LEAVE IT TO DELAWARE: WHY CONGRESS SHOULD STAY OUT OF CORPORATE GOVERNANCE

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ABSTRACT

Commentators have debated the relative merits of state and federal regulation of corporate law and corporate governance for many years. The debate has attained heightened importance with the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2012. In Dodd-Frank, Congress intruded into the allocation of decision-making authority between shareholders and directors, a subject generally relegated to state law, by adopting federal provisions on say on pay and proxy access. In so doing, Congress made an explicit determination that the financial crisis had exposed shareholders' inability to ensure management accountability.

This Article criticizes the congressional usurpation of Delaware's traditional role in regulating corporate governance. Focusing on the topics of proxy access and say on pay, the Article demonstrates the continued superiority of Delaware's approach over federal regulation. In particular, this Article reveals that in precisely those areas where Delaware's approach has been criticized, market developments have enabled investors to use moderated responses and private ordering to address perceived problems, without incurring excessive costs or destabilizing management authority. In contrast, Dodd-Frank's reforms eliminate the potential for issuer-specific tailoring and experimentation, while mandating procedures that are unlikely to provide investors with meaningful value.

Nonetheless, Delaware's effective regulation of corporate governance and its ability to maintain its leadership position, face continuing challenges in the form of business and technological developments. The Article argues that Delaware's lawmaking structure is particularly well-suited to adapt to these challenges. The Article concludes by exploring Delaware's ongoing responses to three such challenges—private dispute resolution, globalization, and developments in shareownership.

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I. INTRODUCTION

Traditionally, states have regulated corporate law and corporate governance. In response to the stock market crash of 1929 and the subsequent Great Depression, Congress considered adopting a federal corporation law, but instead chose an alternative approach reflected in the federal securities laws.[1] In part, this decision was driven by a concern that Congress lacked the constitutional authority to regulate the internal affairs of the corporation.[2]

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[1] *See, e.g.*, Securities Act of 1933, 15 U.S.C. §§ 77a-77z (2011); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78pp (2011).

[2] *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 56, 66-67 (1982); *see also* John E. Tracy & Alfred Brunson MacChesney, *The Securities Exchange Act of 1934*, 32 MICH. L.

Any such concern about congressional power to regulate corporate law and corporate governance has long since dissipated. Today it is clear that Congress can federalize corporate law entirely.[3] Nonetheless, although the line between corporate law (regulated by the states) and securities regulation (regulated by the federal government) has shifted somewhat over the years,[4] the separation has remained largely intact. Congress has, for the most part, steered clear of efforts to regulate corporate governance.[5]

Following the governance scandals of the late 1990s, including Enron, WorldCom, and HealthSouth, Congress made its most significant intrusions into state regulation of corporate law.[6] In the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley")[7] Congress imposed certification requirements on corporate officials,[8] mandated audit committees,[9] and barred loans to corporate officers.[10] Commentators criticized these requirements, warning of the creeping federalization of corporate law.[11] The characterization of Sarbanes-Oxley as intruding upon state regulation of corporate governance, however, was largely overstated. The primary focus of Sarbanes-Oxley—accounting regulation and the auditing process—had historically been a component of federal rather than state regulation.[12] Sarbanes-Oxley did little to alter the core concern of state corporate law–the balance of power among officers, directors, and shareholders.

REV. 1025, 1036-37 n.22 (1934) (explaining efforts by the drafters to limit the statute's vulnerability to constitutional attack).

[3] *See* William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619, 624 (2006) ("Congress could draw on the same Commerce Clause on which it draws in supplementing the state system to occupy the entire field of corporate law.") (footnote omitted); Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, 26 REGULATION (Spring 2013) ("No one seriously doubts that Congress has the power under the Commerce Clause, especially as it is interpreted these days, to create a federal law of corporations if it chooses.").

[4] *See infra* notes 26-40 and accompanying text.

[5] *See* Arthur Fleischer, Jr., *"Federal Corporation Law": An Assessment*, 78 HARV. L. REV. 1146, 1153 (1965) ("The federal securities laws affect a wide range of corporate activities, but generally they do not preempt complementary state laws; they are pervasive but not exclusive.").

[6] *See* Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1779-80 (2011) (describing economic and other developments that led Congress to adopt Sarbanes-Oxley); Bainbridge, *supra* note 3, at 28 (describing federalization by Sarbanes-Oxley).

[7] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

[8] § 906, 116 Stat. at 806 (codified as amended at 18 U.S.C. § 63 (2006)).

[9] § 202, 116 Stat. at 772 (codified as amended at 15 U.S.C. § 78j-1 (2006)).

[10] § 402, 116 Stat. at 787 (codified as amended at 15 U.S.C. § 78m (2006)).

[11] *See* Bainbridge, *supra* note 3, at 31 (arguing that Congress needs to "back off" and allow Sarbanes-Oxley to "shake out its flaws" before further "tinkering").

[12] *See* Bratton & McCahery, *supra* note 3, at 666-67 (arguing that the governance issues addressed by Sarbanes-Oxley had, to a large extent, previously been federalized).

With its adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2012 ("Dodd-Frank"),[13] Congress went further than it did in Sarbanes-Oxley. For the first time, Congress intruded into the allocation of decision-making authority within the corporate entity. In Dodd-Frank, Congress enacted two provisions that specifically enhance shareholder power: say on pay[14] and proxy access.[15] Congress also required the Securities and Exchange Commission ("SEC") and stock exchanges to adopt additional corporate governance disclosure requirements.[16] In so doing, Congress made a deliberate determination that the financial crisis had exposed shareholders' inability to ensure management accountability. The corporate governance provisions in Dodd-Frank reflect a congressional decision to afford shareholders greater control over the election process in general and give them a greater voice, especially on executive compensation issues.

Much has been written on the specifics of both proxy access and say on pay.[17] Yet Dodd-Frank raises a more troubling issue—the desirability of congressional regulation of corporate governance. Of course this issue is not new; commentators have debated the merits of state versus federal regulation of corporate law for many years.[18] The merits of the debate, however, are context-specific. Over the years, much has changed with respect to the structure of the public corporation and the capital market discipline to which the corporation is subject. Investor ownership has shifted from passive retail investors to increasingly activist institutional investors.[19] Greater liquidity

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[13]Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[14]§ 951, 124 Stat. at 1899 (codified as amended at 15 U.S.C. § 78n-1 (2006)).

[15]§ 971, 124 Stat. at 1915 (codified as amended at 15 U.S.C. § 78n (2006)). Congress did not specifically mandate proxy access, but rather authorized the SEC to adopt a proxy access rule. *Id.*

[16]*See Proxy Access Struck Down by Courts*, PEARL MEYER & PARTNERS, 3-4 (Aug. 4, 2011), http://www.pearlmeyer.com/pearl/media/pearlmeyer/pdf/pmp-ca-proxyaccessstruckdown-8-4.11.pdf (describing five additional governance provisions including claw-back implementation policies and noting that, as of the date of the alert, the SEC had announced its intention to defer rule-making on these provisions).

[17]*See* Jill E. Fisch, *The Destructive Ambiguity of Federal Proxy Access*, 61 EMORY L.J. 465, 499-500 (2012) (arguing that the SEC's proxy access rule is ambiguous and unlikely to give shareholders increased input into the composition of corporate boards); Marcel Kahan & Edward Rock, *The Insignificance of Federal Proxy Access*, 97 VA. L. REV. 1347, 1347-48 (2011) (arguing that proxy access produces significant disadvantages while only providing minimal advantages).

