 states have passed or are considering their own version of the Sarbanes-Oxley Act, and that some of the laws are tougher than the federal regulations); Laura Mahoney, *New Laws Target Corporate Accountability, Conform Calif. Penalties to Sarbanes-Oxley*, 35 SEC. REG. & L. REP. (BNA) 1608 (Sept. 29, 2003) (describing new California law); Carolyn Whetzel, *Governor Signs Bill to Tighten Corporate Accounting Practices*, 34 SEC. REG. & L. REP. (BNA) 1446 (Sept. 2, 2002) (describing California measures going beyond those of Sarbanes-Oxley Act).

4. See News Release, District Attorney-New York County, Sept. 12, 2002, <http://www.manhattanda.org/whatsnew/press/2002-09-12.htm> (last visited Oct. 14, 2005) (announcing indictment of Tyco's former CEO, CFO, and Chief Corporate Counsel).

5. See, e.g., David Teather, *Attorney General Spitzer to Run for New York Governor*, THE GUARDIAN, Dec. 8, 2004, at 18 ("Eliot Spitzer, the campaigning New York attorney general who has made his name battling corruption on Wall Street, yesterday announced plans to run for state governor. Mr. Spitzer has risen to prominence by exposing some of the worst practices that took hold among investment banks during the dotcom boom of the late 1990s.").

In this Article, we take a step back from the recent scandals and the responses they have generated and ask some logically prior questions. What is the structure of corporate lawmaking in the United States? What is the relation between federal and state corporate lawmaking?<sup>6</sup> And how does that relationship shape the style and content of corporate law?

The relationship between federal lawmaking power and state—in particular Delaware—corporate law has become the focus of significant scholarly attention. In a recent article, Mark Roe has argued that, because of the possibility of federal intervention, most Delaware corporate law rules either mimic the rules favored by federal lawmakers or get preempted by federal law.<sup>7</sup> In Roe's world, states, and in particular Delaware, are basically federal implementation agents who enjoy little autonomy. Roe views the federal enactment of the Sarbanes-Oxley Act as the ultimate proof of his thesis, with the federal authorities "[d]ropping [p]retense" and "squelching the states with [their] own substantive law."<sup>8</sup>

Responding to Roe in an article contemporaneous to ours, Roberta Romano argues that states compete largely unimpeded by federal threats because states correlatively exercise control over Congress.<sup>9</sup> According to Romano, the key components of state corporate law—fiduciary duties and the allocation of authority between managers and shareholders—have not been changed by federal law.<sup>10</sup> The Sarbanes-Oxley Act is, at most, a fairly narrow exception as it arguably alters the allocation of authority only in its audit committee provisions.<sup>11</sup>

The articles by Roe and Romano represent the latest chapter of the classic state-competition debate in corporate law, where some scholars posit that federal regulation is needed to prevent a race to the bottom,<sup>12</sup> while others maintain that federal intervention is

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6. The literature on this question is expanding. Important recent contributions include: Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REG., Spring 2003, at 26; Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003); Robert B. Thompson, *Corporate Governance After Enron*, 40 HOUSTON L. REV. 99 (2003); and Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections on Federalism*, 56 VAND. L. REV. 859 (2003).

7. See Roe, *supra* note 6, at 591–92.

8. *Id.* at 632–33.

9. Roberta Romano, *Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?* 39–40 (Yale Univ. Int'l Ctr. For Fin., Working Paper No. 05-02, 2005), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=693484](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=693484).

10. *Id.*

11. *Id.* at 34.

12. See, e.g., Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1441 (1992) (arguing that, in

undesirable and existing federal rules should be repealed in order not to impede a race to the top.<sup>13</sup> Roe's thesis implies that the whole debate is misconceived because the federal authorities call all the shots. Romano contends that state competition, and the concomitant race to the top, is alive and well even after Sarbanes-Oxley.

Our position differs both from Roe's and Romano's. We argue that the possibility of federal preemption constitutes a threat to Delaware, but this threat is significant only in times—such as during the recent corporate scandals—when systemic change is seen as generating a significant populist payoff. Sarbanes-Oxley is neither the death knell for state competition, as Roe suggests, nor an aberration, as Romano argues, but a response to a particular political climate that constitutes a threat to Delaware's highly-profitable chartering business.

We further suggest that Delaware has adapted to this threat by pursuing what we will call a classical or 19<sup>th</sup> century common law model of lawmaking. But this classical model of lawmaking entails some intrinsic limitations, including that legal change is slow, standard-based, and incremental. These limitations explain how Delaware responded to the recent corporate scandals and, in turn, create a space where the relationship between federal rules and Delaware law is symbiotic, rather than competitive as depicted by the classical state-competition debate. Our thesis thus seeks to explain the structure of Delaware corporate law and to offer a proper domain for federal law even for commentators broadly sympathetic to the race-to-the-top view.

In Part I, we analyze the institutional and political landscape of corporate lawmaking. Although Delaware exercises a significant lawmaking role, it is faced with an omnipresent specter of a federal takeover, which could threaten the substantial income the state derives from franchise fees. The principal threat for Delaware is the possibility that federal intervention will be triggered by a situation in which systemic change generates significant populist political payoffs. This danger is aggravated by Delaware's apparent lack of democratic legitimacy: why should a small state set national policy for corporate

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certain areas, state competition leads to rules biased towards managerial interests); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 663–66 (1974) (arguing that state competition results in a race to the bottom).

13. See, e.g., Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 919–20 (1982) (postulating that Delaware has attracted corporations because its laws maximize shareholder value); see generally Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998) (calling for repealing much of federal securities regulation and replacing it with state law).

law? It is in Delaware's interest to structure its law to minimize its exposure to such an attack. In addition, Delaware must take account of the rules on personal jurisdiction and on conflict of laws embedded in the federal structure.

Part II identifies a number of salient traits that characterize Delaware's corporate law. Most important and controversial legal rules are the product of judge-made law. Judicial opinions are filled with quasi-deterministic reasoning. Statutory amendments to the corporation law are initially drafted by a bar committee, are adopted without change or debate by the legislature, and address largely technical and noncontroversial matters. Delaware's judiciary has substantial expertise on corporate law and is nonpolitical. In contrast to Delaware's first-rate system for the private enforcement of corporate laws, public enforcement is virtually nonexistent. And the scope of corporate law is largely confined to the regulation of the internal affairs of a corporation.

In Part III, we argue that these traits can be understood as adaptations to the political and institutional landscape in which Delaware operates. In many respects, Delaware's corporate law may be the last vestige of the classical 19th century common law model in America: most important legal rules are promulgated by a nonpartisan, expert judiciary; these rules are presented as derived from long-standing and widely accepted principles; the law is enforced through civil litigation brought by private parties; and even legislative amendments generate neither debate nor controversy. All this has the effect of creating and enhancing a technocratic, apolitical gloss over Delaware's corporate law and thus helps to shield Delaware from being attacked for lacking democratic legitimacy. At the same time, the scope of Delaware's corporate law is designed to minimize conflicts by assuring that Delaware has the requisite personal jurisdiction over defendants to enforce its law effectively and that the prevailing conflict rules point to substantive Delaware law as applicable to a dispute.

In Part IV, we assess Delaware's response to the recent corporate scandals and the division of corporate lawmaking roles between Delaware and the federal government. We argue that Delaware's response to the scandals—or rather, the lack thereof—flows from its adherence to the classical common law model. Faced with corporate scandals, calls for action, and *Sturm und Drang*, Congress passed sweeping legislation and Eliot Spitzer crusaded against Wall Street. But Delaware waits until a legal dispute is brought in its courts, and even then addresses the issues only in an incremental fashion. While this means that Delaware has been out of

the limelight, potentially hurting its image in the short term, staying out of the political limelight is in Delaware's long-term interest. Spitzer may be a successful politician, and he may even be the right Attorney General for New York, but he would not be the best person to assure that hundreds of millions in annual franchise fees keep flowing into Delaware's coffers. But because the classical common law style, together with jurisdictional and conflict rules, constrain Delaware, federal law is needed to complement Delaware's. This is so where Delaware's common law regime cannot effectively supply the optimal legal regime—e.g., because it requires public enforcement or is highly regulatory—or where the rules on personal jurisdiction or conflicts inhibit Delaware's ability to regulate. In that respect, the relation between federal law and Delaware law is symbiotic, rather than competitive: Delaware is happy to have federal law pick up the slack and thereby reduce the likelihood that ineffective regulation produces a populist backlash.

## I. THE LANDSCAPE OF CORPORATE LAWMAKING

In this Part, we examine the division of corporate lawmaking between federal and state authorities. We provide a stylized description of two related landscapes of corporate lawmaking—the institutional and the political—and analyze the powers of and constraints placed on lawmaking by federal actors and by Delaware.

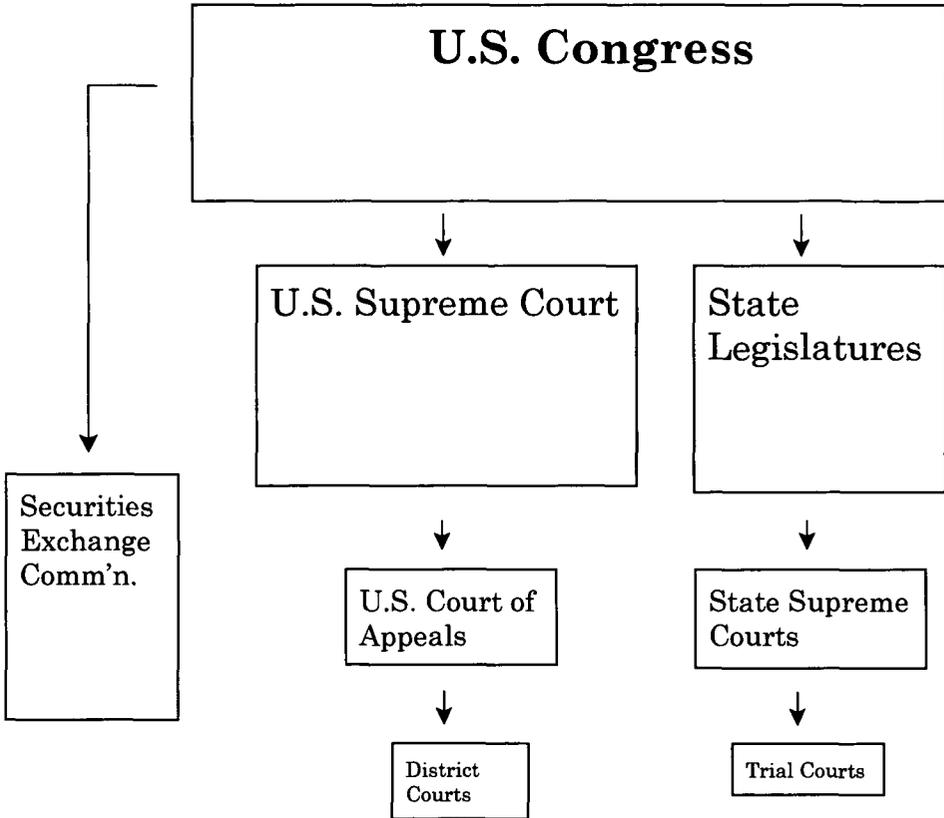
### A. *The Institutions of Corporate Lawmaking*

Figure 1 provides a simplified overview of the allocation of corporate lawmaking *authority* in the United States. Congress sits at the top of the chart. There is little constitutional doubt that, if Congress wished to enact a national corporate law that would displace all state corporate law, it could do so pursuant to its power under the Commerce Clause.<sup>14</sup>

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14. See Roe, *supra* note 6, at 607–20 (discussing topics where federal rules have displaced state rules).

Figure 1. Allocation of Corporate Law-Making Authority.



Constituencies/customers:

- Investors
- Employees
- Managers
- Corporate Lawyers
- Corporations

Given this authority, Congress faces several options. It can legislate corporate law directly, enacting either a comprehensive corporate law or discrete elements. It can set relatively broad standards and then establish an administrative agency, such as the SEC, with subsidiary lawmaking powers. It can set broad standards and leave it to courts to adjudicate cases and develop the law through a common law process. It can enact enabling provisions which leave the task of making specific rules to the domain of private choice. Or it can do nothing and thereby leave the regulation of corporate conduct to the states.

If Congress is willing to allow the states to act, the states then face similar options: to legislate directly; to establish an administrative agency; to let courts develop rules through the common law process; or to enact enabling provisions. In addition, states must determine the applicable "choice of law" rules: should the applicable law be the law of the corporation's state of incorporation; should it be the law of its principal place of business; or should a forum state apply its own law even if the corporation's ties to the state are more tenuous?<sup>15</sup>

Abstracting for the moment from public choice concerns (to be covered in the next Section), a public-regarding legislature would need to consider a variety of factors in deciding how best to legislate in the corporate area. First, there is the question of institutional competence. Promulgating detailed fine-grained rules requires a certain level of institutional infrastructure that an administrative agency, like the SEC, may possess, but that a legislature is likely to lack. Second, there is the question of the appropriate degree of decentralization. Is a uniform national rule optimal? Is it better to allow for diversity among the states? To what extent should companies be permitted to set their own rules?

But Figure 1 only provides part of the picture. For people who focus on corporate law, a picture of corporate lawmaking that puts Congress at the top and the Delaware courts, as a subset of other state courts, toward the bottom fails to capture who the important corporate law actors are.

If one focuses not on lawmaking *power* but on lawmaking *role*, a different picture emerges. Consider, in this regard, Figure 2.

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15. State legislatures' freedom of action in this regard may be subject to some constitutional constraints. See *Edgar v. MITE Corp.*, 457 U.S. 624, 645-46 (1982) (holding that Illinois' antitakeover statute that applied to companies with tenuous contacts to the state violated the Commerce Clause).

Figure 2: The Lawmaking Role

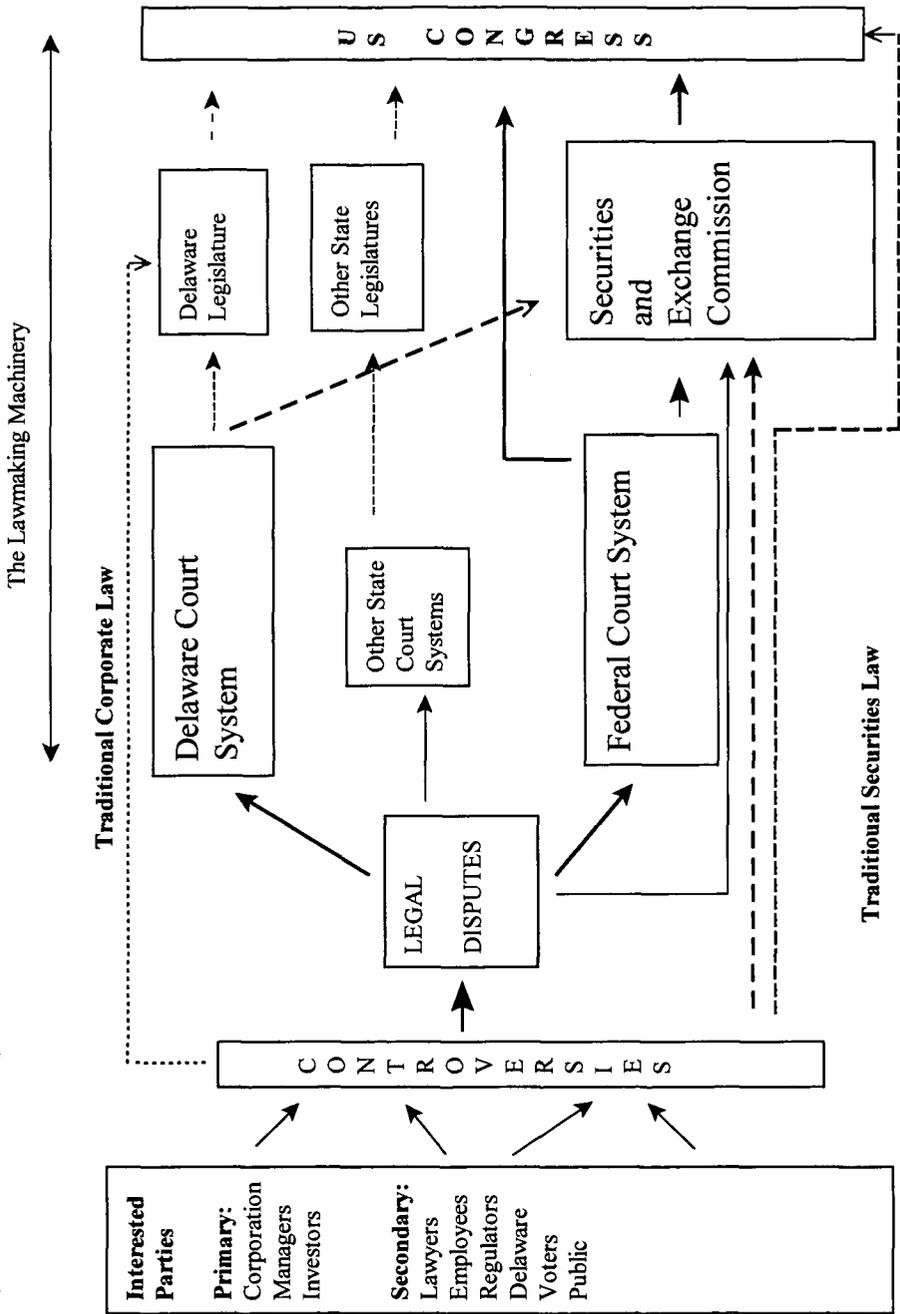


Figure 2 recognizes that courts, in the process of resolving disputes, often have the first opportunity to address problems through lawmaking. As Hart and Sacks pointed out:

In the development of Anglo-American legal systems, courts have functioned characteristically as the place of initial resort for the settlement of problems which have failed of private solution.