[18]The seminal article is William Cary's call for a federal corporation law because of his perception that state regulatory competition produced a "race to the bottom." *See* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 663-66 (1974).

[19]*See* Jill E. Fisch, *Securities Intermediaries and the Separation of Ownership from Control*, 33 SEATTLE U. L. REV. 877, 879 (2010) (describing the shift from retail to institutional

and lower transaction costs have increased turnover and shortened investor time horizons. Technological changes have created new financial instruments and trading strategies. Boards of directors have become more independent and have established regularized procedures for oversight and monitoring.[20]

Recent regulatory and market developments offer reasons to reexamine the federalism debate. In particular, do Dodd-Frank's governance provisions respond to a failure in state corporation law (specifically Delaware law) to provide shareholders with sufficient tools to hold directors and officers accountable?[21] Does Delaware law unduly frustrate market discipline? And more generally, if recent developments require a reexamination of the allocation of corporate decision-making authority, what is the best mechanism for conducting that analysis?

This Article focuses on several recent developments, and Delaware's response, to demonstrate the continued superiority of Delaware's approach to regulating corporate governance.[22] In particular, the Article reveals that in precisely those areas where Delaware's approach has been criticized, market developments have enabled investors to use moderated responses and private ordering to address perceived problems, without incurring excessive costs or destabilizing management authority.[23] In contrast, Dodd-Frank's reforms reduce the opportunity for issuer-specific tailoring and experimentation, while crafting procedures that are unlikely to provide investors with meaningful value.

Nevertheless, state corporate law, and Delaware law in particular, are not perfect. In addition, ongoing business developments create new challenges for Delaware's ability to maintain its leadership role.[24] As this Article is written, Delaware law continues to evolve in response to those challenges.[25]

Part II briefly reviews the debate over the federalization of corporate law. In Part III, this Article evaluates those possible "failures" of Delaware corporate law addressed by Dodd-Frank—executive compensation and proxy access—and considers Delaware's approach in comparison to federal regulation. Part IV considers some of the most recent challenges to

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ownership).

[20] *See, e.g.*, Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1465, 1468 (2007) (describing the shift to independent boards).

[21] *See infra* Part III.

[22] *See infra* Parts II.B, III (comparing Delaware corporate law to federal law).

[23] *See infra* Part II.B.

[24] *See infra* Part IV.B.

[25] *See infra* Part IV.

Delaware's lawmaking structure and the innovations in the Delaware system that respond to those challenges.

II. THE FEDERALIZATION OF CORPORATE LAW

A. *The Ongoing Debate*

The existing division between state and federal regulation of corporate law is largely the product of historical accident.[26] Prior to the 1920s, states regulated the internal affairs of corporations through state corporation law.[27] States also regulated transactions in the securities issued by those corporations through state blue sky laws.[28] Before the industrial revolution, both subjects presented primarily local rather than national concerns.[29]

The capital markets grew rapidly in the early 1900s.[30] The stock market bubble of the 1920s, the crash in 1929, and the Great Depression revealed a strong relationship between the health of the capital markets and the national economy.[31] It was this relationship that led Congress, in the early 1930s, to adopt the federal securities laws.[32]

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[26]Philip A. Loomis, Jr., *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214, 216-17 (1960) (describing the historical origins of the federal securities laws).

[27]Bratton & McCahery, *supra* note 3, at 629-31 (explaining that state corporate law emerged fully formed by "the boom years" of the 1920s).

[28]*See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 350-52 (1991) (recounting the development of state blue sky laws).

[29]*See* William T. Allen, *20th Century Evolution and Growth of Delaware Corporation Law*, 17 DEL. LAWYER 16, 18 (1999).

[30]*Id.*

[31]Loomis, *supra* note 26, at 216-17 ("The Exchange Act like the Securities Act of 1933, was enacted in an effort to eliminate certain abuses in financial markets which were believed to have contributed to the famous stock market crash of October 1929, and to the devastating depression which followed.").

[32]As Congress stated in adopting the Act:

> National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit.

See Securities Exchange Act of 1934 § 2(4), 15 U.S.C. § 78b(4) (1934).

Members of the Congress that adopted the federal securities laws were cognizant of then-existing limitations in the ability of shareholders to hold corporate managers accountable.[33] Adolf Berle and Gardiner Means had just published their paradigm-shifting book about the separation of ownership and control in the public corporation,[34] and Berle was an important influence on President Roosevelt in connection with the new legislation.[35] The President of the New York Stock Exchange testified in the Senate hearings that a national corporation law was the appropriate response to the identified deficiencies in existing state regulation.[36] Congress considered draft legislation that would have extended federal regulation to matters that included cumulative voting and the composition of the board of directors.[37] As I have observed elsewhere, however, Congress ultimately retreated from a federal corporation law.[38] This retreat reflected congressional concerns about both its authority to regulate the internal affairs of corporations under the Commerce Clause and the desirability of government control of business.[39]

Any concern about congressional authority to regulate corporations has long been put to rest. Under the increasingly liberal interpretation of the Commerce Clause, Congress' power is understood to be very broad, and clearly corporations (even very small ones) affect interstate commerce

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[33] *See* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1209-12 (1999) (examining congressional knowledge of the limitations on corporate governance).

[34] *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1968).

[35] *See* Williams, *supra* note 33, at 1215-16 (citing Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 420 n.156 (1990)) ("Although Berle had a peripheral role in the actual drafting of the Securities Act and the Exchange Act, he was an important member of Roosevelt's 'brain trust,' and his ideas were pivotal in providing the intellectual foundation for securities regulation.").

[36] Then NYSE President Richard Whitney testified during the Senate hearings on the 1934 Act that, "[t]he apparent purpose of [the bill] is to correct the abuses in corporate procedure which exist today because of the inadequacy of state laws. The remedy . . . is a national incorporation law applicable to all companies doing business in interstate commerce. This should be accomplished by direct Federal legislation." Allen D. Boyer, *Federalism and Corporation Law: Drawing the Line in State Takeover*, 47 OHIO ST. L.J. 1037, 1051 n.69 (1986) (citing *Stock Exchange Practices, Hearings on S. Res. 84 before the Senate Comm. on Banking and Currency*, 72d Cong. (1933), *S. Res. 56* & *S. Res. 97*, 73d Cong. (1934)).

[37] *See* Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 391, 466-67 (1991).

[38] *See* Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 VAND. L. REV. 1129, 1142-44 (1993).

[39] *See id*. at 1181-82.

sufficiently to allow broad federal oversight.[40] The prudential component of the analysis remains, however, controversial.

Academics have, in fact, debated for decades over the desirability of federalizing corporate law.[41] Bill Cary is frequently credited with starting the modern version of this debate, in his classic Yale Law Journal article.[42] Cary argued that management influence over state law, coupled with the competition among states to attract incorporations, generated a race to the bottom, producing lax legal standards that favored managers over shareholders.[43]

In response, Ralph Winter,[44] followed by Roberta Romano,[45] among others,[46] criticized Cary's analysis. Winter argued that existing market mechanisms—especially the discipline of the capital markets—precluded a race to the bottom and instead generated a race to the top by creating incentives for managers to choose a legal regime that maximizes firm value.[47] Romano demonstrated that the political dynamic of state regulation—and Delaware in particular—provided a safety net that was likely to temper the potential excesses of national corporate law.[48] Other scholars highlighted the importance of interest groups in driving the production of corporate law, again notably in Delaware.[49]

Scholars challenged the regulatory competition story. Marcel Kahan and Edud Kamar argued that no such competition exists, and that "[o]ther than Delaware, no state is engaged in significant efforts to attract incorporations of public companies."[50] Mark Roe contended that Delaware's true competitor is not other states but the federal government, which offers

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[40]*See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 597 (2003) ("[T]he internal affairs doctrine is just an understanding, not a crisp constitutional rule, and all corporate law could be federal law.").

[41]*See id*. at 600-01 (arguing that Delaware's primary competition comes from the federal government, not other states); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 4-6 (1993) (defending US system of regulatory competition over federal regulation of corporate law).

[42]*See* Cary, *supra* note 18, at 700-01.

[43]*Id.* at 697-701.

[44]Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254-57 (1977).

[45]ROMANO, *supra* note 41, at 14-16.

[46]*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, 915 (1982) (arguing that the race to the bottom thesis is based on a fundamental misunderstanding of the law).

[47]Winter, *supra* note 44, at 256.

[48]*See* ROMANO, *supra* note 41, at 28-31.

[49]*See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 471-72 (1987).

[50]*See e.g*., Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 684 (2002).

the prospect of supplanting state corporate law with uniform federal rules.[51] Various other scholars have offered interpretations of the balance of authority between the states, specifically Delaware and the federal government, offering characterizations that range from cooperative federalism[52] to a thaumatrope.[53]

At the same time, scholars acknowledge that the line between state and federal regulation has not remained stable over time.[54] Beginning with the enactment of the federal securities laws, Congress has repeatedly intruded upon territory previously reserved for state regulation. The most significant of these intrusions include the Williams Act,[55] the Foreign Corrupt Practices Act,[56] Sarbanes-Oxley,[57] and now Dodd-Frank.[58]

Notably, however, the Dodd-Frank intrusions, although small, reflect a difference in kind. Prior federal regulation was primarily disclosure-oriented. Although disclosure requirements affect the allocation of decision-making power among managers, directors, and shareholders, this effect is largely indirect. For the most part, federal law has not attempted to reallocate substantive governance rights. Dodd-Frank is different, however. For the first time, Congress has determined that shareholders' governance rights are insufficient and attempted to increase shareholder power relative to management.

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[51] *See* Roe, *supra* note 40, at 590 (explaining how federal government can take away Delaware's authority over corporate law entirely and has, in the past, threatened to do so).

[52] Bratton & McCahery, *supra* note 3, at 620.

[53] Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 BUS. LAW. 1, 1 (2005).

[54] *See, e.g.*, Robert B. Thompson, *Delaware, the Feds, and the Stock Exchange: Challenges to the First State as First in Corporate Law*, 29 DEL. J. CORP. L. 779, 797 (2004) (citing Bus. Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990)) (recognizing that by using exchanges, the SEC has moved the line between federal and state regulation further into the federal realm).

[55] Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78l-78n (1988)).

[56] Foreign Corrupt Practices Act, Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified in 15 U.S.C. §§ 78m(b)(2), 78dd-1-2, 78ff (2000)).

[57] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002); *see also* Roe, *supra* note 40, at 633 ("Sarbanes-Oxley digs deep into corporate governance, regulating the nitty-gritty."); Bratton & McCahery, *supra* note 3, at 661 (describing Sarbanes-Oxley and the Foreign Corrupt Pracices Act as examples of Congress responding to failures in Delaware law).

[58] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

B. *In Defense of State Regulation*

Most academic commentators defend state regulation of corporate law as superior to federal legislation.[59] As noted above, these arguments are based on a variety of claims about regulatory competition, the susceptibility of lawmakers to political pressure, and the enabling nature of state law in comparison to mandatory federal rules.[60] Claims about the superiority of state regulation are typically couched in general terms. As a practical matter, however, the primary focus of these claims is Delaware corporate law. Because Delaware supplies corporate law to the majority of publicly-traded companies, and has been the dominant state regulator of corporations since the 1910s, a defense of state regulation is typically a defense of Delaware corporate law.[61] Moreover, Delaware law offers distinctive substantive and structural attributes that other commentators and I have argued make it particularly well-suited for regulating the public corporation.[62]

First, the manner in which Delaware produces its law is arguably distinctive. Delaware offers knowledgeable high-quality lawmakers, who are particularly concerned with the production of corporate law.[63] The Corporate Law Council of the Delaware Bar Association consists of expert practitioners who regularly examine the state's law and bring developing issues to the legislature on a regular basis.[64] The legislature responds to the Council's recommendations, updating the statute regularly.[65] This structure

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[59]*See* ROMANO, *supra* note 41, at 3-5; Winter, *supra* note 44, at 251-52.

[60]*See supra* Part II.A.

[61]Other states vary in the degree to which the structure and substance of their corporation law resembles that of Delaware. *Compare* Nevada, which is generally described as having "corporate laws that are explicitly more lax towards management and board liability than Delaware law, Michal Barzuza & David C. Smith, *What Happens in Nevada? Self-Selecting into Lax Law* 1-2 (VA Law & Econ. Research Paper No. 2011-08), *available at* http://ssrn.com/abstract=1644974, *with* North Dakota, which is designed to be "more shareholder friendly than Delaware," Stephen M. Bainbridge, *Why the North Dakota Publicly Traded Corporations Act Will Fail* 4 (UCLA School of Law, Law-Econ Research Paper No. 09-07), *available at* http://ssrn.com/abstract=1364402.

[62]*See, e.g.*, Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1078 (2000).

[63]*See* Lawrence A. Hamermesh, *Panel Three: Sarbanes-Oxley Governance Issues, The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1753-54 (2006).

[64]*See id.* at 1754-55 (explaining that revisions to the Delaware code generally originate from the Council). The formal process of using a practitioner committee to study the corporation statute and recommend revisions and updates was initiated by the Delaware Assembly in 1963, and resulted, through the work of Professor Ernest L. Folk, III, in a comprehensive revision to the Delaware statute in 1967. *See Delaware Corporation Law Revision Committee*, http://law.widener.edu/lawlibrary/research/onlineresources/Delawareresources/delawarecorporationlawrevisioncommittee.aspx.

[65]*See, e.g.*, Demetrios G. Kaouris, *Is Delaware Still a Haven for Incorporation?*, 20 DEL. J.

makes the Delaware legislature remarkably responsive to business and market developments.[66] The Delaware statute has traditionally been among the first to recognize and respond to topics ranging from the reimbursement of proxy expenses[67] to the authorization of telephonic board meetings.[68] Similarly, the Delaware Court of Chancery is drawn from experts in the corporate law community.[69] Because of these judges' detailed knowledge of business and business law, their decisions are informed, realistic, and highly respected.[70]

Second, Delaware law-making is multi-faceted. Delaware involves three institutions in the law-making process. This structure offers a series of checks and balances.[71] Although I have written elsewhere about the particular advantages offered by the Delaware Court of Chancery,[72] it is important to remember that its decisions are overseen by a more generalist, yet also highly respected, Supreme Court.[73] Among the Supreme Court's contributions are a unanimity norm that lends particular authority to the Court's decisions (apart from the rare cases that feature dissenting opinions), and the Court's willingness to update the state's prior decisional law without

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CORP. L. 965, 973 (1995).