... [T]he body of decisional law announced by the courts in the disposition of these problems tends always to be the initial and continues to be the underlying body of law governing the society. Legislatures and administrative agencies tend always to make law by way not of original solution of social problems, but by alteration of the solutions first laid down by the courts.<sup>16</sup>

Hart and Sacks's notion of courts as first-line lawmakers provides an important modification of the picture of lawmaking authority in Figure 1. In the first instance, a myriad of corporate law disputes are brought to the Delaware Court of Chancery. Other corporate law disputes are brought to the federal courts or the courts of other states.<sup>17</sup> In resolving these disputes, courts will often be the first body to address a problem through lawmaking.

Consider Figure 2 in more detail. Controversies arise among corporations, managers, and investors; and between corporations and employees, regulators, citizens and others. When these controversies become legal disputes, they can go either to the Delaware courts, other state courts, or the federal system. Which forum parties resort to for litigating their disputes, in turn, is influenced and sometimes determined by two additional elements peculiar to the U.S. federal system. The first element concerns personal jurisdiction. Under the Due Process Clause of the U.S. Constitution, state courts can assert jurisdiction only over defendants who have the requisite minimum contacts with the forum state. The second element concerns the rules on conflict of laws. These rules, which are part of the law of each state, determine which jurisdiction's law applies to a dispute. Under the prevailing conflict of laws rules, the law of the state of incorporation typically governs the internal affairs of the corporation.<sup>18</sup> With respect to other issues, however, these rules will rarely point to the law of the state of incorporation as governing a dispute.

But, as shown in Figure 2, public controversies will occasionally avoid the legal machinery entirely. Instead, such

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16. HENRY M. HART, JR. & ALBERT M. SACKS, *THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND APPLICATION OF LAW* 163-64 (William N. Eskridge, Jr. & Philip P. Frickey eds., 1994).

17. *E.g.*, *Moore Corp. v. Wallace Computer Servs.*, 907 F. Supp. 1545 (D. Del. 1995).

18. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 303-310 (1971).

controversies are brought to the SEC or directly to either the state legislature or to the U.S. Congress. Moreover, once a legal dispute has been adjudicated by the courts, parties<sup>19</sup> interested in the legal rule promulgated face a decision whether to accept the result or to seek to have it changed. For disputes adjudicated within the Delaware system, the choices are to turn to the Delaware legislature,<sup>20</sup> to go to the SEC,<sup>21</sup> or to lobby Congress.<sup>22</sup> Similarly, parties dissatisfied with the legal rules emerging from federal court adjudications can turn either directly to Congress or to the SEC.<sup>23</sup>

While, as depicted in Figure 1, members of the Delaware judiciary may appear to be little more than secondary actors, Figure 2 indicates that Delaware judges can have a critical role.<sup>24</sup> Whether they do or not depends on where disputes are litigated and how often the Delaware legislature or federal lawmakers intervene. As discussed in Part II, Delaware courts adjudicate, in the first instance, most corporate law disputes involving public corporations that raise issues addressed by state law,<sup>25</sup> and the Delaware legislature rarely intervenes. As discussed in Part III, this manner of lawmaking serves to fend off federal intervention.

### B. *The Politics of Federal Intervention*

Figures 1 and 2 also provide a starting point for understanding the politics of federal intervention in corporate lawmaking. Generally, Delaware exercises the first-line rulemaking role for much of

19. By parties, we mean interest groups and political actors that have a stake in the legal rule announced in a case, rather than the specific parties to the litigation.

20. An example of this is the enactment of Section 102(b)(7) in the wake of *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). See generally DEL. CODE ANN. tit. 8, § 102(b)(7) (2005).

21. An example here is the SEC's reversal of the discriminatory self-tender defense sanctioned generally in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). See DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE 1010* (5th ed. 1998).

22. An example is the Sarbanes-Oxley Act's prohibition of all loans to executives. See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance* 86–89, 150–53 (European Corporate Governance Inst., Finance Working Paper No. 52/2004, 2004), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=596101](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=596101).

23. See *infra* Part II.A, especially note 90 (detailing several instances where rules on insider trading announced by federal courts have been reversed by Congress or the SEC). Since federal courts sometimes also interpret state law, some federal court rulings can also be reversed by state legislatures.

24. See RONALD DWORKIN, *LAW'S EMPIRE* 239–75 (1986) (Hercules, the judge, in a theory of “law as integrity”); RONALD DWORKIN, *TAKING RIGHTS SERIOUSLY* 105–30 (1977) (Hercules, the judge, deciding cases on principle rather than policy).

25. For a contrary view, see Thompson & Sale, *supra* note 6, at 860–61 (arguing that corporate governance is regulated primarily through federal securities law and shareholder litigation).

corporate law, mostly because Delaware courts are in the forefront of resolving corporate disputes. A significant prospect of change can arise only if a significant interest group is highly dissatisfied or if political actors foresee political benefit from advocating legal change. Even when there is a prospect for such change, however, there are forces pushing back.<sup>26</sup>

Consider the possibility of congressional intervention.<sup>27</sup> Suppose that some politicians become convinced that interstate competition for corporate charters results in a race to the bottom;<sup>28</sup> or they favor a federal takeover of state corporate law for more naked

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26. Our view of the threat of federal intervention thus differs from Mark Roe's recent insightful analysis of the issue. Roe regards the federal authorities as having some independent substantive policy preferences. In order not to trigger federal intervention, state rules must match or come close to these preferences. See Roe, *supra* note 6, at 607. As discussed in this Section, we see federal intervention as a product of either interest-group lobbying (where interest groups have both preferences for the actual content of legal rules and the identity of the regulator) or populist politics and regard the latter as the more serious threat.

27. Piecemeal reform can also come from the SEC, with a somewhat different sort of political dynamic. See, e.g., Editorial, *Headline Risk at the SEC*, WALL ST. J., May 10, 2004, at A16 [hereinafter *Headline Risk at the SEC*] (accusing the SEC of adopting cumbersome regulations on mutual fund trading for their headline value); Mark Maremont & Deborah Solomon, *Behind SEC's Failings: Caution, Tight Budget, '90s Exuberance*, WALL ST. J., Dec. 24, 2003, at A1 (describing various reasons for the SEC's cautious approach to regulation). Historically, there have been a variety of more or less pervasive SEC incursions into the traditional topics of Delaware corporate law. The more confined incursions include rules governing going private transactions, tender offers, and dual-class recapitalizations. The more pervasive ones include the proxy rules that govern shareholder voting and insider trading rules. Without delving deeply into the politics of agency rulemaking, one can note that the SEC is subject to many of the same pressures as Congress, and that, when the key constituencies are satisfied with the status quo, SEC attempts to expand its reach can usually be resisted. Additionally, the SEC can only act to the extent Congress has delegated the requisite authority, and can be overridden by Congress or the courts if it steps out of line. See Bus. Roundtable v. SEC, 905 F.2d 406, 407 (D.C. Cir. 1990) (holding that the SEC overstepped its statutory authority by controlling the allocation of substantive powers among classes of shareholders).

Stock exchanges also have the ability to act, either on their own behest or because of SEC pressure. While the exchanges have wider latitude to make corporate law rules than the SEC does, they are constrained by their desire to attract listings, and competition from other exchanges. They may thus be reluctant to adopt rules opposed by managers who exercise control over where companies are listed (more so than over where they are incorporated). More fundamentally, exchanges lack enforcement powers. The most serious sanction—delisting—is hardly credible when there are competing exchanges, and, moreover, hardly a consolation for shareholders who are supposedly helped by the rules. For this reason, only clear-cut rules by the exchanges that create no ex-post ambiguities have real bite (if a violation is obvious, most companies will not dare to do it, even if enforcement is weak). See generally Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675, 697–700 (2002) (discussing stock exchanges' difficulties in enforcing their listing agreement when firms can easily list on competing exchanges).

28. See, e.g., Bebchuk, *supra* note 12, at 1441 (enumerating areas in which federal regulation should be expanded); Cary, *supra* note 12, at 705 (asserting that "[t]he absurdity of this race for the bottom . . . should arrest the conscience of the American bar").

political considerations. How might parties favoring the status quo resist such a move?

They might make a constitutional argument: namely, that such a wholesale displacement of state corporate law would be beyond Congress's powers under the Commerce Clause. As a matter of contemporary constitutional law, this is a weak—indeed, nearly laughable—argument.<sup>29</sup> In light of Congress's constitutional ability to intercede directly and to shift corporate lawmaking authority among the various players, the "internal affairs" doctrine—according to which the internal affairs of a corporation are governed by the law of the

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29. There is no plausible constitutional argument that Congress would not have the power, under the Commerce Clause, to preempt state corporate law with a national corporate law. Article I, Section 8 of the U.S. Constitution (the Commerce Clause) grants Congress the power to "regulate Commerce with foreign Nations and among the Several States." This has been expansively interpreted. For good, comprehensive discussions, see Erwin Chemerinsky, CONSTITUTIONAL LAW § 3-3 (2d ed. 2002); 1 LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW §§ 5-4, 5-5 (3d ed. 2000). From 1937 to 1995, the Supreme Court did not hold a single congressional action to be beyond the regulatory power conferred by the Commerce Clause. *Id.* During this period, for example, the Supreme Court held that Congress had Commerce Clause power to regulate stock in public utilities, *Am. Power & Light Co. v. SEC*, 329 U.S. 90, 96 (1946), and to regulate interstate insurance transactions, *United States v. Se. Underwriters Ass'n*, 322 U.S. 533, 553 (1944). Indeed, the Commerce Clause is the sole jurisdictional basis for federal securities regulation.

In a line of cases beginning in 1995, the Supreme Court indicated that there exist limits to Congress's regulatory power under the Commerce Clause. See *United States v. Lopez*, 511 U.S. 549, 551 (1995) (holding the Gun-Free School Zones Act unconstitutional); *United States v. Morrison*, 529 U.S. 598, 617–19 (2000) (holding the civil damages provision in the Violence Against Women Act unconstitutional). See also *Jones v. United States*, 529 U.S. 848, 850–51 (2000) (interpreting federal law narrowly to avoid constitutional doubts whether Congress had exceeded its power under the Commerce Clause with regard to arson); *Solid Waste Agency of No. Cook County v. United States Army Corps of Eng'rs*, 531 U.S. 159, 162 (2001) (same with regard to migratory birds); Chemerinsky, *supra* this note, § 3-3.5. But this line of cases focuses entirely on the extent to which Congress can regulate *noncommercial* or *noneconomic* activity under the Commerce Clause. There is no suggestion in the opinions or in subsequent case law that the judicial skepticism would extend to indisputably commercial activity such as securities regulation or corporate governance.

The only genuine Commerce Clause issue that has recently arisen in corporate and securities law is the extent to which the Supremacy Clause or the (dormant) Commerce Clause preempt or preclude state regulation of takeovers. See, e.g., *Edgar v. MITE Corp.* 457 U.S. 624, 630 (1982) (holding that Illinois' state takeover statute unduly burdened interstate commerce in violation of the Commerce Clause); *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 94 (1987) (holding that Indiana's statute regulating the acquisition of control shares in public corporations did *not* violate the Commerce Clause). In *CTS*, in which the Supreme Court upheld Indiana's control share acquisition statute, the Court held that the statute did not violate the Commerce Clause, as it did not discriminate against interstate commerce, 481 U.S. at 89–98, nor subject corporations to inconsistent standards, *id.* at 88–89. Neither case raises any question as to Congress's power to preempt state corporate law in the area of tender offers; only about whether Congress in fact intended to do so and, in the case of *CTS*, whether, in the absence of any such intent, the Commerce Clause otherwise precluded the states from acting. Indeed, neither case makes any sense without an assumption that Congress could choose to regulate takeovers nationally.

state of incorporation—is better thought of as a contingent allocation of responsibility based on prudential considerations, and not any sort of iron dictate.

But even if a frontal constitutional attack is weak, the underlying themes of “corporate federalism” or “cooperative federalism”<sup>30</sup> and states’ rights have significant political and legal salience. It could, in other words, be an effective policy argument in the halls of Congress or the offices of the SEC.<sup>31</sup> It could also influence courts when they interpret ambiguous federal legislation.<sup>32</sup>

But, of course, the course of legislation is only partially determined by such policy and legal arguments. Interest groups matter too. Figures 1 and 2 provide a useful guide to those actors with sufficiently large interests to get involved politically. The constituents with an interest in corporate law are primarily managers and investors, with several other groups, such as lawyers and employees, taking a secondary interest in corporate law rules. To the extent that managers are opposed to a change in the law, organizations such as the Business Roundtable would lobby against it. To the extent that institutional investors are opposed, one would expect them to lobby as well. Moreover, Delaware is itself interested in limiting federal intrusions into corporate law, and Delaware’s interests are influentially represented. For example, during the 107th Congress, when the Sarbanes-Oxley Act was enacted, both Delaware senators were on committees that considered the bill: Joseph Biden on the Judiciary Committee and Thomas Carper on the Banking, Housing & Urban Affairs Committee.<sup>33</sup>

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30. While one might speak of a “corporate law federalism,” it is more (descriptively) accurate to think of the distribution of corporate lawmaking as “decentralization.” See Edward L. Rubin & Malcom Feeley, *Federalism: Some Notes on a National Neurosis*, 41 UCLA L. REV. 903, 910–14, 950–951 (1994) (arguing that federalism is better understood as managerial decentralization). Whatever the general persuasiveness of Rubin and Feeley’s view, in corporate law it is accurate: the extent of Congress’s power under the Constitution to legislate in the corporate area is such that “our corporate law federalism” is a matter of an implicit or explicit decentralization driven by bureaucratic, political and legal process factors, as we discuss in greater detail in the text.

31. See Letter from Chief Justice E. Norman Veasey, Delaware Supreme Court, to Alan Beller, Director of Division of Corporate Finance, SEC (Mar. 11, 2004) (expressing reservations about the proposed SEC rule on shareholder nominations because it “intrudes upon and may be in conflict with corporate internal affairs that are the province of state law.”) (on file with authors).

32. The U.S. Supreme Court has been solicitous of states’ primacy in corporate law. See, e.g., *CTS*, 481 U.S. at 91; *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 478–79 (1977) (refusing to broaden Rule 10b-5 to cover merger transactions such that “established state policies of corporate regulation would be overridden”).