[66]The administrative system in Delaware also has a reputation for being responsive to business needs. *See id*. at 977 (describing the speed and technology of the Delaware Secretary of State's office).

[67]*See* DEL. CODE ANN. tit. 8, § 113 (2011).

[68]*See* DEL. CODE ANN. tit. 8, § 141(i) (2011); *see also* Edward P. Welch & Patricia Moran Chuff, *Recent Developments in Delaware Corporate Law: The "Technology Amendments" to the Delaware General Corporate Law*, SKADDEN, ARPS, SLATE, MEAGHER, & FLOM LLP & AFFILIATES, http://www.skadden.com/insights/recent-developments-delaware-corporate-law-technology-amendments-delaware-general-corporate (describing technology amendments adopted by the Delaware legislature in 2000 to allow Delaware corporations to take advantage of developments in technology in various areas of corporate governance).

[69]Lewis S. Black, Jr., *Why Corporations Choose Delaware*, DEL. DEP'T OF STATE DIV. OF CORPS. (2007), *available at* http://corp.delaware.gov/whycorporations_web.pdf (stating that the Court of Chancery attracts some of the best lawyers in Delaware to serve as Chancellors and Vice Chancellors).

[70]*See, e.g.*, William H. Rehnquist, *The Prominence of the Delaware Court of Chancery in the State-Federal Joint Venture of Providing Justice, Speech at the Bicentennial of the Delaware Court of Chancery*, 48 BUS. LAW. 351, 354 (1992) (praising the Delaware Court of Chancery).

[71]The structure of the institutions also provides a degree of insulation from political pressure. The Court of Chancery is a bi-partisan body, and its members are appointed by the governor after consultation with the local legal community. Similarly, the Corporate Law Council provides the legislature with a degree of insulation from the standard political forces. Finally, Delaware's size and citizen base limit the extent to which interest groups can be effectively mobilized at the state level. *See* ROMANO, *supra* note 41, at 39-41.

[72]Fisch, *supra* note 62, at 1078.

[73]*See* Kaouris, *supra* note 65, at 976-78 (describing the importance and reputation of the Delaware Supreme Court); Randy J. Holland, *Delaware's Business Courts: Litigation Leadership*, 34 J. CORP. L. 771, 775-77 (2009) (highlighting the advantages of the Delaware courts).

an excessive reliance on principles of *stare decisis*.[74] The Delaware court system is known for its efficiency, including its leadership in incorporating technological innovations.[75] In addition, both the Court of Chancery and the Supreme Court are capable of hearing cases on an expedited schedule, providing litigants with a prompt resolution of what are often time-sensitive disputes.[76]

Third, the structure of Delaware's corporate law is largely enabling rather than mandatory. By and large the Delaware statute specifies default rules that can be modified through issuer-specific charter and bylaw provisions. The degree of individualized tailoring permitted by the Delaware statute is extensive. For example, firms can choose among voting structures that include majority or plurality voting, standard or classified boards, cumulative and class voting rules, supermajority requirements, and more. These choices allow companies to tailor their structures to firm-specific features, such as the presence of a majority shareholder, the level of institutional ownership, and the degree of management ownership. Firms can also choose how to allocate power between shareholders and directors through enabling provisions concerning the power to amend the bylaws, the ability of shareholders to call special meetings, and so forth.

Finally, in its decisional law, Delaware takes a highly incremental approach akin to that characteristic of traditional common law adjudication.[77] Although some commentators have criticized Delaware case law as unduly indeterminate,[78] the incremental approach allows the courts both to withhold broad policy judgments pending sufficient ripening of the issues and to distinguish holdings on a fact-specific basis, increasing the responsiveness of legal rules to the factual context in which they are applied. In previous writings, I have also argued that Delaware's indeterminacy encourages parties in business transactions to resolve disputes through negotiation and settlement.[79]

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[74]*See, e.g.*, Holland, *supra* note 73, at 776 ("The Supreme Court's tradition of issuing unanimous opinions is known as Delaware's 'unanimity norm.' That practice differs markedly from the decisionmaking patterns in the highest courts of other states . . . .").

[75]*See, e.g.*, *id*. at 773 (describing various technological innovations including electronic docketing and filing systems found in the Delaware courts).

[76]*See id*. at 777 ("The Court of Chancery is renowned for the unparalleled alacrity with which it conducts trials and decides important issues of corporate law.").

[77]*See* Fisch, *supra* note 62, at 1072-74 (describing the advantages of incremental decision-making in corporate law adjudication).

[78]*See* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1927-28 (1998).

[79]Fisch, *supra* 62, at 1098.

These features of Delaware corporate law provide particular advantages with respect to the regulation of corporate governance—the rules and structures that determine the allocation of decision-making authority within the corporation. Because corporations differ from each other—in their shareholder bases, their need to respond to creditor interests, the markets in which they operate, the strengths of individual corporate leaders such as the founder and/or CEO—they have different needs with respect to this allocation of authority. In addition, the needs of a specific corporation and corporations in general may change over time in response to market developments.

Variation among corporations with respect to the most appropriate governance structure coupled with frequent fluctuations in market conditions that create new governance needs or cause prior structures to become obsolete enhances the value of corporate law rules that are dynamic and flexible. General mandates are particularly problematic both because a single rule may not work best for all corporations and because it may be particularly difficult ex ante to determine the appropriate response to ongoing business developments.

As a result, innovation in corporate law has largely relied on private ordering—issuer-specific tailoring of a firm's governance structures through charter and bylaw provisions.[80] As then Vice Chancellor Strine explained, private ordering enables "the market [to] assess what works best without the high costs that come with the imposition of an unproven, invariable mandate."[81] One of the most prominent recent examples of a governance development that was implemented through private ordering is majority voting.[82]

Delaware law has taken a moderate approach to private ordering. On the one hand, the Delaware statute offers issuers extensive freedom to modify statutory default provisions through appropriate charter and bylaw

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[80]This Article uses the term "private ordering" to describe issuer-specific corporate governance provisions. These provisions are contractual in nature and typically take the form of a charter or bylaw provision, although they may be embodied in a traditional contract. *See, e.g.*, Unisuper Ltd. v. News Corp., 898 A.2d 344, 346 (Del. Ch. 2006) (describing the agreement between a corporation's board and its shareholders over the board's power to adopt a poison pill); *see also* Fisch, *supra* note 17, at 495-97 (advocating use of private ordering in determining the scope of shareholder power to nominate director candidates); *see generally* D. Gordon Smith, Matthew Wright & Marcus Kai Hintze, *Private Ordering with Shareholder Bylaws*, 80 FORD. L. REV. 125 *passim* (2011) (discussing various uses of the term "private ordering").

[81]Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 7 (2010).

[82]*See, e.g.*, *id.* at 6-7 (discussing the benefits of private-ordering-derived majority voting).

provisions, and the courts have largely employed a contractual analysis in evaluating and interpreting such provisions.[83] On the other hand, the courts have been somewhat skeptical of shareholder efforts to constrain director discretion through restrictive bylaws. As an example, the authority of shareholders to limit the board's power to adopt or extend a poison pill remains unclear under Delaware law, and the courts initially resisted proxy access bylaws as well, until the legislature explicitly affirmed their validity.[84] This Article returns to the question of whether developments in shareholder demographics present the need for modification of Delaware's current approach in Part IV.[85]

III. DODD-FRANK AS A RESPONSE TO "FAILURES" IN DELAWARE LAW

Congressional efforts to federalize corporate law respond in part to perceived deficiencies in state regulation. In the past, those deficiencies included the failure of the blue sky laws to constrain speculation and fraud in securities transactions,[86] the issues raised by the growth in hostile takeovers in the 1960s,[87] and the perceived limitations of state court willingness to impose sufficient accountability on officers and directors through the application of fiduciary duties.[88] More recently, Sarbanes-Oxley responded to the wave of corporate scandals of the Enron era—specifically to identified weaknesses in the auditing process and the associated reliability of audited financial statements.[89]

Dodd-Frank contains statutory provisions that deal with two alleged "failures" in Delaware law.[90] To address concerns about excess executive

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[83] *See, e.g.*, Airgas, Inc. v. Air Prods. & Chems., Inc., 8 A.3d 1182, 1188 (Del. 2010) ("Corporate charters and bylaws are contracts among a corporation's shareholders; therefore, our rules of contract interpretation apply.").

[84] *See* DEL. CODE ANN. tit. 8, § 112 (2009).

[85] *See infra* Part IV.B.3.

[86] *E.g.*, Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1, 23 (1998) (citing LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 148-52 (3d ed. 1989)) ("[T]he legislative history of the Act clearly expresses dissatisfaction with the then-existing system in which the states alone regulated securities sales.").

[87] *See, e.g.*, Robert J. Graves, *A Failed Experiment: State Takeover Regulation after Edgar v. Mite Corp*., 1983 U. ILL. L. REV. 457, 459-61 (explaining that Congress adopted the Williams Act out of a concern that current law offered insufficient protection for investors).

[88] *See* Cary, *supra* note 18, at 701 (calling for adoption of a federal minimum standard of fiduciary duties because state law is insufficient).

[89] *See, e.g.*, Bratton & McCahery, *supra* note 3, at 666 (describing the scope of Sarbanes-Oxley).

[90] In addition to these provisions, Dodd-Frank contains a number of additional corporate

compensation, Dodd-Frank required the SEC to adopt rules mandating a shareholder vote on such compensation—say on pay.[91] To address concerns about the role of shareholders in the election of directors, Dodd-Frank authorized the SEC to adopt a proxy access rule.[92]

This Part considers, by looking at recent Delaware decisions, whether Dodd-Frank's federalization of these issues of corporate governance can be justified as a response to "failures" of Delaware law. It argues that Delaware's experiences were not failures, but instead illustrate the capacity of the Delaware system to respond to ongoing governance issues. In contrast, this Part demonstrates the relative deficiencies of federal alternatives. Although it is too early to evaluate Congress' response under Dodd-Frank, the initial evidence is less than promising and reinforces commentators' prior intuitions about the superiority of state regulation.

A. *Executive Compensation*

1. Background

Perhaps the issue that has raised the most concern about the adequacy of state corporate law and, in particular, the extent of managerial agency problems, is executive compensation.[93] Commentators have hotly debated both the level and structure of the pay of U.S. executives.[94] The debate was highlighted most prominently in Lucian Bebchuk and Jesse Fried's 2004

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governance reforms. Most of these reforms require disclosure rather than implementation of specific governance mechanisms. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 972, 124 Stat. 1376 (2010) (requiring disclosure of whether an issuer has a separate Chairman and CEO, and why). It should be noted that Congress considered, but did not adopt, more extensive mandatory reforms. For example, proposed Section 972 would have required the stock exchanges to adopt listing standards that essentially required issuers to use majority, rather than plurality, voting. *See* S. REP. NO. 111-176, at 146-47 (2010).

[91] Dodd-Frank § 972 .

[92] *Id.* § 971.

[93] *See, e.g.*, Randall S. Thomas & Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers' Fiduciary Duties*, 95 MINN. L. REV. 846, 876-79 (2011) (describing concerns about the system of setting executive compensation and efforts that have been made to respond to these concerns).

[94] *See, e.g.*, Colin Barr, *Obama Talks Tough on CEO Pay*, CNNMONEY (Feb. 4, 2009), http://money.cnn.com/2009/02/04/news/obama.exec.pay.fortune/index.htm. *Compare* Steven N. Kaplan, *Are U.S. CEOs Overpaid?*, 22 ACAD. MGMT. PERSPS. 1, 1-2 (2008) (arguing that CEOs are not overpaid), *with* James P. Walsh, *CEO Compensation and the Responsibilities of the Business Scholar to Society*, 22 ACAD. MGMT. PERSPS. 26, 27, 30 (2008) (questioning Kaplan's analysis and citing evidence that executive pay is a matter of widespread public concern).

book, *Pay without Performance: The Unfulfilled Promise of Executive Compensation*.[95]

Perceived deficiencies in state regulation of compensation led to previous federal regulatory reforms ranging from tax laws designed to encourage corporations to tie executive compensation more closely to corporate performance, to increasingly detailed SEC disclosure requirements.[96] These reforms were premised on the absence of state law mechanisms that allowed shareholders or courts to oversee executive pay. Delaware statutory law authorizes the board to determine the compensation of the company's executives,[97] and Delaware case law offers shareholders no practical mechanism for challenging such board determinations, affording compensation decisions the full protection of the business judgment rule.[98]

2. The *Disney* Litigation

The prolonged litigation[99] over the compensation of Michael Ovtiz in the *Disney* case appeared, for a time, to raise the possibility that Delaware would change its approach. When the Court of Chancery refused to grant the defendants' motion to dismiss[100] and ordered a trial on the issue of whether the director defendants breached their duty of good faith by, among other things, agreeing to include a $140 million severance provision in Ovitz's employment contract, many commentators touted this development as offering new potential for judicial scrutiny of pay practices.[101]

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[95] LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).

[96] *See* Jill E. Fisch, *Teaching Corporate Governance Through Shareholder Litigation*, 34 GA. L. REV. 745, 761-62 (2000) (describing the federal government's prior efforts to address excesses in executive compensation through tax and disclosure requirements).

[97] *See* DEL. CODE ANN. tit. 8, § 141(h) (2010).

[98] *Cf.* Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay, in Search of Excess*, 92 COLUM. L. REV. 1876, 1897-1900 (questioning whether pay levels and practices would be affected if courts applied a different legal standard in reviewing compensation decisions, such as a proportionality test).

[99] The case was filed in 1986 and was not concluded until 1996. David C. Donald, *Approaching Comparative Company Law*, 14 FORDHAM J. CORP. & FIN. L. 83, 102 n.88 (2008).

[100] *In re* Walt Disney Co. Deriv. Litig., 825 A.2d 275, 289-90 (Del. Ch. 2003), *aff'd sub nom.* Brehm v. Eisner, 906 A.2d 27 (Del. 2006).