33. [2001-2002 Transfer Binder] Cong. Index (CCH) 11,501-02 (Aug. 23, 2002).

Finally, the Constitution and internal congressional rules make it easier to stop legislation than to enact it. To pass a law, legislation must ordinarily be approved by congressional committees; be put on the agenda by the congressional leadership; be approved by majorities in both houses of Congress; either not be filibustered or be favored by a supermajority of the Senate; and either be approved by the President or favored by veto-proof majorities in both houses. As a result, a determined minority of legislators can often block legislation favored by a majority.

To be sure, even with this built-in status quo bias, Delaware must keep the principal organized interest groups affected by Delaware corporate law reasonably satisfied in order to avoid federal intervention. For several reasons, however, we do not regard federal intervention due to interest group pressure as a major threat for Delaware.

First, "satisfied" in this context relates not only to the specific legal rules in force but more generally to a judgment of comparative institutional competence—namely, which lawmaking institution is likely to perform better over the long term. Even if managers or investors are dissatisfied with a particular substantive rule of Delaware law, there are a number of plausible reasons why they may nevertheless not push for federal intervention. They may, for instance, believe that they will carry more relative weight in Delaware than in any of the alternative federal institutions, perhaps because unions or SEC bureaucrats will be more influential at the federal level. In addition, Delaware may be more responsive to new developments, have greater expertise in applying rules, or otherwise be able to devise rules that are superior to those likely to emerge from federal actors. Moreover, it may be less costly to influence Delaware than Congress or the SEC. And finally, a state system may be viewed as a less risky forum because, for example, it is less likely to generate radical legislation or because it affords greater opportunities to opt-out of legislation (by changing corporate domiciles) than a monopolist federal regulator.

Second, even when Congress has enacted legislation otherwise trampling on states' rights, it has historically taken special care not to intrude upon Delaware. For example, the Securities Litigation Uniform Standards Act,<sup>34</sup> 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

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34. 15 U.S.C. § 77p (2000) (amending 15 U.S.C. § 77(p) (1933)). Technically, the Act makes most securities class actions removable to federal court. *Id.*

laws on misrepresentations or deceit in class actions, contains the so-called "Delaware carve-out."<sup>35</sup> The carve-out specifically exempts actions for misrepresentations based on the corporate law of a company's state of incorporation.<sup>36</sup> Similarly, the Class Action Fairness Act, designed to assure that most class actions with a national class of plaintiffs are adjudicated in federal court, specifically excludes corporate law class actions arising under the law of the company's state of incorporation.<sup>37</sup> Perhaps not coincidentally, Delaware's Senator Carper was one of eight original sponsors (and one of a handful of Democratic supporters) of the Senate version of the Act.<sup>38</sup> Thus, for one reason or another, Delaware's corporate law seems to enjoy great respect on Capitol Hill.

Most importantly, however, Delaware has strong incentives to keep investors and managers satisfied *even apart from the possibility of federal intervention*. Investors and managers control incorporation decisions of companies when they go public and decisions of existing public companies to reincorporate. As Delaware caters anyway to investors and managers in order to attract incorporations, keeping investors and managers sufficiently satisfied that they do not lobby for federal intervention should not require much additional effort or adjustment.<sup>39</sup> Moreover, to the extent that particular investors and managers are dissatisfied, it is usually much easier for them to induce a particular firm to incorporate in a different state than to lobby for a change in federal law.

A greater concern than federal intervention due to interest group pressure is the possibility that federal intervention will be triggered by a situation in which systemic change generates a significant populist political payoff (a payoff unrelated to interest

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35. See, e.g., *Spehar v. Fuchs*, No. 02-9352CM, 2003 U.S. Dist. LEXIS 10406, at \*25 n.4 (S.D.N.Y. June 17, 2003) (noting that the Securities Act contains three exceptions known as the "Delaware carve-outs").

36. 15 U.S.C. § 77p(d)(1) (2005).

37. Class Action Fairness Act, Pub. L. No. 109-2, § 5(a), 119 Stat. 4, 13 (2005) (to be codified at 28 U.S.C. § 1453(d)(2)).

38. Similarly, Senator Biden, a member of the Senate Judiciary Committee, probably influenced the committee's decision not to eliminate state of incorporation as a venue for bankruptcy cases. See David A. Skeel, Jr., *Bankruptcy Judges and Bankruptcy Venue: Some Thoughts on Delaware*, 1 DEL. L. REV. 1, 44 (1998). Although Delaware derives some benefits from being a venue in major bankruptcy cases, these benefits pale in comparison to those from being the domicile of most publicly traded companies. See Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 694-95 n.50 (2002).

39. To be sure, the relative power of investors and managers may differ from the incorporation and reincorporation contexts to the context of federal lobbying, thus providing some incentives for the groups that are more powerful in the lobbying context to seek federal intervention. But the direction of that difference is unclear, unstable, hard to predict, and likely to be small. Kahan & Kamar, *supra* note 38, at 740-45.

group pressure).<sup>40</sup> Such situations can arise in times of crisis or scandal or due to political entrepreneurship.<sup>41</sup>

High-profile scandals can shift the balance of power both in Congress and, derivatively, at the SEC, by triggering a deep, populist theme in American politics and energizing broad, loosely organized constituencies. The classic examples of large scale federal incursion into corporate law in response to crisis and scandal are the enactment of the 1933 Securities Act and the 1934 Securities Exchange Act, which created the SEC and, more recently, the enactment of the Sarbanes-Oxley Act and the changes in the stock exchange listing rules. In both instances, we had major scandals that coincided with the bursting of a stock market bubble that left investors licking their wounds and looking for someone to blame.<sup>42</sup> Congressional hearings were held and there was a feeling that “something must be done.” Congress felt pressure to act, and act it did.<sup>43</sup>

The danger of a populist backlash against Delaware is aggravated by the lurking argument that Delaware lacks political legitimacy. Why should a small state—a “pigmy,” as a leading proponent of a federal corporate law referred to it pejoratively<sup>44</sup>—have so significant a lawmaking role for national corporate law and derive huge profits in the process? From the perspective of democratic theory, would it not make more sense if the members of Congress, elected by all U.S. citizens, made the law affecting corporations with national operations and shareholders? It is against this background lack of democratic legitimacy that populist appeals for federal intervention will be made and resonate.<sup>45</sup>

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40. For example, the press describes Eliot Spitzer's actions as populist. See, e.g., John Cassidy, *The Investigation: How Eliot Spitzer Humbled Wall Street*, THE NEW YORKER, Apr. 7, 2003 at 54, 54 (“Spitzer was well placed to launch a populist crusade.”); Editorial, *Spitzer's Grandstand*, WALL ST. J., Mar. 5, 2004, at A14 (“New York Attorney General Eliot Spitzer fancies himself a populist hero for assailing Wall Street misdeeds . . .”).

41. For examples from the history of U.S. regulation of business, see MARK ROE, STRONG MANAGERS, WEAK OWNERS 26–45, 51–146 (1994).

42. See Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L.Q. 849, 850 (1997) (noting that most new regulations follow stock market crashes).

43. See, e.g., Romano, *supra* note 22, at 146–74 (discussing how the Act is a product of political entrepreneurship, rather than interest-group lobbying); *Headline Risk at the SEC*, *supra* note 27 (accusing the SEC of adopting cumbersome mutual fund regulations for their headline value).

44. Cary, *supra* note 12, at 701.

45. See, e.g., Cary, *supra* note 12, at 698 (querying whether Delaware should lead in corporate law when it gives so much power to management); Jonathan Chait, *Rogue State: The Case Against Delaware*, NEW REPUBLIC, Aug. 19–26, 2002, at 20, 22–23 (crediting Delaware with “the national emasculation of corporate governance”); *Triumph of the Pygmy State*, ECONOMIST, Oct. 23, 2003, at 55, 55–56 (questioning why the laws of a state with approximately 0.3 percent of population governs more than half of public corporations).

Alas for Delaware, it can do nothing to deprive Congress of its power to enact corporate laws. Likewise, it can do little to prevent crises, scandals, or the emergence of political entrepreneurs. What Delaware can do, however, is structure its law in a manner adapted to preserve its scope and reduce the likelihood that it will become the target of systemic change.

As we discuss in Part III, many traits of Delaware corporate law can be understood as adaptive to the institutional and political landscape in which Delaware, as the leading supplier of corporate law, must operate. This landscape includes Delaware's constitutional and political vulnerability to federal intervention and the strictures imposed by jurisdictional and conflict rules. Our claim is not that Delaware purposefully adopted all these traits to serve its aims. We do not believe that the connection is that direct. Rather, the claim is that key patterns of Delaware corporate lawmaking are consistent with the Delaware actors being sensitive to their institutional role and its limitations. Even if these patterns have not been purposefully adopted, the fact that they serve this function contributes to their survival.

Finally, we will argue in Part IV that not every federal intervention into corporate law is against Delaware's interest. Because of the political constraints placed on Delaware by its desire to avoid systemic change and because of the legal constraints imposed by jurisdictional and conflict rules, Delaware cannot effectively regulate certain types of misconduct. In these areas, which include much of traditional securities regulation, Delaware should have no major problem with federal regulation. To the contrary, 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 a populist backlash against Delaware as a principal regulator. Thus, the relationship between federal and state regulation in corporate law is, in our view, much more symbiotic than most commentators acknowledge.<sup>46</sup>

## II. SALIENT TRAITS OF DELAWARE CORPORATE LAW

Delaware's corporate law has a number of salient and characteristic traits. These traits concern its style, the manner in which it is enforced, and its scope. In this Part, we explore Delaware

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46. Cf. Roe, *supra* note 6, at 592 (focusing on the role of federal regulation as Delaware's competition); Bebchuk, *supra* note 12, at 1441 (calling for federal intervention to preempt state law); Cary, *supra* note 12, at 701-03 (same); Romano, *supra* note 13, at 2361-62 (arguing that much of the federal securities regulation should be repealed and replaced with state law).

corporate law's traits in six areas: the breadth of its judge-made law; its quasi-deterministic judge-made law; the making of its statutory law; its judiciary; its enforcement mechanism; and the overall scope of its corporate law. As we will explain in the next Part, all these traits can be seen as adaptations to the peculiar landscape in which Delaware, a tiny state that is the leading supplier of corporate law, must operate.

### A. *The Breadth of Judge-Made Law*

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. In Delaware, judge-made law, to the virtual exclusion of statutory law, governs fundamental issues such as fiduciary duties of directors, officers, and controlling shareholders, the prerequisites for a derivative suit, and disclosure obligations. Even powers that the Delaware code explicitly accords to the board of directors are subject to a judicially created and interpreted duty not to use these powers for "inequitable purposes."<sup>47</sup> Thus, judge-made, rather than statutory, law governs issues such as:

- when directors are liable (the famous "business judgment" rule);<sup>48</sup>
- what counts as a self-interested transaction;<sup>49</sup>
- who is regarded as a controlling shareholder;<sup>50</sup>
- the scope of a controlling shareholder's obligations;<sup>51</sup>
- the legal test to determine the validity of a self-interested-transaction;<sup>52</sup>
- when a director is considered "independent";<sup>53</sup>

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47. See, e.g., *Schnell v. Chris-Craft Indus.*, 285 A.2d 437, 439 (Del. 1971) (enjoining management from expediting the annual stockholders' meeting to obstruct a proxy fight with dissident shareholders).

48. See, e.g., *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1052–53 (Del. Ch. 1996) (applying the business judgment rule from common law to find no director liability).

49. See, e.g., *Orman v. Cullman*, 794 A.2d 5, 23 (Del. Ch. 2002) (clarifying that, where self-dealing is absent, a director is interested when a decision *materially* benefits or detrimentally impacts the director in a way not shared by the corporation or stockholders).

50. See, e.g., *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1114–15 (Del. 1994) (finding that minority shareholder exercised actual control by dominating corporate affairs).

51. See, e.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (explaining when the intrinsic fairness applies to parent-subsidiary dealings).

52. See, e.g., *Marciano v. Nakash*, 535 A.2d 400, 404 (Del. 1987) (establishing a legal standard for evaluating a transaction when company directors are on both sides).

- the legal effect of approval of a transaction by independent directors or by disinterested shareholders;<sup>54</sup>
- what constitutes a “corporate opportunity”;<sup>55</sup>
- the legal tests regulating takeover defenses;<sup>56</sup>
- when a board can take actions that interfere with shareholder franchise;<sup>57</sup>
- when a shareholder can institute a derivative suit without making a prior demand on the board;<sup>58</sup>
- when shareholders lose their limited liability;<sup>59</sup>
- limitations on charitable giving;<sup>60</sup> and
- the right of contestants to be reimbursed for expenses incurred in proxy contests.<sup>61</sup>

Neither historic contingency nor the nature of the legal rules at issue fully explains this breadth of judge-made law. To be sure, the law of fiduciary duties has historically been developed by the judiciary. Nevertheless, Delaware’s judge-made law is distinctive in a number of ways. First, Delaware, whose economic well-being depends on the franchise revenues it earns from public corporations, should be expected to pay significant attention to the way its law is generated. Other states, which do not derive significant economic benefits from chartering companies, may be affected by inertia and inattention with respect to the structure of their corporate law. In Delaware, however, where franchise taxes account for almost 20 percent of the state

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53. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984) (explaining that directors are independent when their decisions are based on the merits).

54. See, e.g., *Kahn*, 638 A.2d at 1117 (shifting the burden of proof regarding fairness to the shareholder-plaintiff in these circumstances).

55. See, e.g., *Broz v. Cellular Info. Sys., Inc.*, 673 A.2d 148, 154–55 (Del. 1996) (defining “corporate opportunity” and explaining standards for when a director or officer may or may not take the opportunity).

56. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.* 493 A.2d 946, 955 (Del. 1985) (requiring that “defensive measures must be reasonable in relation to the threat posed”).

57. See, e.g., *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 661 (Del. Ch. 1988) (requiring “compelling justification” for such actions).

58. See, e.g., *Aronson*, 473 A.2d at 818 (requiring pleading with particularity of facts alleging self-interest, lack of independence, or action contrary to corporation’s best interests).

59. See, e.g., *Mabon, Nugent & Co. v. Tex. Am. Energy Corp.*, No. 8578, 1988 Del. Ch. Lexis 11, at \*9 (Del. Ch. June 27, 1988) (listing instances when the court will pierce the veil to reach a parent corporation).

60. See, e.g., *Theodora Holding Corp. v. Henderson*, 257 A.2d 398, 405 (Del. Ch. 1969) (applying standard of reasonableness); *Kahn v. Sullivan*, 594 A.2d 48, 61 (Del. 1991) (finding a charitable gift to be reasonable in the context of approving a settlement).

61. See, e.g., *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339, 344–45 (Del. 1983) (affirming superior court’s reimbursement of reasonable expenses for proxy solicitation).

budget,<sup>62</sup> historical artifact cannot, by itself, explain why the legislature has not taken a more active role.

Second, even though fiduciary duty law has historically been judge-made, many other states have statutorily revised portions of fiduciary duty law. For example, Indiana has a statute governing a board's fiduciary duties in a takeover contest;<sup>63</sup> Idaho's statute defines "conflicting interest";<sup>64</sup> California's statute defines "control";<sup>65</sup> Ohio's statute revises the burden of proof in shareholder lawsuits;<sup>66</sup> Michigan's statute defines a special class of independent directors and accords them special rights in derivative proceedings;<sup>67</sup> over 30 states have passed statutes permitting a board to consider broader interests in discharging their fiduciary duties;<sup>68</sup> and the Revised Model Business Corporation Act, adopted by over 20 states, codified the standards of conduct and liability for directors<sup>69</sup> and the standards for commencement and dismissal of derivative suits.<sup>70</sup> Delaware law, by contrast, contains no equivalent statutory provisions. Thus, corporate law is judge-made in Delaware to a greater extent than in most other states.