[101] *See, e.g.*, Jill E. Fisch, *Institutional Competition to Regulate Corporations: A Comment on Macey*, 55 CASE W. RES. L. REV. 617, 622 (2005) ("[C]ourts in Delaware have seized upon the duty of good faith as a potential mechanism for increasing their oversight of the compensation process."); Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis,"* 30 IOWA J. CORP. L. 675, 692 (2005) ("The Disney litigation [is] . . . an extended morality tale on the board's responsibility to monitor executive compensation.").

Ultimately *Disney* failed to live up to commentators' hopes that the Delaware courts would take a more active role in policing executive pay.[102] Instead, the case reaffirmed both the application of the business judgment rule[103] and the extensive deference to be afforded to board compensation decisions.[104] As one critic explained, the *Disney* decision demonstrated the Delaware Supreme Court's intention to "stay out of the business [of policing executive compensation decisions] in any meaningful way."[105] Critics warned that the *Disney* case left a gap in the regulation of executive pay.[106]

Was the *Disney* case a failure? A careful reading of the *Disney* decision suggests that the court reached the correct outcome as a matter of both substance and policy. On a substantive level, there are reasons to question whether Ovitz's pay, albeit substantial, could be fairly characterized as excessive. Ovitz left a lucrative position at Creative Artists Agency, a position that paid him $20 million a year as well as positioning him as one of the most powerful people in Hollywood, to join Disney.[107] He agreed to join Disney in the number two position, subordinate to Michael Eisner,[108] who was reputedly a difficult colleague.[109] If things did not work out at Disney, Ovitz faced the possibility that his reputation in Hollywood would be damaged; a possibility for which he demanded downside

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[102] *See Brehm*, 906 A.2d at 36 (affirming the trial court's determination that the defendants did not breach their fiduciary duties), *aff'g by an equally divided court In re* Walt Disney Co. Deriv. Litig., 825 A.2d 275 (Del. Ch. 2003).

[103] *See id.* at 58-60 (applying the business judgment rule to the compensation committee's approval of Ovitz's employment agreement and holding that the committee's actions met that standard); *cf.* Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 IOWA J. CORP. L. 833, 833, 853, 855 (2007) (questioning whether the business judgment rule deference is appropriate given the problem of structural bias presented by board compensation decisions).

[104] In this sense, the later opinions echoed the Court of Chancery's initial reaction according great deference to the board's judgment, because the "size and structure of executive compensation are inherently matters of judgment." Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000), *aff'd*, 906 A.2d 27 (Del. 2006).

[105] Jennifer S. Martin, *The House of Mouse and Beyond: Assessing the SEC's Efforts to Regulate Executive Compensation*, 32 DEL. J. CORP. L. 481, 489 (2007).

[106] *See, e.g.*, *id.*

[107] *Brehm*, 906 A.2d at 36, 39.

[108] *In re* Walt Disney Co. Deriv. Litig., 907 A.2d 693, 703 (Del. Ch. 2005), *aff'd sub nom.* Brehm v. Eisner, 906 A.2d 27 (Del. 2006) ("Ovitz did recognize that Eisner was Chairman and would be his superior, but he believed that the two would work in unison in a relationship akin to the one that exists between senior and junior partners.").

[109] Author and journalist Kim Masters described Michael Eisner as "such a dominant figure and such a difficult personality." Interview by Terence Smith with Kim Masters, Journalist, Disney's Troubled Kingdom, NPR (PBS television broadcast Mar. 14, 2005) (transcript *available at* http://www.pbs.org/newshour/bb/entertainment/jan-june05/disney_3-14.html).

protection.[110] In addition, given the size of Disney and its operations, the economic significance of his severance package, relative to the potential value that could be imparted by an effective president,[111] was strikingly low.[112] Finally, the structure of Ovitz's pay package was also the result of Disney's effort to maintain its deductibility under existing tax laws.[113] Could a court, in hindsight, truly have determined that the board's decision was unreasonable?

The wisdom of the *Disney* courts' reluctance to second-guess the board's decision is further supported by the methodological challenges presented in evaluating executive compensation. Some commentators assert that executives are paid too much; others take issue with both the claim and the methodology.[114] Starting in the early 1990s, commentators urged issuers to rely more heavily on performance-based compensation, theorizing that this would align manager and shareholder interests thereby reducing agency costs.[115] Due to the stock market performance in the 1990s, performance-based compensation, particularly stock options, led to soaring overall pay levels.[116] At the same time, options turned out to skew executive incentives, creating reasons for executives to engage in excessive risk-taking and to manage to the market.[117] Today commentators offer a range of

[110] *Walt Disney Co.*, 907 A.2d at 702 (citation omitted) ("Ovitz was making approximately $20 to $25 million a year from CAA and owned fifty-five percent of the company. From the start, Ovitz made it clear that he could not give up his fifty-five percent interests in CAA without downside protection.").

[111] As Justice Jacobs observed, the market appeared to value the Ovitz hire. On the day it was announced, Disney common stock rose 4.4 percent, or $1 billion. *See Brehm*, 906 A.2d at 40.

[112] *See Walt Disney Co.*, 907 A.2d at 768 n.533 (comparing size of severance package to Disney's contemporaneous revenues and income—$19 billion and $3 billion, respectively).

[113] *See, e.g.*, Victor Fleisher, *The Tax and Financial Engineering Angle*, THE CONGLOMERATE (Aug. 10, 2005), *available at* http://www.theconglomerate.org/2005/08/the_tax_angle.html (arguing that Disney structured Ovitz's pay package in order to maintain its deductibility under IRC § 162(m)(4)(C)).

[114] *See, e.g.*, Beth Florin, Kevin F. Hallock & Douglas Webber, *Executive Pay and Firm Performance: Methodological Considerations and Future Directions*, 29 RESEARCH IN PERS. & HUMAN RES. MGMT. 49, 50-53 (2010) (describing methodological issues in measuring and comparing executive compensation).

[115] *See, e.g.*, James E. Heard, *Executive Compensation: Perspective of the Institutional Investor*, 63 U. CIN. L. REV. 749, 758-62, 765 (1995) (describing increased institutional attention to pay for performance and resulting issuer shift toward compensation plans that link pay and performance).

[116] *See, e.g.*, Jennifer Reingold, *Special Report: Executive Pay*, BUSINESSWEEK (Apr. 19, 1999), http://www.businessweek.com/1999/99_16/b3625001.htm (observing that "a pay structure that has linked most executive compensation to the stock market through huge option grants" has, with unprecedented growth in the US stock market, made US CEOs "wildly wealthy").

[117] Option-based compensation also led to the option backdating scandals. *See, e.g.*, Eric Dash, *Dodging Taxes Is a New Wrinkle in the Stock Options Game*, N.Y. TIMES, at C1 (Oct. 30,

new compensation proposals, each with the promise of remedying prior flaws, but with the potential to produce new unintended consequences.[118] Directors recognize the need for performance-based pay, but struggle with the selection of appropriate performance metrics and the identification of suitable time frames.[119]

Within this context, the *Disney* opinions emerge as an illustration of the norm-generating value of Delaware decisional law. Without imposing liability, the *Disney* opinions stressed the importance of evolving board practices with respect to the process of setting executive compensation,[120] including the use of compensation committees, the duty of such committee members to be informed, and reliance on pay consultants.[121] The courts highlighted key deficiencies in the process by which the board set Ovitz's compensation and emphasized the distinction between procedures that were legally adequate and those that constituted best practices.[122] The case, therefore, offered Delaware corporations valuable guidance as to the appropriate considerations and methodology associated with the determination of executive pay. In particular, the courts made clear that boards and compensation committees have an affirmative duty to participate actively and on an informed basis in compensation decisions.