Third, the Delaware judiciary has taken the lead in expanding the breadth of judge-made law beyond its traditional domain. Judicial decisions in Delaware have thus created novel doctrines regulating actions by a board of directors that are taken for inequitable purposes<sup>71</sup> or that are intended to interfere with shareholder franchise<sup>72</sup> and have minted a new fiduciary duty of disclosure.<sup>73</sup>

62. Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 240 (1985).

63. IND. CODE ANN. § 23-1-35-1(f) (LexisNexis 2004).

64. IDAHO CODE ANN. § 30-1-860(1) (2005).

65. CAL. CORP. CODE § 160 (West 2005).

66. OHIO REV. CODE ANN. §§ 1701.59(C)–(D) (West 2005).

67. MICH. COMP. LAWS ANN. § 450.1495 (West 2005).

68. Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1827, 1828 tbl.3 (2002).

69. REV. MODEL. BUS. CORP. ACT §§ 8.30–8.31 (1999). The Comment notes that these rules "spell[] out a practical working definition of 'conflicting interest'" and are designed to create "bright line specificity and predictability." *Id.*, subch. F, introductory cmt. For a discussion of the tortured history of this effort and its ultimate failure, see R. Franklin Balotti & Joseph Hinsey IV, *Director Care, Conduct, and Liability: The Model Business Corporation Act Solution*, 56 BUS. LAW. 35, 35 (2000).

70. REV. MODEL. BUS. CORP. ACT §§ 7.40–7.46 (1999).

71. See, e.g., *Schnell v. Chris-Craft Indus.*, 285 A.2d 437, 439 (Del. 1971) (enjoining management from expediting the annual stockholders' meeting to obstruct a proxy fight with dissident shareholders).

72. *MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1131–32 (Del. 2003); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659–63 (Del. Ch. 1988).

While these new doctrines can all be justified as complementing traditional fiduciary duties, they nevertheless represent an extension of the historic breadth of these duties and have been rejected by other jurisdictions.<sup>74</sup> At a minimum, these doctrines show the great comfort on the part of Delaware's judiciary, and great tolerance on the part of its legislature, for having the courts expand the scope of judge-made law to address novel problems, rather than waiting for the legislature to act.

Fourth, the Delaware Supreme Court has shown a certain degree of discomfort with, perhaps even hostility to, legislative intrusions into its domain. There are numerous examples of this tendency.

- Section 262(h) of the Delaware General Corporation Law ("DGCL") explicitly provides that, in an appraisal proceeding, the fair value of shares is to be assessed "exclusive of any element of value arising from any accomplishment or expectation of the merger."<sup>75</sup> Yet, in *Weinberger v. UOP*, the Delaware Supreme Court read this "to be a very narrow exception to the appraisal process designed to eliminate use of *pro forma* data and projections of a speculative variety . . ."<sup>76</sup>
- Section 144(a)(1) and (2) of the DGCL provides that a self-dealing transaction shall not be voidable solely for this reason if it is approved after full disclosure by "a majority of the disinterested directors" or "*in good faith* by vote of the shareholders."<sup>77</sup> Yet, in *Marciano v. Nakash*, the Delaware Supreme Court read this to require "approval by fully informed disinterested directors under section 144(a)(1), or *disinterested* stockholders under section 144(a)(2)," in order to insulate a self-dealing transaction from attack.<sup>78</sup>
- Section 157(b) of the DGCL provides that "[i]n the absence of actual fraud in the transaction, the judgment of the directors as to the consideration for the issuance of such rights or options and the sufficiency thereof shall be conclusive."<sup>79</sup> Yet, in numerous compensation cases, the Delaware Supreme Court

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73. BLOCK ET AL., *supra* note 21, at 499–500.

74. See, e.g., *Invacare Corp. v. Healthdyne Techs., Inc.*, 968 F. Supp. 1578, 1581 (N.D. Ga. 1997) (declining to follow *Blasius*); *Solfanelli v. Mainwaring*, No. 91-6249, 1992 U.S. Dist. LEXIS 18883, at \*13 (E.D. Pa. Nov. 4, 1992) (finding no duty of candor under Pennsylvania law). Most states have not had occasion to determine whether they will adopt these new doctrines.

75. DEL. CODE ANN. tit. 8, § 262(h) (2005).

76. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 713 (Del. 1983).

77. DEL. CODE ANN. tit. 8, §§ 144(a)(1)–(2) (2005) (emphasis added).

78. 535 A.2d 400, 405 n.3 (1987) (emphasis added).

79. DEL. CODE ANN. tit. 8, § 157(b) (2005).

reads this to permit review of grants of options (even to nondirectors) under a waste standard, not the statutorily decreed “actual fraud” standard.<sup>80</sup>

- Section 251(c) of the DGCL was amended in 1998 to permit a merger agreement to expressly stipulate that it must “be submitted to the stockholders whether or not the board of directors determines at any time subsequent to declaring its advisability that the agreement is no longer advisable and recommends that the stockholders reject it.”<sup>81</sup> Yet, the Delaware Supreme Court in *Omnicare v. NCS* held that this very stipulation constituted a per se breach of fiduciary duty by the board when a “cohesive group of stockholders with majority voting power” concurrently agreed to vote in favor of the merger.<sup>82</sup>
- Section 220 of the DGCL was amended in 2003 to afford a stockholder of a Delaware corporation the right to inspect the books and records of a subsidiary of the corporation as long as “the corporation could obtain such records through the ‘exercise of control’ over [the] subsidiary.”<sup>83</sup> Yet earlier this year, the Delaware Supreme Court ruled in *Weinstein Enterprises Inc. v. Orloff* that, even though J.W. May, Inc. was a subsidiary of Weinstein Enterprises and Weinstein Enterprises controlled its affairs, a shareholder of Weinstein Enterprises was not entitled by Section 220 to obtain any records of J.W. May that were not in Weinstein Enterprises’ actual possession.<sup>84</sup>

Fifth, in Delaware, legislative overturning of judge-made corporate law is practically unheard of.<sup>85</sup> In the modern era, there has

80. See, e.g., *Michelson v. Duncan*, 407 A.2d 211, 223 (Del. 1979):

Section 157 was intended to protect directors’ business judgment in consideration inuring to the corporation in exchange for creating and issuing stock options . . . [W]e do not read section 157 as intended to erect a legal barrier to any claim for relief as to an alleged gift or waste of corporate assets in the issuance of stock options where the claim asserted is one of absolute failure of consideration.

See also *Zupnick v. Goizueta*, 698 A.2d 384, 387 (Del. Ch. 1997) (interpreting Section 157 to bar claims for waste unless there was no consideration or actual fraud).

81. DEL. CODE ANN. tit. 8, § 251(c) (2005).

82. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 937 (Del. 2003).

83. DEL. CODE ANN. tit. 8, § 220(b)(2)(b) (2005).

84. *Weinstein Enterprises Inc. v. Orloff*, 870 A.2d 499, 511 (2005).

85. In other areas and other states, the legislature does act to overturn judge-made law. See, e.g., H.R. 309, 142d Gen. Assem., 2d. Sess. (Del. 2004), available at <http://www.legis.state.de.us/LEGISLATURE.NSF/Archives/?openframeset&Frame=Main&Src=/lis/lis142.nsf/?open> (choose House Bill from Bill Type drop-down menu and type correct number in Bill Number field; then click Go! button) (last visited Oct. 17, 2005) (overturning Delaware Supreme Court

been only one significant instance of such overturning, and this instance represents the classic exception that proves the rule. In 1985, the Delaware Supreme Court, in *Smith v. Van Gorkom*,<sup>86</sup> greatly increased the risk that directors would be held liable for breaches of their duty of care. The decision, described by leading commentators as “shocking”<sup>87</sup> and “one of the worst decisions in the history of corporate law,”<sup>88</sup> led to the enactment of Section 102(b)(7). By permitting a company to opt out of personal liability for good-faith breaches of the duty of care, Section 102(b)(7) took the sting out of the *Van Gorkom* decision. Numerous other states followed Delaware and corporations, with wide shareholder support, quickly availed themselves of the opportunity to opt-out of personal liability.<sup>89</sup> But for this egregious instance, we are not aware of any significant corporate law decision in Delaware that has been legislatively overruled.<sup>90</sup> In comparison, in

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precedents on searches and seizures); H.R. 1, 140th Gen. Assem., 1st. Sess. (Del. 1999), available at <http://www.legis.state.de.us/LEGISLATURE.NSF/Archives/?openframeset&Frame=Main&Src=/lis/lis140.nsf/?open> (click on All Legislation; then click on Search in Legislation and follow instructions) (last visited Oct. 17, 2005) (overturning Delaware Supreme Court precedents on statutes of limitations); H.R. 249, 140th Gen. Assem., 1st. Sess. (Del. 1999), available at <http://www.legis.state.de.us/LEGISLATURE.NSF/Archives/?openframeset&Frame=Main&Src=/lis/lis140.nsf/?open> (click on All Legislation; then click on Search in Legislation and follow instructions) (last visited Oct. 17, 2005) (overturning Delaware Supreme Court precedents on insurance law); Eric Robinson et al., *State Takeover Statutes: A Fifty-State Survey* 10, 20, 24, 40, 42, 56 (1989) (unpublished survey, on file with author) (noting that Colorado, Georgia, Indiana, New Jersey, New York, and Virginia passed statutes overturning court decisions that had invalidated poison-pill plans).

86. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

87. WILLIAM T. ALLEN & REINIER KRAAKMAN, *COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION* 254 (2003).

88. Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 *BUS. LAW.* 1437, 1455 (1985).

89. Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 *EMORY L.J.* 1155, 1160, 1165–68 (1990).

90. According to an analysis of the legislative history and contemporary comments by renowned Delaware practitioners, there have been 26 amendments to the Delaware General Corporation Law since 1967 (the year the present modern corporation statute was enacted) that have responded in some fashion to judicial decisions. See Memorandum from Amy Simmer, Summer Associate at Morris, Nichols, Arsht & Tunnel, to Roberta Romano (Summer 2005) (on file with author). We would like to thank Morris, Nichols, and Roberta Romano for permission to cite this memorandum. Of these 26 amendments, 3 related to federal tax law, 6 codified a judicial decision or amended the law in a manner consistent with a judicial decision, and 11 responded to a judicial suggestion to clarify the law, clarified ambiguities, or addressed issues raised but not decided in a judicial decision. None of these amendments can be characterized as a judicial reversal.

Of the remaining 6 amendments, 2 “reversed” chancery court decisions rendered, respectively, 19 and 22 years prior to the amendment, and 3 related to chancery court decisions interpreting a statute and amended the statute in a way inconsistent with the chancery court interpretation. We would characterize the former two amendments as legislative updates, rather than legislative reversals, since the case law at issue was rather dated at the time of the amendment and since the legislature would have acted more quickly had it been unhappy with

the comparatively narrow field of insider trading, at least five decisions by the United States Supreme Court or federal circuit courts have been overturned by Congress or the SEC.<sup>91</sup>

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the judicial decision at the time it was rendered. With respect to the latter three amendments, there is an inherent ambiguity concerning whether the legislature thought that the court had misinterpreted the statute or whether it thought that the court interpreted the statute correctly as drafted but realized that it should have drafted the statute differently. In any case, none of these amendments related to Delaware Supreme Court decisions, and the subject matter of the amendments was narrow: they related to whether the appraisal provision in Section 262(i) authorized an award of compound interest, whether members of a membership corporation enjoy rights to inspect books and records equivalent to shareholders in stock companies, and whether an annual meeting must be held even if written consents are obtained for the election of directors. Thus, we would not characterize the judicial decisions that were reversed as significant. The final amendment related to whether election inspectors may contact a broker or similar institution to clarify its voting intentions when the broker has submitted multiple proxies relating to more votes than shares registered in its name. In 1989, the chancery court held that such clarification was not permissible, relying on a supreme court decision from 1971 that held "conflicting proxies, irreconcilable on their faces or from the books and records of the corporation, may not be reconciled by extrinsic evidence." *Concord Fin. Group v. Tri-State Motor Transit Co. of Del.*, 567 A.2d 1, 6 (Del. Ch. 1989) (quoting *Williams v. Sterling Oil of Okla.*, 273 A.2d 264, 265 (Del. 1971)). In 1990, the legislature provided by statute that brokers and similar institutions may be consulted to reconcile overvotes. DEL. CODE ANN. tit. 8, § 231(d) (2005). This issue is important, and the legislature's timing suggests that it was stimulated by the 1989 decision. The 1989 decision was only rendered by the chancery court, however, and it appears that the chancery court felt itself bound by the 1971 supreme court decision on point, which had not been legislatively addressed for over 20 years.

91. See, e.g., *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5, 16 (2d Cir. 1983) (holding that there is no private right of action where violation is premised on misappropriation theory), *superseded by statute*, Securities Exchange Act of 1934, § 20A(a), 15 U.S.C. § 78t-1(a) (2005) (establishing a private right of action based on contemporaneous trading); *Laventhall v. Gen. Dynamics Corp.*, 704 F.2d 407, 414 (8th Cir. 1983) (holding that insider owes no duty to abstain from trading to holder of options), *superseded by statute*, Securities Exchange Act of 1934, § 20(d), 15 U.S.C. § 78t(d) (2005) (extending insider trading prohibition to derivatives where trading in underlying security is not permitted); *United States v. Smith*, 155 F.3d 1051, 1066-69 (9th Cir. 1998) (adopting "use" test), *superseded by statute*, Securities Exchange Act Rule 10b5-1, 17 C.F.R. § 240.10b5-1 (2005) (establishing "awareness" test for insider trading); *United States v. Chestman*, 903 F.2d 75, 79-80 (2d Cir. 1990) (holding, under the particular facts, that family members of insiders owed no duty to family, corporation, or shareholders that obligated them to abstain from trading), *superseded by statute*, Securities Exchange Act Rule 10b5-2, 17 C.F.R. § 240.10b5-2(b)(3) (2005) (establishing presumptive duty of trust and confidence among family members); *Chiarella v. United States*, 445 U.S. 222, 232-35 (1980) (holding that employee of printer working for bidder had no relation with target shareholders that obligated employee to abstain from trading), *superseded by statute*, Securities Exchange Act Rule 14e-3, 17 C.F.R. § 240.14e-3 (2005) (prohibiting trading based on information related to tender offer received directly or indirectly from bidder). One factor that is likely to contribute to the low rate of legislative reversals in Delaware is the greater expertise of the Delaware court (relative to the Delaware legislature and to federal courts) on issues of corporate law. But as we discuss below, the relative expertise of Delaware's judiciary is itself an adaptation to the threat of federal preemption. See *infra* Parts II.D., II.E.

### B. The Quasi-Deterministic Style of Delaware's Judge-Made Law

Beyond the breadth of judge-made law, the mode of judge-made law is noteworthy. As several commentators have recently emphasized, judge-made Delaware law eschews hard rules in favor of flexible and highly fact-intensive standards.<sup>92</sup> This results in an extraordinarily high degree of flexibility. A typical Delaware opinion reads as if the specific facts, combined with long-standing and universally accepted fiduciary principles, clearly dictate the outcome of the case. This permits Delaware law to respond to new problems or to revise the way it deals with old problems without openly admitting that the judges have made new law or have changed old law.<sup>93</sup>

Indeed, the Delaware Supreme Court rarely overrules its own precedents explicitly.<sup>94</sup> 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<sup>95</sup> or by attributing any misunderstanding by lawyers or lower court judges to their failure

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92. See, e.g., Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1233–40 (2001); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1927–34 (1998); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1024 (1997).

93. Cf. Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Debate on State Competition over Corporate Charters*, 112 YALE L.J. 553, 603–04 (2002) (arguing that indeterminacy helps Delaware fend off federal intervention). Bebchuk and Hamdani view indeterminacy as helping Delaware hide the extent to which its law favors managers and the extent to which it changes the law to respond to the fear of federal intervention. *Id.* at 603. By contrast, we view indeterminacy as reinforcing the technocratic gloss of judge-made law.