2006), *available at* http://query.nytimes.com/gst/fullpage.html?res=9505E3DF123FF933A05 753C1A9609C8B63 (describing option compensation and backdating scandals).

[118] *See, e.g.*, Yoram Landskroner & Alon Raviv, *The 2007-2009 Financial Crisis and Executive Compensation: Analysis and a Proposal for a Novel Structure* 14-20 (N.Y.U Stern Sch. of Bus., Fin. Working Paper No. FIN-09-003), *available at* http://hdl.handle.net/2451/28105 (proposing new pay component based on whether firm value is within designated range); Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long Term*, 26 YALE J. ON REG. 359, 364-67 (2009) (proposing that executives be paid in restricted stock that is locked up until two to four years after the executive's departure and contains a clawback feature); Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 NW. U. L. REV. 1205, 1207-08 (2011) (advocating paying bankers with debt securities instead of equity).

[119] *See, e.g.*, *Alignment of Performance Goals with Shareholder Value Top Compensation Challenge in 2011*, BUS. WIRE (May 4, 2011, 10:09 AM), http://www.businesswire.com/news/home/20110504006312/en/Alignment-Performance-Goals-Shareholder-Top-Compensation-Challenge (stating, based on survey data, that corporate directors report selecting performance goals that align with shareholder value creation as their biggest challenge).

[120] Notably, the court did so without mandating that a board employ specific procedures. In contrast, Dodd-Frank required the SEC to adopt rules directing national securities exchanges to adopt listing standards imposing specific requirements with respect to the independence of compensation committees, the committees' use of compensation advisors, and the consideration of conflicts of interest by such advisors. *See* SEC Press Release, SEC Adopts Rule Requiring Listing Standards for Compensation Committees and Compensation Advisers (June 20, 2012), *available at* http://www.sec.gov/news/press/2012/2012-115.htm.

[121] *See In re* Walt Disney Co. Deriv. Litig., 906 A.2d 27, 56 (Del. 2006).

[122] *See id.* ("[A] helpful approach is to compare what actually happened here to what would have occurred had the committee followed a 'best practices' (or 'best case') scenario, from a process standpoint.").

Finally, as with most Delaware decisional law, the *Disney* case left open the potential for courts to oversee executive compensation. In the *Citigroup* derivative litigation, the plaintiffs challenged the board's decision to approve CEO Harold Prince's termination package, a package that included $68 million in compensation, an office, an administrative assistant, and a car with a driver.[123] The plaintiffs argued that paying this "multi-million dollar compensation package to a departing CEO whose failures as CEO were allegedly responsible, in part, for billions of dollars of losses at Citigroup" constituted waste.[124] Although the court noted that the legal standard for establishing waste was a stringent one, it refused to dismiss this claim, finding that plaintiffs had adequately alleged a reasonable doubt that Prince's compensation met the legal standard.[125] Moreover, the court signaled the availability of judicial oversight, at least in extreme cases, observing that "'there is an outer limit' to the board's discretion to set executive compensation . . . ."[126] In light of this language, the *Disney* decision is perhaps better understood as involving a failure of proof, rather than a failure of Delaware law.

3. The Response to *Disney*

The emphasis on the board as a mechanism of accountability offers an alternative to litigation as a tool for monitoring executive pay—a tool that has become significant due to the involvement of institutional investors. Institutions are increasingly focused on executive compensation and are using their voting power to hold corporate boards accountable for compensation decisions. In particular, institutions are disciplining compensation committees for awarding excessive executive pay through the use of "withhold" votes.

In the vast majority of corporate elections, the issuer's slate of director candidates runs unopposed, and shareholders have little chance to elect anyone else.[127] Nonetheless, shareholders can withhold their votes from director candidates to show a lack of support.[128] These symbolic "vote no"

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[123] *In re* Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106, 138 (Del. Ch. 2009).

[124] *Id*.

[125] *See id.*

[126] *Id.* (quoting Brehm v. Eisner, 746 A.2d 244, 262 n.56 (Del. 2000)).

[127] *See* JILL E. FISCH, *The Transamerica Case*, *in* THE ICONIC CASES IN CORPORATE LAW 46, 67-68 (Jonathan R. Macey ed., 2008) (explaining the role of "withhold" votes in board elections).

[128] *Id.* at 68 (explaining how institutional investors use "withhold" votes to communicate their lack of satisfaction with an issuer).

campaigns offer shareholders the opportunity to communicate their opposition to a candidate or an issuer policy without the cost or disruption associated with litigation or an election contest.[129]

Empirical studies indicate that institutional investors are using this approach to convey their concern about compensation levels and policies.[130] For example, one recent study showed that compensation committee membership, coupled with a high level of executive pay, was highly correlated with a director nominee receiving a reduced number of votes in favor.[131] Another study examined the voting behavior of Vanguard,[132] the largest mutual fund complex in the United States.[133] Vanguard has been outspoken in its criticism of excessive executive compensation.[134] Vanguard addresses this concern through its votes in director elections.[135] Specifically, the study found that Vanguard exercised more than 75 percent of the withhold votes that it cast with respect to directors who served on their company's compensation committee (despite the fact that such directors comprised only 39 percent of the total pool).[136] Vanguard was also significantly more likely to cast withhold votes at companies with abnormally high executive compensation.[137]

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[129]The concept of a "withhold vote" campaign was pioneered by Joseph Grundfest. *See* Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 903-08 (1993).

[130]*See* Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 880 (2010).

[131]*Id.* at 878.

[132]Stephen J. Choi, Jill Fisch & Marcel Kahan, *Voting Through Agents: How Mutual Funds Vote on Director Elections*, HARV. BUS. L. REV. (forthcoming 2013), *available at* http://lsr.nellco.org/cgi/viewcontent.cgi?article=1390&context=upenn_wps.

[133]John Waggoner, *Vanguard Is Now Largest Mutual Fund Company*, USA TODAY, http://www.usatoday.com/money/perfi/funds/2010-10-05-fundline05_ST_N.htm (last updated Oct. 5, 2010) (reporting that, as of October 2010, Vanguard had $1.3 trillion in assets under management).

[134]Eleanor Bloxham, *How Can We Address Excessive CEO Pay?*, CNNMONEY (Apr. 13, 2011), http://management.fortune.cnn.com/2011/04/13/how-can-we-address-excessive-ceo-pay/ (quoting Jack Bogle, founder of The Vanguard Group, as describing CEO compensation levels as "outrageous").

[135]*See* Choi et al., *supra* note 132, at 30. Significantly, Vanguard does not appear to favor addressing executive compensation through shareholder proposals. *See* Jackie Cook, John Keenan & Beth Young, *Tipping the Balance? Large Mutual Funds' Influence Upon Executive Compensation*, THE AM. FED'N OF STATE, CNTY. AND MUN. EMPS., AFL-CIO, 23 (2009-2010), http://www.afscme.org/news/press-room/press-releases/2011/body/2011-AFSCME-Mutual-Fund-Report.pdf (reporting that Vanguard supported fewer than 1 in 20 shareholder-sponsored compensation proposals).

[136]Choi et al., *supra* note 132, at 30.