94. A LexisNexis search in the Delaware Supreme Court database using the search term “overrule” has revealed no instance in the last 20 years in which the court overruled its own corporate law precedent. It did, however, reveal ten decisions in other areas in which the court overruled its own precedent. See, e.g., *Pub. Water Supply Co. v. DiPasquale*, 735 A.2d 378, 382 (Del. 1999) (overruling a 1994 decision regarding judicial review of administrative agencies).

95. Compare *Unocal Corp. v. Mesa Petroleum*, 493 A.2d 946, 946 (Del. 1985) (noting that directors may consider “the impact [of a takeover bid] on ‘constituencies’ other than shareholders [i.e., creditors, customers, employees, and perhaps even the community generally]” in resisting a bid), with *Revlon Inc. v. MacAndrews & Forbes*, 506 A.2d 173 (Del. 1986) (faulting directors for taking into account the adverse impact of bid on noteholders, whose rights “were fixed by contract” and therefore “required no further protection,” and explaining that board may consider other constituencies only if “there are rationally related benefits accruing to stockholders”). Compare *In re Tri-Star Pictures, Inc.*, Litig. 634, A.2d 319, 333 (Del. 1993) (“In Delaware existing law and policy have evolved into a virtual per se rule of damages for breach of the fiduciary duty of disclosure.”), with *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 141 (Del. 1997) (“*Tri-Star* stands only for the narrow proposition that, where directors have breached their disclosure duties in a corporate transaction that has in turn caused impairment to the economic or voting rights of stockholders, there must at least be an award of nominal damages.”).

to read supreme court precedent carefully.<sup>96</sup> Similarly, supreme court justices in Delaware rarely dissent.<sup>97</sup>

Consistent with the presentation of Delaware law as a body of stable, clear, uncontroversial, and easy-to-follow standards laid down in a body of precedent, the court reacts harshly when directors' actions fail to measure up. In such instances, judicial opinions highlight these failures in preachy, moralistic terms.<sup>98</sup> Deficiencies in the conduct of directors—whether because of ill-will, lack of backbone, or at the least incompetence—are presented as constituting a failure for which punishment is warranted (and not, say, to a reasonable, good-faith interpretation of what prior judicial decisions require), and directors are regularly pilloried for such failures by the Delaware Supreme Court.<sup>99</sup>

### C. *The Making of Delaware's Statutory Law*

Although formally adopted by the legislature, Delaware's elected representatives have no significant role in crafting Delaware's

96. Compare *Weinberger v. UOP*, 457 A.2d 701 (Del. 1983) (noting that in a freezeout merger, the plaintiff's "monetary remedy ordinarily should be confined to . . . appraisal"), with *Rabkin v. Phillip A. Hunt Chemical Corp.*, 498 A.2d 1099, 1104 (Del. 1985) (reversing the chancery court's application of that principle and faulting it for adopting a "narrow interpretation of *Weinberger* [that] would render meaningless our extensive discussion of fair dealing found in that opinion"). Compare *Paramount Commc'ns v. Time Inc.*, 571 A.2d 1140 (Del. 1989) (noting the chancery court held that the Time-Warner merger agreement did not result in change of control because control remained in fluid aggregation of unaffiliated shareholders, but explicitly premising its holding on different ground, i.e., absence of a break), with *Paramount Commc'ns Inc. v. QVC Networks Inc.*, 637 A.2d 34 (Del. 1994) (endorsing the rationale offered by the chancery court in *Time* and noting that defendants "misread" earlier cases and "totally ignore" portions of their language). See also *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1116 (Del. 1994) (resolving conflict in chancery court as to effect of approval by special committee by noting that a "definitive answer" can be found in earlier supreme court opinions); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1284 n.34 (Del. 1988) ("Following *Revlon*, there appeared to be a degree of 'scholarly' debate about the particular fiduciary duty that had been breached in that case, i.e., the duty of care or the duty of loyalty. In [*Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1345 (Del. 1987)], we made it abundantly clear that both duties were involved in *Revlon*, and that both had been breached.") (emphasis added).

97. David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 VA. L. REV. 127, 132 (1997) (noting the low rate of dissents, in absolute terms and compared to other states).

98. See *Rock*, *supra* note 92, at 1016 (describing the opinions of Delaware courts as "corporate law sermons").

99. *Kahn v. Tremont Corp.*, 694 A.2d 422, 429–30 (Del. 1997) (noting that disinterested directors "abdicated their responsibility" and "default[ed] on their obligation to remain fully informed"); *QVC*, 637 A.2d at 50 (stating that the directors of *Paramount* "remained prisoners of their own misconceptions"); *Mills*, 559 A.2d at 1280 (describing the board of *Macmillan* as "torpid, if not supine"); *Rabkin*, 498 A.2d at 1106 (noting that the special board committee of *Hunt* directors engaged in a "quick surrender" when faced with a squeeze-out offer by *Hunt's* controlling shareholder); *Rock*, *supra* note 92, at 1028–60 (detailing other instances in which Delaware courts castigated actions by directors).

statutory corporate law. It is the Council of the Corporation Law Section of the Delaware Bar Association, rather than a legislative committee,<sup>100</sup> that prepares drafts of proposed amendments to the General Corporation Law.<sup>101</sup> These proposals are often instigated by lawyers who have encountered an ambiguity or a technical problem in the statute that they want to have clarified or corrected. After the Corporation Law Section has developed a proposal, it is submitted to the legislature. Delaware's legislature then typically adopts the proposed amendments. Neither a legislative committee nor the legislature as a body changes the proposal or debates its merits, and the vote on the proposed amendment tends to be unanimous.<sup>102</sup> Legislators claim no expertise over corporate law, and partisan politics play no role in its formation.<sup>103</sup>

Even within the Delaware bar, proposed amendments hardly ever generate controversy.<sup>104</sup> One reason is that the Corporation Law Section endeavors to make the necessary compromises to reach a

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100. The Delaware Senate has twenty-six committees; the House has twenty-eight committees. Official Website of the State of Delaware, <http://www.legis.state.de.us/Legislature.nsf/?OpenDatabase> (last visited Oct. 17, 2005).

101. Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 898 (1990).

102. This is not the uniform mode for legislation in Delaware. In other areas, bills are amended in the legislative process, pass with dissent, or are defeated. See, e.g., H.R. 15, 142d Gen. Assem., 1st Sess. (Del. 2003), available at <http://www.legis.state.de.us/LEGISLATURE.NSF/Archives/?openframeset&Frame=Main&Src=/lis/lis142.nsf/?open> (choose House Bill from Bill Type drop-down menu and type correct number in Bill Number field; then click Go! button) (last visited Oct. 17, 2005) (showing several proposed amendments to the bill on smoking regulation and noting its eventual defeat in the Senate); H.R. 24, 142d Gen. Assem., 1st Sess. (Del. 2003), available at <http://www.legis.state.de.us/LEGISLATURE.NSF/Archives/?openframeset&Frame=Main&Src=/lis/lis142.nsf/?open> (choose House Bill from Bill Type drop-down menu and type correct number in Bill Number field; then click Go! button) (last visited Oct. 17, 2005) (noting the Senate defeat of a bill clarifying crime of offering false instrument for filing); H.R. 182, 142d Gen. Assem., 1st Sess. (Del. 2003), available at <http://www.legis.state.de.us/LEGISLATURE.NSF/Archives/?openframeset&Frame=Main&Src=/lis/lis142.nsf/?open> (choose House Bill from Bill Type drop-down menu and type correct number in Bill Number field; then click Go! button) (last visited Oct. 17, 2005) (showing a divided committee report on and several amendments to a bill on health care negligence suits). That Delaware's Constitution requires a two-thirds majority for changes in the corporate law does not account for the lack of dissent or defeat, since supermajority requirements make it easier to defeat a bill and thus create incentives to dissent. DEL. CONST. art. IX, § 1.

Nor is this the uniform mode for corporate law legislation in states other than Delaware. See Kahan & Kamar, *supra* note 38, at 732 (describing the significant political controversy over the section of New York law imposing personal liability on large shareholders for wage claims); Andrew Ross Sorkin, *Michigan Senate Approves Change in Takeover Laws*, N.Y. TIMES, Sept. 19, 2003, at C4 (noting that a bill protecting the Taubman family's right to block a takeover of its shopping mall company by Simon Property Group was passed 24-14 after an amendment to the bill that would have enabled the bidder to continue its takeover effort was defeated 19-19).

103. Alva, *supra* note 101, at 898.

104. See *id.* at 909-13 (using the involuntary redemption statute as a case study).

consensus. For example, a significant amount of bargaining took place within the Council over the precise scope of Section 102(b)(7) in order to generate an unanimous proposal for the legislature to act upon.<sup>105</sup>

The ultimate reason for the lack of controversy over statutory amendments, however, is that, although Delaware regularly revises its corporate law, most amendments address minor or technical issues. Consider, for example, the 1999 amendments to the DGCL, which made changes to ten sections.<sup>106</sup> Six of the changes concern only nonstock corporations<sup>107</sup> or deal with the conversion of a corporation into a domestic LLC, a limited partnership, or a business trust (with unanimous shareholder approval), and vice versa.<sup>108</sup> The remaining four amendments address the following:

- Section 102(a) (name of corporations) was changed to provide that punctuation in terms such as “Ltd.” is optional and that foreign terms designating corporate existence are acceptable as part of the name.
- Section 202 (transfer restrictions) was changed to clarify that restrictions may be placed on the amount of stock owned by any person, that a restriction may obligate a holder to sell restricted securities or provide for an automatic sale, and that restrictions imposed to qualify as a REIT are presumed to be reasonable.
- Section 251(g) (mergers with wholly-owned subsidiaries to create a holding company) was changed to clarify that the directors of the surviving company may be changed without vote by the shareholders of the holding company.
- Section 253 (short-form merger) was changed to clarify that the 90 percent ownership prerequisite for short-form mergers applies only to classes of outstanding shares that would, but for that section, be entitled to vote on the merger.

Thus, none of the 1999 amendments relate to corporate governance, fiduciary duties, or other core issues of corporate law, and

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105. *Id.* at 914–15.

106. Act of July 2, 1999, ch. 123 (Del. Adv. Legis. Serv., LEXIS through Sept. 6, 2005).

107. Section 170 (dividends) was changed to clarify that nonstock corporations can declare dividends whether they are for profit or not for profit. DEL. CODE ANN. tit. 8, § 170(a) (2005). Section 242 (charter amendment) was modified to eliminate the requirement of two meetings by the governing body of a nonstock corporation to adopt a charter amendment. *Id.* § 242(b)(3). Section 255 (merger of nonstock corporations) lowers the approval threshold from two-thirds to a majority of members, thus conforming to the threshold for stock corporations. *Id.* § 255(c).

108. A new section, 266, permits a conversion by a corporation; another new section, 265, permits a conversion into a corporation; and amendments to Section 391 provide for fees for these conversions. *Id.* §§ 266, 265, 391(a)(25)–(26).

none could even remotely be anticipated to generate public debate or controversy. Although statutory amendments occasionally venture somewhat further afield from the technical,<sup>109</sup> the 1999 amendments typify Delaware's legislative changes to its corporation law.<sup>110</sup>

#### D. *Distinctive Features of Delaware's Judiciary*

Delaware's judiciary—the generator and, as discussed below, the primary enforcer of this distinctive law—is itself peculiar in several respects. First, as noted above, Delaware is the only state that has a specialized corporate trial court, the Court of Chancery, which decides cases without juries.<sup>111</sup> Usually, several of the five supreme court justices (at present, three) are former members of the chancery court. Thus, both on the trial and the appeals court level, corporate cases are decided by a specialized judiciary.

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109. For example, in a 1998 amendment, Section 251(c) was changed so that the merger agreement could “require that the agreement be submitted to the stockholders whether or not the board of directors determines at any time subsequent to declaring its advisability that the agreement is no longer advisable and recommends that the stockholders reject it.” Act of June 29, 1998, ch. 339, § 44 (Del. Adv. Legis. Serv. LEXIS through Sept. 6, 2005) (codified at DEL. CODE ANN. tit. 8, § 251(c) (2005)). Of course, under federal law and Delaware fiduciary duty law, the directors would have to inform shareholders of their revised views and of the basis for these views. Moreover, the Delaware Supreme Court has held that directors violate their fiduciary duties by including such a requirement in the merger agreement when shareholders lack the effective ability to block the merger in the shareholder vote. *See Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 937 (Del. 2003). This holding greatly limits the practical significance of the amendment with regard to merger agreements that lose board support but retain shareholder support.

110. By contrast, laws in other states address more substantive issues. For example, in 1999, several states amended substantive provisions of their corporation laws. Maryland enacted the Maryland Unsolicited Takeover Act, ch. 300, 1999 Md. Laws 300 (codified as amended at MD. CODE ANN. CORPS. & ASS'NS §§ 3-801–3-805 (2005)), which includes several potent anti-takeover defenses, including the endorsement of a slow-hand pill, the application of the business judgment rule to takeover defenses, and the power of a board to adopt a staggered board without shareholder approval. *See* Subramanian, *supra* note 68, at 1864–66. Georgia amended its corporate law to sanction dead-hand pills. *See* Xueqing Linda Ji, *A New Look at Dead-Hand Provisions In Poison Pills: Are They Per Se Invalid After Toll Brothers and Quickturn?*, 44 ST. LOUIS L.J. 223, 263 (2000). Georgia also amended its business combination statute to provide that one does not become an interested shareholder as a result of shares tendered in a tender offer (until the shares are accepted) or as a result of a proxy solicited in a proxy solicitation to ten or more persons. GA. CODE ANN. § 14-2-1110(4)(c) (2005). The Model Business Corporation Act was amended to eliminate appraisal rights for charter amendments, provide a market out, and change the standard for shareholder approval of asset sales from “substantially all” to a more concrete test. MODEL BUS. CORP. ACT §§ 12.02(a), 13.02(a) (2005). Obviously, these examples are just illustrative and do not prove that substantive amendments to corporate codes are less common in Delaware than in other states.

111. Kahan & Kamar, *supra* note 38, at 708.

Second, compared both to judges in other states and to federal judges, Delaware's judiciary is nonpoliticized.<sup>112</sup> Delaware is one of only eight states in which judges are selected based on merit by a nominating commission and face no elections thereafter.<sup>113</sup> In addition, Delaware's constitution mandates a partisan balance in the supreme court and the overall judiciary.<sup>114</sup>

To be sure, unlike federal judges, Delaware judges serve a limited term.<sup>115</sup> But just as with initial appointment decisions, reappointment decisions are nonpoliticized. In modern times, there has only been one judge, Justice Andrew Moore, who wanted to get reappointed, but failed. The reason for this failure, however, is unrelated to his politics or his jurisprudence. Rather, Justice Moore, while praised for his intellectual prowess, is said to have lost favor among the corporate bar because he was perceived as "arrogant, acerbic, sanctimonious and upbraiding."<sup>116</sup>

Finally, to a greater extent than is typical for members of the judiciary, Delaware judges propagate their vision outside the court room. Delaware judges publish an extraordinary amount of extra-judicial writing.<sup>117</sup> Members of Delaware's judiciary also regularly

112. See also Skeel, *supra* note 97, at 134 (describing the judicial appointment process as apolitical because it "is largely divorced from party politics in practice").

113. THE LAWYER'S ALMANAC J-5-J-12 (2005).

114. DEL. CONST. art IV, § 3.

115. LAWYER'S ALMANAC, *supra* note 113, at J-5-J-12.

116. Karen Donovan, *Shareholders' Advocates Protest Justice's Removal*, NATL. L.J., June 6, 1994, at B1, B2; see also John Close & Nicholas Varchaver, *Justice Denied in Delaware*, AM. LAW., July-Aug. 1994, at 23, 23 (noting that Justice Moore, "the author of a string of seminal opinions," was prone to hand out "harsh chastisement of attorneys," "projected a sense of arrogance," and engaged in "ad hominem" questioning during oral argument).

117. The following is an incomplete list of such writings by current (and very recently retired) members of the Delaware Supreme Court and Court of Chancery: William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *The Great Takeover Debate: A Meditation On Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067 (2002); William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449 (2002); William B. Chandler III, *On the Instructiveness of Insiders, Independents, and Institutional Investors*, 67 U. CIN. L. REV. 1083 (1999); William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953 (2003); Randy J. Holland, *State Constitutions: Purpose and Function*, 69 TEMP. L. REV. 989 (1996); Randy J. Holland, *State Jury Trials and Federalism: Constitutionalizing Common Law Concepts*, 38 VAL. U. L. REV. 373 (2004); Randy J. Holland & Cynthia Gray, *Judicial Discipline: Independence with Accountability*, 5 WIDENER. L. SYMP. J. 117 (2000); Randy J. Holland & David A. Skeel, Jr., *Deciding Cases Without Controversy*, 5 DEL. L. REV. 115 (2002); 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 (2001); Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations*, 27 DEL. J. CORP. L. 499 (2002); Leo E. Strine, Jr., *The Social Responsibility of*

participate in professional meetings, attend academic conferences, and give lectures to corporate directors.<sup>118</sup> For example, Delaware judges regularly appear at the annual Tulane Corporate Law Institute: at the 2004 conference, Justices Veasey, Steele, and Jacobs from the Delaware Supreme Court and Vice-Chancellor Strine from the Chancery Court were all present.<sup>119</sup>

### *E. The Reliance on Private Enforcement*

Another notable trait of Delaware's corporate law is that it is enforced exclusively through private lawsuits. Delaware has no regulatory agency that either examines compliance with corporate law or enforces its corporate law through fines, injunctions, or cease-and-desist orders; the state 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,<sup>120</sup> these powers are virtually never exercised.<sup>121</sup>

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*Boards of Directors and Stockholders in Charge of Control Transactions: Is There Any "There" There?*, 75 S. CAL. L. REV. 1169 (2002); E. Norman Veasey, *Corporate Governance and Ethics in a Post Enron/Worldcom Environment*, 72 U. CIN. L. REV. 731 (2003); E. Norman Veasey, *The Ethical and Professional Responsibilities of the Lawyer for the Corporation in Responding to Fraudulent Conduct by Corporate Officers or Agents*, 70 TENN. L. REV. 1 (2002); E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 1 DEL. L. REV. 169 (1998); E. Norman Veasey, *Ethics 2000: Thoughts and Comments on Key Issues of Professional Responsibility in the Twenty-First Century*, 5 DEL. L. REV. 1 (2002); E. Norman Veasey, *Law and Fact in Judicial Review of Corporate Transactions*, 10 U. MIAMI BUS. L. REV. 1 (2002); E. Norman Veasey, *The Many Facets of Judicial Independence Diamond*, 20 QUINNIPIAC L. REV. 779 (2001); E. Norman Veasey, *Musings on the Dynamics of Corporate Governance Issues, Director Liability Concerns, Corporate Control Transactions, Ethics, and Federalism*, 152 U. PA. L. REV. 1007 (2003); E. Norman Veasey, *Policy and Legal Overview of Best Corporate Governance Principles*, 56 SMU L. REV. 2135 (2003); E. Norman Veasey, *Reflections on Key Issues of the Professional Responsibilities of Corporate Lawyers in the Twenty-First Century*, 12 WASH. U. J.L. & POL'Y 1 (2003); E. Norman Veasey, *The Roles of the Delaware Courts in Merger and Acquisition Litigation*, Speech Presented at the Fourth Annual Mergers and Acquisitions Insight Information Co. (June 18, 2001), in 26 DEL. J. CORP. L. 849 (2001); E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—or Vice Versa?*, 149 U. PA. L. REV. 2179 (2001); E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441 (2003).

118. Interestingly, while the Delaware Court of Chancery does not keep track systematically of chancellors' speeches or public appearances, the SEC provides a website with links to speeches and public statements of commissioners and staff. See U.S. SEC, Commission Speeches and Public Statements, <http://www.sec.gov/news/speech.shtml> (last visited Oct. 8, 2005).

119. Indeed, the brochure's promised benefits include the opportunity to "learn from and interact with members of the Delaware Supreme Court and Court of Chancery." Brochure, Tulane University Law School Sixteenth Annual Corporate Law Institute, March 2004 (on file with author).

120. DEL. CODE ANN. tit. 8, §§ 124(3), 284(a) (2005).

121. A search in Westlaw's Delaware Business Organization Case Law file revealed three cases involving charitable corporations in which the Attorney General took some action.

In striking contrast to this lack of public enforcement, Delaware has taken great care in developing a first-rate system for private enforcement. It is the only state in the nation that has a specialized corporate court, the Court of Chancery. This 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.<sup>122</sup> If needed, appeals from the Court of Chancery are heard by the Delaware Supreme Court quickly and decided promptly after oral argument.<sup>123</sup> Moreover, Delaware takes pains to ensure that the chancery court has the personal jurisdiction that it needs in order to resolve corporate disputes involving Delaware corporations. Thus, when the United States Supreme Court invalidated the statutory basis for Delaware's personal jurisdiction as inconsistent with due process,<sup>124</sup> thereby threatening the ability of the chancery court to resolve corporate disputes, Delaware passed a new statute within 13 days establishing a different statutory basis for its jurisdiction over corporate directors.<sup>125</sup> More recently, in light of the trend by public corporations to have only a few officers serve on the board of directors, Delaware expanded its personal jurisdiction statute to include a corporation's senior or most highly compensated officers, whether or not they are members of the board of directors.<sup>126</sup>

This focus on private enforcement is distinctive both from the international and the national perspective. Internationally, corporate law rules are to a large extent publicly enforced. Public enforcement agents include the securities regulators of various countries; the Panel on Takeovers and Mergers, which enforces the U.K. City Code on Takeovers and Mergers; and prosecutors, who, in Continental Europe, bring criminal proceedings against misbehavior by corporate executives (including actions that would be regarded in the United States as, at most, civil breaches of fiduciary duties).<sup>127</sup> Within the

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Otherwise, the Attorney General appeared in corporate disputes only as a defendant in cases challenging the constitutionality of Delaware's anti-takeover law.

122. Kahan & Kamar, *supra* note 38, at 708 n.95.

123. *Paramount Comm'ns, Inc. v. QVC Networks Inc.*, 637 A.2d 828 (1993) (providing the court's order resolving dispute, which is dated same day as the oral argument).

124. *Shaffer v. Heitner*, 433 U.S. 186, 216-17 (1977) (holding that Delaware's quasi-in-rem statute was not a valid basis for its exercise of jurisdiction over directors and officers of Delaware corporations).

125. See Kahan & Kamar, *supra* note 38, at 714 n.117 (deeming directors to have consented to jurisdiction).

126. Frederick H. Alexander, *Significant Amendments Made to Delaware Corporation Law*, 35 SEC. REG. & L. REP. (BNA) 1331, 1333 (Aug. 11, 2003).

127. For example, several sections of the German Aktienrecht and U.K. company law impose criminal penalties and fines for misconduct. See, e.g., Aktiengesetz [AktG, Stock Corporation Act] §§ 399 (false statements) and 404 (violation of duty of confidentiality); Companies Act 1985, c. 6,

United States, corporate law rules adopted through the federal securities laws are enforced publicly, either on an exclusive basis or concurrent with private enforcement.<sup>128</sup> Similarly, stock exchanges, to the extent that they enforce listing requirements designed to protect shareholders, can be regarded as quasi-public third-party enforcement agents. Finally, a plethora of publicly-enforced state and federal laws—such as the Trust Indenture Act,<sup>129</sup> the Investment Company Act,<sup>130</sup> the Investment Advisers Act,<sup>131</sup> and state Blue Sky laws<sup>132</sup>—protect investors against overreaching by bond issuers, managers of mutual funds, brokers, and issuers of securities.

To be sure, other states are not necessarily more active than Delaware is in enforcing corporate laws publicly. But none of the other states has any significant stake in its corporate law, and none of the other states has developed sophisticated structures for the private enforcement of its corporate laws comparable to Delaware's.<sup>133</sup> Moreover, some states publicly prosecute corporate misconduct, albeit under the guise of their criminal, rather than their corporate, law. Recently, for example, the Manhattan District Attorney charged Dennis Kozlowski, the CEO, and two other officers of Tyco International with grand larceny and violations of the general business law for looting the company through excessive compensation

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pt. X, § 342 (Eng.) (criminalizing the extension of loans to directors in violation of Company Act). For a particularly high-profile and dramatic example, see the current criminal prosecution of Josef Ackermann, CEO of Deutsche Bank, over his approval as a director of Mannesmann of a bonus to Mannesmann's CEO at the conclusion of the control battle with Vodafone. See, e.g., Mark Landler, *Banker Faces German Court Over Pay Issue*, N.Y. TIMES, Jan. 20, 2004, at C1; Marcus Walker, *After Huge Merger, German CEO Faces Trial Over Payout*, WALL ST. J., Nov. 6, 2003, at A1; see also *Santander Chairman Ordered to Stand Trial*, WALL ST. J., Apr. 28, 2004, at C2 (reporting that three executives of a Spanish bank were being tried for arranging generous severance packages for some of the bank's former executives).

128. See Securities Exchange Act of 1934, § 21(a), 15 U.S.C. § 78u(a)(1) (2005) (empowering SEC to investigate violations of and enforce provisions of Securities Exchange Act); *Pitt Cites Record Number of Financial Reporting Actions*, 34 SEC. REG. & L. REP (BNA) 1747 (Oct. 28, 2002) (noting that SEC brought 163 actions for financial reporting and issuer disclosure violations in fiscal year 2002).

129. Trust Indenture Act of 1939, ch. 411, 53 Stat. 1149 (codified as amended at 15 U.S.C. §§ 77aaa–77bbbb (2005)).

130. Investment Company Act of 1940, ch. 686, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1–80a-64 (2005)).

131. Investment Advisers Act of 1940, ch. 686, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1–80b-21 (2005)).

132. E.g., Uniform Securities Act (amended 2002), 7C U.L.A. 1 (Supp. 2005) (listing states that have already adopted the Act).

133. No state has a corporate court similar to Delaware's chancery court. See Kahan & Kamar, *supra* note 38, at 708–15 (discussing other states' less successful efforts to establish business courts). Only twelve other states have consent statutes relating to directors that are similar to Delaware's and, to our knowledge, no other state has a consent statute relating to officers. See *id.* at 714 n.113.

or taking unauthorized loans—classic self-dealing transactions by a corporate fiduciary.<sup>134</sup> And, with a federal investigation pending, Oklahoma's Attorney General filed criminal charges against former WorldCom CEO Bernard Ebbers and five others for defrauding the state's pension funds and other investors.<sup>135</sup> Delaware, the domicile of choice for public firms, can and did extend its criminal jurisdiction to similar misconduct harming Delaware corporations<sup>136</sup>—yet we are not aware of any instances in which Delaware prosecutors have investigated or charged corporate officials. Thus, even relative to other states, Delaware's focus on private enforcement stands out.

### F. *The Scope of Corporate Law*

The scope of Delaware's corporate law includes the regulation of the internal affairs of the corporation and concerns the powers, rights, and duties of the corporation, its shareholders, officers, and directors. Delaware's corporate law, however, largely does not address matters beyond the internal affairs of the corporation. Although the scope of Delaware's law in this respect is similar to the scope of corporate law in other states in the United States, it differs from the scope of corporate law in other countries. U.K. company law, for example, prohibits carrying out a business under a misleading name,<sup>137</sup> imposes a duty on a corporation to identify its name and characteristics in dealing with outsiders,<sup>138</sup> regulates debentures,<sup>139</sup> and deals with security interests.<sup>140</sup> In the United States, these issues are addressed by different bodies of state or federal law.<sup>141</sup>

Within the confines of internal affairs, Delaware corporate law broadly covers most areas: the creation and dissolution of a corporation; the powers of a corporation; the decisionmaking powers of shareholders, directors, and officers; shareholder voting; and the

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134. News Release, District Attorney-New York County, *supra* note 4.

135. *Oklahoma Files First Criminal Charges Against WorldCom*, THE INDEPENDENT, Aug. 23, 2003, at 19; see also *Former Qwest Chairman Anschutz to Pay \$4.4M in N.Y. State Spinning Case*, 35 SEC. REG. & L. REP. (BNA) 857 (May 19, 2003) (noting settlement by corporate executive of charges brought by N.Y. Attorney General that he received profitable allocations of IPO shares from Salomon Smith Barney "as an inducement or reward for investment banking business" from the company).

136. Delaware criminal law applies to offenses where the result occurs in Delaware or to conspiracies where at least one overt act occurs within Delaware. DEL. CODE ANN. tit. 11, §§ 204(a)(1)–(2) (2005).

137. Companies Act 1985, c. 6, pt. I, c. II, § 33 (Eng.).

138. *Id.* pt. XI, c. I, §§ 348–351.

139. *Id.* pt. V, c. VIII, §§ 190–195.

140. *Id.* pt. XII, c. I, §§ 395–409.

141. See, e.g., U.C.C. §§ 9-101 et seq. (2005) (dealing with secured transactions).

obligations of corporate fiduciaries.<sup>142</sup> In general terms, Delaware corporate law (though not necessarily the laws of other U.S. states) also covers much of the same territory as the federal securities laws, though it does so in a rather different manner. Federal law, for example, requires public companies to disclose a wide array of information, on a regular basis or in relation to a vote.<sup>143</sup> Delaware law also governs the company's disclosure of information. But rather than imposing specific disclosure requirements, Delaware law requires a company to disclose all material information when shareholders are asked to vote or to take other actions<sup>144</sup> and grants shareholders a general right to inspect the company's books and records for a proper purpose.<sup>145</sup> Federal law, including stock exchange rules sanctioned by the SEC, requires the board of directors of public corporations, including certain committees, to contain specified percentages of independent directors. Delaware law also governs board composition. But rather than the stick of mandated requirements, Delaware law uses the carrot of granting greater legal protections to properly constituted boards.<sup>146</sup> Federal law prohibits certain forms of coercion and discrimination in tender offers.<sup>147</sup> Delaware law subjects coercion and discrimination by the corporation to legal scrutiny for breach of fiduciary duty and permits a board wide latitude in defending itself against a coercive offer by a third party.<sup>148</sup> Federal law criminalizes insider trading and creates a private right of action on behalf of investors.<sup>149</sup> Delaware law creates a right of action on the part of the company, enforceable through a derivative suit by shareholders.<sup>150</sup>

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142. See, e.g., notes 48–62, *supra*, and accompanying text.

143. Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 982–83 (1992). Federal disclosure rules also apply to a company that seeks to issue shares. *Id.* at 983 & n.22. Delaware has no equivalent rules, presumably due to the fact that a sale of shares is outside the internal affairs of a company.

144. See *Erickson v. Centennial Beauregard Cellular LLC*, No. 19974, 2003 Del. Ch. LEXIS 38, at \*13–\*16 (Del. Ch. Apr. 11, 2003) (holding that the disclosure statement in a short-form merger did not comply with requirement to disclose all material information related to the merger to permit shareholders to make an informed decision on whether to exercise their appraisal rights).

145. Del. Code Ann. tit. 8, § 220 (2005).

146. *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994).

147. Securities Exchange Act of 1934, § 14(d), 15 U.S.C. § 78n(d) (2005).

148. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 957–58 (Del. 1985).

149. *Chiarella v. United States*, 445 U.S. 222, 225–26 (1980); *but see* Securities Exchange Act, § 16(b), 15 U.S.C. § 78p(b) (2005) (providing statutory insider trading provisions that enable private, derivative-suit-like enforcement mechanism).

150. See *Brophy v. Cities Serv. Co.*, 70 A.2d 5, 8 (1949) (“When . . . a person ‘in a confidential or fiduciary position, in breach of his duty, uses his knowledge to make a profit for himself, he is accountable for such profit’”) (citation omitted); *Guttman v. Huang*, 828 A.2d 492, 505 (Del. Ch.

These differences in approach between Delaware and federal law, of course, are related to the distinctive traits of Delaware law. As noted before, much of Delaware law is judge-made and privately enforced. But the development of specific disclosure requirements, of mandated rules of board composition, of criminal violations, and even of inflexible per se rules on coercion and discrimination is hard to mesh with traditional modes of judge-made law, and specifically with the modes of privately enforced, judge-made corporate law in Delaware. Because of the distinctive traits of Delaware law, its regulation of disclosure, board composition, coercive tender offers, and insider trading, though striking in the same direction, takes a form different from federal law.

### III. DELAWARE'S TRAITS AS ADAPTATIONS TO THE POLITICAL LANDSCAPE

The various traits of Delaware corporate law discussed in the last Part should all be viewed through the lens of the institutional and political landscape in which Delaware must operate. Delaware operates in a federal system in which its regulatory powers co-exist with and can be constrained by the powers of the federal government and the various other states. In this system, Delaware is faced with an omnipresent, albeit not imminent, specter of a federal takeover. Such a takeover could make Delaware corporate law irrelevant, or at least greatly diminish the price companies are willing to pay to incorporate in Delaware, and thus eradicate the huge profits Delaware derives from being the domicile of choice for publicly-traded U.S. corporations. Indeed, given the historic failure of states to take significant measures to compete with Delaware for incorporations,<sup>151</sup> the possibility of federal preemption of state corporate law due to populist pressure probably constitutes the single most important

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2003) (citing to *Brophy* for the proposition that "Delaware law has long held . . . that directors who misuse corporate information to profit at the expense of innocent buyers of their stock should disgorge their profit."). As of late, Delaware seems to have become an easier venue for plaintiffs to pursue insider trading claims than the federal courts. See *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 921, 923 (Del. Ch. 2003) (refusing to dismiss derivative insider trading claim upon recommendation of special litigation committee even where similar direct claims under federal law have been dismissed for failure to meet the federal pleading requirements).

151. See generally Kahan & Kamar, *supra* note 38, at 684, 701–24 (supporting empirically the claim that "[o]ther than Delaware, no state is engaged in significant efforts to attract incorporation of public companies").

threat to Delaware's profits from the franchising business.<sup>152</sup> Moreover, embedded in this federal system are rules on personal jurisdiction and on conflict of laws which constrain Delaware's ability to regulate certain types of corporate conduct effectively. In this Part, we explain the traits of Delaware corporate law as modes of adaptation to this landscape.

A. *Embracing Common Law Classicism: The Creative Use of Anachronism?*

There is something determinedly old-fashioned about Delaware corporate law. The most superficial feature is the pomp and ceremony, the celebration of old distinctions such as that between law and equity, the attention to tradition.<sup>153</sup> But it goes much deeper. Delaware corporate law may be the last vestige of the 19<sup>th</sup> century common law style in America.

The traits of Delaware corporate law described above are striking in part because they represent a rather pure, and therefore rather unfamiliar, form of the common law system. It is worth pausing for a moment to appreciate just how much of a throwback Delaware is. The relationship between the Delaware judiciary and legislature exemplifies the traditional relationship between a common law judiciary and the legislature, and illustrates one of the traditional differences between a common law jurisdiction and a code jurisdiction. The dominance of the judiciary in making law, and the judiciary's stubborn insistence on its primacy in relation to legislation, was already described, explored, and ultimately decried by Roscoe Pound in his classic 1908 article *Common Law & Legislation*.<sup>154</sup> Pound famously attacked the attitude that lay behind the 19<sup>th</sup> century American common law judicial precept that "statutes in derogation of the common law shall be narrowly construed."<sup>155</sup> Similarly, in thinking about Delaware through Hart and Sacks's conceptual framework, one is struck by the extent to which Delaware corporate

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152. See Roe, *supra* note 6, at 600 (noting that Delaware's chief competitive pressure comes not from other states, but from the federal government); Bebchuk & Hamdani, *supra* note 93, at 558 (same).

153. See, e.g., Delaware State Courts, Overview of the Delaware State Court System at <http://courts.delaware.gov/Courts/> (last visited Oct. 17, 2005) (describing the Court of Chancery as having "jurisdiction to hear all matters relating to equity"). See also DELAWARE SUPREME COURT: GOLDEN ANNIVERSARY 1951-2001 (Randy Holland & Helen Winslow eds., 2001) (tracing the history of Delaware courts since before 1776 and discussing their precedents in a variety of legal areas).

154. Roscoe Pound, *Common Law and Legislation*, 21 HARV. L. REV. 383 (1908).

155. *Id.*

law reflects a pre-New Deal understanding: no administrative agencies, private enforcement, and incremental legislation from an otherwise largely passive legislature. And although never explicitly stated, the precept that “statutes in derogation of judge-made law shall be narrowly construed” offers a good guide to Delaware’s corporate law jurisprudence.<sup>156</sup>

And yet we (including the Delaware judges and lawyers) are all moderns. We all know that we live in the post-New Deal administrative state. We have all learned the lessons that the Legal Realist taught<sup>157</sup> and that Critical Legal Studies reemphasized:<sup>158</sup> that law has an unavoidable political and moral aspect; that legal answers are created, not discovered; that the law’s affectation of technocratic expertise and neutrality is often a cover for political and normative choices. We therefore cannot assume that Delaware’s embrace of the 19<sup>th</sup> century style is simply a naive (mis)understanding of the nature of law.

What, then, could be behind this seemingly disingenuous affectation? We argue that this old common law vision, with its distinctive judicial virtues, is adaptive given Delaware’s vulnerable position in the corporate lawmaking hierarchy. Just as the old common law style has been explained as a way that politically weak judges preserve their autonomy (or, less charitably, grab political power), so too that style can serve to aid a politically weak state in preserving its lawmaking autonomy within a larger political landscape. By aligning itself with this history, Delaware gains legitimacy.

### *B. Preserving the Technocratic and Apolitical Gloss*

Several of the traits described above have the effect of creating and enhancing a technocratic, apolitical gloss on Delaware law. The public perception of Delaware’s corporate law as largely technocratic and apolitical is important for Delaware as it helps fend off federal intervention. As explained in Part I, Delaware has a legitimacy problem: why should a little state make the national rules of corporate law? By constructing its law as technocratic and apolitical, Delaware

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156. See *supra* Part II.A.

157. See, e.g., JEROME FRANK, *LAW AND THE MODERN MIND* 32–41 (1935) (acknowledging that judges “make and change the law” and attributing the contrary view—law as definitive rules—to a “[c]hildish dread of uncertainty”).

158. See, e.g., Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1707–10, 1751–62 (1976) (explaining the necessity of judicial value judgments, even when courts claim merely to be applying rules).

deflects attention from the democratic deficit of its corporate law, legitimizes its role as promulgator of the de facto national corporate law, and reduces the likelihood of a populist challenge to its preeminence.

Several traits of Delaware law contribute to this technocratic and apolitical gloss. Consider first the breadth of judge-made corporate law. Judge-made law tends to have more of a neutral, apolitical aura than statutory law.<sup>159</sup> Judges are more removed from the political process, and professional norms require judges to give reasoned opinions based on precedent, rather than simply doing what they think is the right thing politically. In judicial reasoning in general, and Delaware's corporate law jurisprudence in particular, partisan conflicts are not openly discussed, monetary contributions are supposed to play no role, lobbying takes the form of technical legal briefs, and political choices are swept under the carpet.

To the extent that corporate law rules are judge-made, the fact that it is Delaware judges rather than federal judges who make the rules does not much detract from the legitimacy of these rules. Judges lack obvious democratic legitimacy in any event. Rather, judicial decisions and judge-made law can be thought to derive legitimacy in the public eye<sup>160</sup> from neutral, nonpartisan, and technical "legal" reasoning. In other words, in the public perception, federal and Delaware judges are largely interchangeable, or at least much more so than federal and Delaware legislators would be. Indeed, since Delaware's judiciary is less politicized and has greater claims to expertise in corporate law than the federal judiciary, its rulings may enjoy greater legitimacy than would corporate rulings of federal judges.

The style of Delaware's judge-made law further enhances the notion that the law is technocratic and apolitical. Delaware's supreme court eschews overruling its own precedent and dissenting opinions.<sup>161</sup> Instead, Delaware Supreme Court opinions adopt a quasi-deterministic reasoning according to which any disagreements with the Court of Chancery or corporate actors are due to faulty legal reasoning or moral shortcomings by others. This serves to gloss over the fact that reasonable minds may differ on how an issue ought to be

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159. See Bebhuk & Hamdani, *supra* note 93, at 604 (noting that reliance on judge-made, rather than legislative, law reduces Delaware's legitimacy problem).

160. Even though many modern legal scholars and practitioners are aware that judicial reasoning is often just a veneer that masks important and controversial decisions of a political nature, the relevant political sphere here is not legal scholars and practitioners, but the general public, which is much less aware or comfortable with judges making political choices.

161. See *supra* note 94 and accompanying text.

resolved and that the outcome of disputes depends not just on the decisionmaker's technical skills but on her policy preferences.

The lack of public enforcement further reduces the state's visible role in the administration of its corporate law. Rather than two state bodies (one that brings actions and another that resolves disputes), only one body, the judiciary, is involved. Delaware thus has no room for (over)eager, or overly lax, and possibly politically motivated law enforcers in the tradition of Eliot Spitzer,<sup>162</sup> Rudy Giuliani,<sup>163</sup> or Harvey Pitt.<sup>164</sup> Delaware, of course, does have courts and judges. But judges are brought to the fore through the decentralized activities of private actors rather than on their own motion; they lack the power and the staff to conduct investigations; and they are supposed to exercise restraint in commenting on disputes. Delaware's judiciary, in particular, is highly respected for its technocratic expertise and represents a model of nonpartisanship. The focus on enforcement of Delaware corporate law through actions initiated by private parties and resolved by Delaware courts thus supports the apolitical and technocratic image of the law.

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162. See, e.g., Michael Slackman & Marc Santora, *Spitzer, Sounding Gubernatorial, Discusses the State of the State*, N.Y. TIMES, Mar. 11, 2004, at B8 ("Since his election as attorney general, Mr. Spitzer has worked quietly and efficiently to position himself for a run for governor, taking on issues—like Wall Street corruption—that have given him a national spotlight while also working to build grassroots support across the state.").

The recent wave of outrage about Wall Street's behavior began, you may recall, when New York State Attorney General Eliot Spitzer deployed an obscure state law to shoo horn out of Merrill Lynch every e-mail message Merrill employees had ever sent relating to the Internet boom. It was easy to see why Spitzer chose Merrill Lynch as his target. He has political ambitions (he wants to be governor of New York, at least), and unlike Goldman, Sachs or Morgan Stanley or one of the other big investment banks more central to the Internet bubble, Merrill actually serviced lots of small customers. It's a firm that voters can relate to.

Michael Lewis, *In Defense of the Boom*, N.Y. TIMES, Oct. 27, 2002 (Magazine), at 44.

163. See, e.g., Catherine S. Manegold, *A Road of Many Turns, an End Triumphant*, N.Y. TIMES, Nov. 3, 1993, at B3:

Campaigning for mayor, Mr. Giuliani always said his quest was a natural progression in a career that took him from the Federal prosecutor's office in Manhattan to the No. 3 official in the Reagan Justice Department and finally United States Attorney for the Southern District of New York. . . .

. . . He became famous for his prosecution of organized crime figures and insider trading. The names Milken, Boesky and Drexel-Burnham Lambert were linked with his after he led a series of assaults against Wall Street's excesses.

164. Harvey Pitt, who had been hailed on his appointment as chair of the SEC, was ultimately forced to resign in the wake of accusations of laxity in response to the corporate and accounting scandals. Stephen Labaton, *Praise to Scorn: Mercurial Ride of S.E.C. Chief*, N.Y. TIMES, Nov. 10, 2002, at A1 (mentioning the unusual speed with which the SEC filed fraud charges against WorldCom).

The extra-cameral activities by members of the Delaware judiciary also mesh well with Delaware's political interests.<sup>165</sup> These activities help market Delaware law to the legal community; let judges obtain information about the views of practitioners and academics; and enable the judiciary to amplify its admonitions to directors to comport with the judiciary's vision of proper corporate governance and thus beef up Delaware's enforcement regime. In all these respects, they make Delaware more attractive as an incorporation haven. But, from our perspective, they also serve an additional function: they create an outlet for dissatisfaction with legal rulings and permit individual members of the judiciary to refine, confine, and maybe even signal a retreat from the court's holdings. The need for this outlet is created by the fact that members of Delaware's judiciary cannot be directly lobbied; that practicing lawyers may be reluctant to criticize judicial rulings openly; and that the judiciary lacks control over its docket and thus may value the opportunity to clarify its holdings before the next case involving that issue arises.

Even in the matters into which the legislature does intrude, Delaware law has—in this instance deservedly—a technocratic and apolitical appearance. Proposed laws are adopted without amendment or debate by overwhelming majorities. Any lobbying that takes place occurs within the Corporation Law Section of the Delaware bar. Thus, even within the legislative process, the dirty portions of politics either do not exist or at least are not visible: campaign contributions, partisanship, and even the special interests of local constituents have no apparent effect on the law, and lobbying is channeled through a professional, consensus-oriented body that meets outside the public's eye and self-consciously avoids taking on controversial issues.

This is not to say that Delaware politics are *generally* more pure than elsewhere or that large in-state interests—be it large local corporations such as DuPont or MBNA, or chicken farmers from the southern part of the state—do not have significant influence in Delaware politics. They do. But precisely because local Delaware politics is impure, it is imperative for Delaware to ensure, as much as possible, that the *corporate* lawmaking process is not, or is perceived not to be, the product of ordinary politicking. Few things would do more to undermine Delaware's legitimacy than, say, a front-page article in a major newspaper discussing how a large corporation got

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165. See *supra* note 117.

some controversial legislation passed by channeling substantial campaign contributions to local politicians.<sup>166</sup>

### C. *The Minimization of Interjurisdictional Conflict*

Another way that Delaware adapts to its position in the federal system is to take account of the rules on personal jurisdiction and conflict of laws to avoid interjurisdictional conflicts. Under the Due Process Clause of the U.S. Constitution, state courts can assert jurisdiction only over defendants who have the requisite minimum contacts with the forum state.<sup>167</sup> Under prevailing rules on conflict of laws, which are part of the law of each state, the law of the state of incorporation governs the internal affairs of the corporation, but other factors determine the law applicable to most other disputes. These jurisdictional and conflict rules help explain the scope of Delaware's corporate law.

Consider, for a moment, how narrow Delaware's corporate law is. It is largely confined to the regulation of the internal affairs of the corporation. This scope is due neither to some inherent understanding of what corporate law is about (for example, U.K. company law encompasses a number of other matters) nor to Delaware not being able to offer a superior substantive product on other matters—because of its quality courts and its responsiveness, it well could. Rather, it is due to conflict of laws rules which would generally not point to the law of the state of incorporation as governing matters outside the internal affairs of the corporation.

Of course, Delaware could revise its own conflict rules to point to Delaware law as governing matters outside the company's internal affairs. But Delaware could not force other states to do the same. Thus, depending on whether a dispute is litigated in Delaware or a different forum, the forum's conflict rules would point to different bodies of law, with possibly different substantive content. As a result, parties would not know which substantive rules apply before a lawsuit

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166. See Sorkin, *supra* note 102 (noting that intense lobbying effort by the Taubman family led to the passage of legislation that would enable the family to block a hostile bid for its shopping mall empire); Editorial, *Spitzer v. Grasso*, WALL ST. J., May 25, 2004, at A16 (suggesting that Spitzer failed to sue fellow Democrat Carl McCall, past chairman of the New York Stock Exchange's compensation committee during Grasso's tenure, for political reasons).

167. *Int'l Shoe Co. v. Washington*, 326 U.S. 310, 316, 319 (1945) (“[D]ue process requires only that in order to subject a defendant to a judgment *in personam*, if he be not present within the territory of the forum, he have certain minimum contacts with it such that the maintenance of the suit does not offend ‘traditional notions of fair play and substantial justice.’ . . . [The Due Process Clause] does not contemplate that a state may make binding a judgment *in personam* against an individual or corporate defendant with which the state has no contacts, ties, or relations.”) (citation omitted).

is brought. Even if Delaware law were substantively superior to the law of other states, parties may well prefer to know with certainty that they are governed by the (inferior) law of, say, Maryland, to uncertainty over whether (inferior) Maryland law or (superior) Delaware law applies.

Moreover, Delaware has a lot to lose from challenging the prevailing rules on conflict of laws. If Delaware is perceived as being overly aggressive in expanding its own law to areas that are not traditionally subject to laws of the state of incorporation, other states may respond by changing their conflict rules to limit the scope of the internal affairs rule. The continued applicability of the internal affairs rule is, of course, the life-blood of Delaware. Thus, Delaware has no interest in pursuing a major change to the status quo of conflict rules.

Furthermore, Delaware would only have a limited ability to enforce many rules that would fall outside the internal affairs doctrine. To enforce its law effectively, Delaware courts need personal jurisdiction over the relevant defendants. Such jurisdiction would be lacking, say, over a creditor who claims a security interest in the company's property—an issue regulated by U.K. company law but not by Delaware corporation law.<sup>168</sup>

Limitations imposed by personal jurisdiction may even affect *how* Delaware regulates internal affairs. For example, Delaware law imposes no duties on shareholders (unless they are controlling shareholders)<sup>169</sup> to disclose information or on a bidder to structure tender offers in a certain manner.<sup>170</sup> Such rules may well complement

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168. See *supra* Part II.F.

169. Though having control of a Delaware corporation is not a sufficient basis for personal jurisdiction, individual controlling shareholders will often be directors and corporate controlling shareholders will usually be under a duty to indemnify their representatives on the board of the controlled company, and thus be subject to the *de jure* or *de facto* jurisdiction of the Delaware courts. *Grace Bros., Ltd. v. Uniholding Corp.*, No. 17612, 2000 Del. Ch. LEXIS 101, at \*50–\*55 (Del. Ch. July 12, 2000) (rejecting the argument that the controlling shareholder was an indispensable party and exercising jurisdiction over individual directors who held a large stake in controlling shareholder, noting that directors could seek indemnification or contribution from the controlling shareholder in a separate action). Moreover, Delaware employs the far-reaching conspiracy theory to obtain personal jurisdiction over controlling shareholders. See, e.g., *Parfi Holding AB v. Mirror Image Internet*, 794 A.2d 1211, 1229–30 (Del. Ch. 2001) (basing jurisdiction on conspiracy theory, which requires that a controlling shareholder participated in a conspiracy and had reason to know that a substantial act or effect in furtherance of conspiracy occurred in the forum state); *Gibralt Capital Corp. v. Smith*, No. 17422, 2001 Del. Ch. LEXIS 60, at \*15–\*20 (Del. Ch. May 8, 2001) (same).

170. Such duties do exist under U.S. federal law and U.K. company law. Securities Exchange Act of 1934, §§ 13(d), 14(d), 15 U.S.C. §§ 78m(d), 78n(d) (2005); Company Act 1985, §§ 198–210A (Eng.). Curiously, Delaware's corporation law has a "reorganization" section that permits companies to insert a clause in their charter that would permit a requisite majority of creditors

the governance structure established by Delaware's corporate law. But because being a shareholder of or a bidder for shares of a Delaware corporation would not likely satisfy the constitutional requirement of minimum contacts, Delaware courts would lack the ability to enforce such duties effectively.

#### IV. IMPLICATIONS AND EXPLORATIONS

##### A. *Responding to Crises*

Delaware corporate law's adaptive adherence to the old common law model carries inherent limitations that can bind uncomfortably when crises arise. In this regard, contrast the different responses to the post-Enron sense that "something must be done." Congress held hearings and ultimately enacted the Sarbanes-Oxley Act. The SEC, on its own accord and in response to congressional dictate, adopted new regulations and leaned on the stock exchanges to reform their corporate governance standards for listed companies.<sup>171</sup> Several states passed new laws or instituted criminal proceedings against executives involved in the scandals.<sup>172</sup>

Compare this to Delaware. Its legislature did not act—it did not hold any hearings and did not pass any legislation—because it eschews controversy. No administrative agency promulgated new rules because Delaware has no parallel to the SEC. No public prosecutor went on the warpath against corporate wrong-doers because Delaware corporate law is enforced by private actions. Given Delaware's traditional mode of addressing controversy, it had to wait until a legal dispute was brought in its courts. Since no case was brought, Delaware had no opportunity to address the recent scandals directly. In short, Delaware has been out of the limelight.

This does not mean, however, that Delaware has been out of the loop. It is much too early to tell what effect the recent scandals will have on Delaware law. We will not know until, several years hence, we look back and trace out the various ways in which the

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(majority in number, three-quarters in value) to approve a compromise or arrangement that, if approved by the court, would be binding on all creditors. DEL. CODE ANN. tit. 8, § 102(b)(2) (2005) (prescribing exact language). It is unlikely that the Delaware courts have the jurisdiction over creditors to enforce this section and it does not appear that it is ever used. See RODMAN WARD, JR. ET AL., *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 102.10 (4th ed. 1999 & Supp. 2005) (citing no relevant cases in commentary on section).

171. See Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The SEC Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 93 (2005).

172. See *supra* notes 3 & 4.

lessons of Enron, etc.—whatever they turn out to be—are, incrementally and slowly, incorporated and expressed in Delaware judicial review of board conduct.<sup>173</sup>

Some may lament that Delaware is slow to respond.<sup>174</sup> But that is to miss a very important point: Delaware's slowness is part and parcel of its adherence to a particular, traditional, reactive model of judge-centered lawmaking. That adherence, as we have argued, is an adaptation to the federalist landscape in which it operates. To deviate in response to some felt necessity would probably be wrong headed. If Delaware were to try to out-reform Congress and the SEC, it would be bound to lose because of its inherent disadvantage in legitimating the provision of national law.

Contrast, in this respect, Delaware's passivity with the activity of Eliot Spitzer, who managed to sideline the SEC on several fronts. Spitzer is the Attorney General of one of the largest states, the geographic home of the major stock exchanges, of the major investment banks, and of numerous investors. As such, Spitzer's democratic legitimacy greatly exceeds Delaware's. But much more importantly, Spitzer, one suspects, is less concerned about preserving New York's long-term regulatory power than about dealing with the current crisis and earning financial (for the state) and political (for himself) rewards for being visibly on the ball while the SEC was asleep. Thus, even if, as is likely, the SEC ultimately reasserts its preeminence in regulating the securities industry and fends off future interference by state regulators,<sup>175</sup> Spitzer will come out a winner. By

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173. We can already see some subtle signs that Delaware law will be changing. For example, in *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 942–48 (Del. Ch. 2003), Vice-Chancellor Strine employed a narrow concept of independence—one that takes into account the fact that interests that are not directly financial, such as collegiality among members of the same faculty or charitable donations to a faculty member's university, can impinge on one's independence—in refusing to dismiss a complaint upon the recommendation of a special litigation committee. And in *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 286–90 (Del. Ch. 2003), Chancellor Chandler refused to dismiss a complaint that a senior officer received an overly generous severance package on the grounds that the alleged lack of board involvement in structuring the severance package may amount to lack of good faith and board members may thus not be protected by Section 102(b)(7). In addition, the Delaware judiciary has been out on the hustings trying to send a message. See, e.g., Chandler & Strine, *supra* note 117, at 1005–06 (urging that courts “sensibly implement[]” the 2002 reforms and that states implement reforms of their own).

174. Others do not. See Romano, *supra* note 22, at 6–12, 215–16 (criticizing Congress for enacting harmful regulations in the Sarbanes-Oxley Act). We take no position on the merits of the Sarbanes-Oxley Act or whether a different legislative response would have been preferable.

175. For efforts in that vein, see Judith Burns, *SEC Warns of Uncoordinated Inquiries*, WALL ST. J., Sept. 10, 2003, at C14 (noting a complaint by the SEC chairman that state officials act “for political gain and may compromise federal investigations in the process”); Tom Lauricella, et al., *Morgan Stanley Case Illustrates States' Strategy*, WALL ST. J., July 15, 2003, at C1 (noting the passage of a bill by the House Financial Services subcommittee that would weaken states' ability to regulate the securities industry).

contrast, any move by Delaware that earns it short-term plaudits but undermines its long-term status as corporate domicile would make it a loser.

*B. The Symbiotic Relationship Between Federal Law and Delaware Law*

Delaware's adherence to a traditional common law model and the rules on jurisdiction and conflict of laws constrain its ability to regulate. When rules are required (or thought to be required) that Delaware is unwilling (because it would be in tension with the common law model) or unable (because of jurisdictional and conflict rules) to supply, any such regulations would be left to a hodgepodge of state rules or, if a national solution is desirable, would have to be imposed by the federal government.

One example of rules that would be difficult for Delaware to supply is the mandatory disclosure rules imposed by the federal securities laws. Consider, first, the logistical requirements. The SEC's Division of Corporate Finance alone has about 400 employees,<sup>176</sup> far more than the whole of the chancery and supreme courts of Delaware. To be able to devise a similarly detailed regulatory regime, Delaware would thus have to change its lawmaking infrastructure radically. It could no longer rely on a small body of judicial officers, but would instead have to establish a major regulatory agency with a number of employees and a budget closer to the SEC's.<sup>177</sup>

Doing so, however, would generate two problems. First, it would bring to the fore issues of democratic legitimacy that Delaware would rather remain obscure. In particular, the adoption and revision of regulations would entail more explicit lawmaking—and thus make controversial political and normative choices more manifest—than at present. Second, adopting a comprehensive regulatory regime would be hampered by conflict rules and jurisdictional limitations. Unlike conflict rules on the internal affairs of a corporation, conflict rules on disclosure regulations with respect to the issuance and trading of

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176. During fiscal year 2003, there were 341 staff in the Corporate Finance division and another 92 in the related Office of Filing and Information Services. SEC, PROTECTING INVESTORS: ANNUAL REPORT 2003 61 (2003), available at <http://www.sec.gov/pdf/annrep03/ar03full.pdf> (last visited Oct. 17, 2005).

177. The SEC's budget for fiscal year 2003 was approximately \$717 million. *Id.* at 142. Delaware's entire budget outlay for the Division of Corporations, the Court of Chancery, and the Supreme Court is about \$10 million. State of Delaware, Office of the Budget Homepage, <http://www.state.de.us/budget/default.shtml> (last visited Nov. 14, 2005).

securities do not point to the law of the state of incorporation.<sup>178</sup> In addition, Delaware lacks personal jurisdiction over various parties subject to the federal regime, such as broker/dealers, 5-percent shareholders, shareholders engaged in secondary offerings of securities, shareholders who solicit proxies, accounting firms, and employees engaged in insider trading. Delaware courts would thus lack the ability to enforce the regulatory regime on these parties, which would likely diminish greatly the effectiveness of any regulatory structure.

More generally, there are several types of rules that Delaware is unlikely to supply and for which federal regulation may (if the requisite rules are indeed efficient) be desirable. The first type concerns issues where prevailing state conflict rules do not point to the state of incorporation. These include, for example, fraud in connection with the sale of securities under Section 11 of the Securities Act and Section 10(b) of the Securities Exchange Act or the manipulation of security prices.<sup>179</sup>

The second type concerns issues as to which individual states cannot constitutionally exercise personal jurisdiction over the relevant defendants.<sup>180</sup> Regulations under the Williams Act of bidders and 5-percent shareholders, regulations of broker/dealers, disclosure requirements for large shareholders under Section 16 of the Exchange Act, and the prohibition against "insider" trading under the misappropriation theory are examples of rules that Delaware could not effectively enforce because its courts would lack the requisite personal jurisdiction over most defendants.

The third type concerns issues where public enforcement is preferable to private enforcement. This includes misconduct that is so severe that criminal penalties are warranted and problems best enforced through prophylactic rules by an administrative agency rather than by private litigation. An example of the latter may be rules against selective disclosure of information like Regulation FD, violations of which may be publicly enforced but cannot form the basis of a private lawsuit.<sup>181</sup>

The fourth type concerns issues for which a detailed rule-based ex ante regulatory regime is desirable. An example may be the

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178. See Romano, *supra* note 13, at 2402–12 (proposing change in the choice-of-law rules to operationalize proposed state competition over securities regulation).

179. On the latter, see the Securities Exchange Act of 1934, § 9, 15 U.S.C. § 78i (2005) and regulations promulgated thereunder.

180. Note here the special broad rules on venue and jurisdiction in securities lawsuits. Securities Exchange Act, § 27, 15 U.S.C. § 78aa (2005).

181. Regulation FD, 17 C.F.R. § 243.102 (2005).

adoption of accounting rules guiding the manner in which a company must disclose financial information, other specific disclosure obligations, or specific rules exempting certain companies, securities, or transactions from certain obligations.

The fifth type concerns issues that are so openly political that they cannot be effectively adopted through a common law judge-made system. An example would be the institution of a codetermination regime, as it prevails in Germany, where employees have substantial representation on the board of directors. A U.S. example might be the adoption of a provision of the Foreign Corrupt Practices Act that prohibits the payment of bribes without regard to their effect on the firm.<sup>182</sup>

Finally, our analysis points to a sixth type of issue that Delaware, although it may be able to regulate as effectively as a federal lawmaker, would gladly yield to the feds. These are issues that are both inherently difficult to regulate effectively and are particularly likely to trigger a populist response. The prime example of such a “hot potato” issue is executive compensation, a topic regulated (ineffectively) by both federal and state law that regularly invites populist anger over the stellar income of (not always stellar performing) executives.

Federal law’s primacy in any of these areas does not necessarily undermine Delaware’s position as national provider of corporate law. To the contrary. If Delaware is not able to regulate certain conduct effectively, it is probably in its interest to have this conduct regulated on the federal level (or by other states) to fill the lacunae in its own law. Without such federal regulation, continued and unsanctioned wrongdoing could result in a populist backlash against Delaware as the provider of an ineffective regulatory regime and lead to a wholesale replacement of Delaware law. Federal regulation can thus strengthen Delaware’s long-term position in two ways. First, by making the system as a whole less scandal-prone, federal regulation reduces the likelihood of a populist attack. Second, to the extent that scandals nevertheless ensue, a federal regulatory system provides an alternative target—a lightning rod from Delaware’s perspective—for a populist attack. Indeed, the federal regime—being more openly political, partisan, and publicly enforced—may well make a more inviting target than Delaware.<sup>183</sup>

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182. 15 U.S.C. § 78dd-2 (2005).

183. In the recent scandals, for example, greater blame was given to the SEC than to Delaware. See, e.g., Labaton, *supra* note 164 (discussing the shortcomings in the administration of ousted SEC chairman Pitt).

Thus, while Delaware lives under the constant threat of federal preemption, there is as well a significant symbiotic element to the relationship between federal law and Delaware law. Delaware benefits from federal regulation, as long as it is in the right areas and of the right sort.

### CONCLUSION

The recent corporate scandals, and the various reactions of the different regulatory actors, provide an opportunity to tease out some important features of our corporate law federalism. In this Article, we have argued that Delaware corporate law, and Delaware's reaction to corporate crises, must be analyzed from within the institutional and political landscape in which Delaware's regulatory powers coexist with, and can be constrained by, the powers of the federal government and the various other states. From this perspective, the 19<sup>th</sup> century common law style of Delaware corporate lawmaking can be understood as a creative use of anachronism, as an invocation of apolitical technocratic expertise as a way of making up for an arguable lack of democratic legitimacy. At the same time, the scope of Delaware's law is crafted in a way that minimizes conflicts with other jurisdictions. Because of the constraints placed on Delaware by the federalist structure, the relationship between federal law and Delaware law can be best understood as symbiotic rather than merely competitive. Although Delaware is threatened by federal preemption, it is also served by federal regulations that regulate areas which Delaware cannot regulate effectively. Such regulations help ward-off crises and thus provide a lightning rod for a populist backlash that could produce severe harm to Delaware's position as the creator of our de facto national corporate law.