[137]*Id.*

4. Say on Pay

Dodd-Frank required the SEC to adopt a rule mandating an advisory vote on executive compensation—so-called say on pay.[138] Say on pay can be compared with the withhold vote practice described in the preceding section. Say on pay had its origins in the United Kingdom, where it was adopted in 2002.[139] The UK experience was reportedly favorable,[140] and institutional investors began advocating for say on pay in the United States.[141] In the several years preceding Dodd-Frank, say on pay had been the subject of several attempts at private ordering. Institutional investors introduced say on pay proposals at dozens of companies through Rule 14a-8,[142] and several received majority shareholder approval.[143] At least one company, Aflac, voluntarily adopted a say on pay provision.[144]

Congress made the vote mandatory. Section 951 of Dodd-Frank amended the federal securities laws to require issuers to submit their compensation disclosure as a separate resolution subject to shareholder vote.[145] The statute specifically provides that this shareholder vote is non-

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[138]Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (2010).

[139]*See, e.g.*, FISCH, *supra* note 127, at 70-71 (describing the history "say on pay"). The UK is in the process of making its shareholder vote on executive compensation binding. *See* Carol Matlack, *A Tougher 'Say on Pay' Migrates to the U.K*, BUSINESSWEEK.COM (June 20, 2012) http://www.businessweek.com/articles/2012-06-20/a-tougher-say-on-pay-migrates-to-the-uk.

[140]*See, e.g.*, Fabrizio Ferri & David Maber, *Say on Pay Votes and CEO Compensation: Evidence from the UK*, REV. FIN. (forthcoming) (manuscript at 4), *available at* http://ssrn.com/abstract=1420394 ("UK investors perceived say on pay to be a value enhancing monitoring mechanism, and were successful in using say on pay votes to pressure firms to remove controversial pay practices and increase the sensitivity of pay to poor performance."). *But see* Jeffrey N. Gordon, Essay, *"Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 341 (2009) (arguing that UK experience with say on pay was not successful—only eight remuneration reports were rejected in six years and executive pay levels have increased).

[141]*E.g.*, FISCH, *supra* note 127, at 71.

[142]*See* Hannah Clark, *CEOs Beware: Congress at Work*, *Compensation*, FORBES.COM (Mar. 1, 2007), http://www.forbes.com/2007/03/01/frank-executive-compensation-lead-comp_ cx_hc_0301frank.html.

[143]*See* FISCH, *supra* note 127, at 71.

[144]*See* Allan Sloan, *Aflac Looks Smart on Pay*, WASH. POST (May 29, 2007), http://www.washingtonpost.com/wp-dyn/content/article/2007/05/28/AR2007052801055.html (describing Aflac's decision voluntarily to offer shareholders a vote on executive compensation).

[145]Dodd-Frank required the SEC to adopt rules to implement say on pay. The SEC adopted Rule 14a-21(a) and several related rules on Jan. 25, 2011. Press Release, U.S. Securities and Exchange Commission, SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act (Jan. 25, 2011), http://www.sec.gov/news/ press/2011/2011-25.htm. *See* Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 76 FED. REG. § 6012. Issuers are also required to permit shareholders to

binding, does not overrule any decision by the issuer or the board, and does not create or imply any change in fiduciary duties.[146] In other words, the vote is purely advisory.[147] Issuers are required, however, to disclose the results of the vote and to explain "[w]hether and, if so, how the registrant has considered the results of the most recent shareholder advisory vote on executive compensation . . . in determining compensation policies and decisions and, if so, how that consideration has affected the registrant's executive compensation decisions and policies."[148]

In adopting say on pay, the Senate Committee made specific reference to the compensation and termination package paid by Citigroup to Charles Prince.[149] The Committee explained that shareholders, as the owners of the corporation, should have the right to express their opinion on the appropriateness of executive pay.[150] The vote, the Committee explained, could serve as a targeted way to signal shareholder discontent and could assist compensation committees in reining in executive pay.[151]

The Committee Report and the legislation do not reference the competing arguments about say on pay and executive compensation that have been raised over the last decade. They do not explain how shareholders can determine whether an issuer's pay levels or compensation structure are appropriate. As noted above, evaluating executive compensation levels and structure raise a variety of methodological challenges, many of which are still the subject of academic debate.[152] These

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vote on golden parachute compensation. *Id*.

[146]Dodd-Frank technically requires three shareholder votes: (1) an advisory vote on executive compensation; (2) a vote on the frequency with which say on pay will occur; and (3) a vote on golden parachute compensation. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (2010).

[147]*Id*.

[148]17 C.F.R. § 229.402(b)(1)(vii) (2011). The informational value of these explanations is unclear. One issuer explained the effect of the shareholder advisory vote on compensation as follows:

> Last year, in a non-binding advisory vote, the Company's shareholders approved the Company's compensation plan for its Chief Executive Officer, Chief Financial Officer, and other three most highly paid executives. The Compensation Committee considered this when determining compensation for its senior executive officers for fiscal year 2011. The Compensation Committee will consider the results of the shareholder vote on executive compensation at the Company's 2011 annual meeting in finalizing planning 2012 compensation.

Oak Valley Bancorp, Schedule 14A (Apr. 28, 2011) *available at* http://www.sec.gov/Archives/edgar/data/1431567/000110465911023325/a11-2796_1def14a.htm.

[149]S. REP. NO. 111-176, at ¶ 54,520 (2010).

[150]*Id*.

[151]*Id*.

[152]*See generally* Florin et al., *supra* note 114 (explaining the methodological challenges); *see also id*. at 17-19 (discussing the various ways in which compensation is defined and measured as well as the factors that impact the link between performance and pay).

challenges include selecting the appropriate measure of compensation, choosing the appropriate benchmark, determining whether to measure compensation on an ex post or ex ante basis, evaluating causality, and incorporating an appropriate measure of risk. Although it is unclear whether boards and compensation committees are conducting appropriate analyses in connection with their compensation decisions, a simplistic analysis of compensation that influences shareholder votes may bring investor pressure to the wrong companies.

Of particular concern is the potential influence of proxy advisory firms, especially Institutional Shareholder Services ("ISS").[153] Given the costs of gathering information and formulating policies on executive compensation, institutional investors are likely to depend heavily on proxy advisor recommendations.[154] It is unclear, however, that those recommendations are of sufficient quality to make the so-called shareholder referenda truly meaningful.[155] Corporate managers have expressed concern, for example, that proxy advisors frequently apply a one-size-fits-all approach, despite the firm-specific issues involved in structuring compensation.[156] The problems associated with this approach are aggravated by advisors' reliance on proprietary models to rate compensation—models that are not fully transparent.[157] In addition, critics have challenged the accuracy of the information collected and used by advisors. Survey data collected by the Center on Executive Compensation revealed, for example, that a majority of respondents reported one or more mistakes in the advisor's published report on their pay practices.[158] Similarly, Bloomberg questioned

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[153]*See generally* Stephen J. Choi, Jill E. Fisch & Marcel Kahan, *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649 (2009) (describing role of proxy advisors, and ISS in particular).

[154]*See, e.g.*, Gordon, *supra* note 140, at 352 (warning that the power that may accrue to a small number of proxy advisors cannot be ignored). To date, this influence has been limited in that although shareholders reject relatively few packages, a negative ISS recommendation is correlated with substantially lower levels of shareholder support than a positive recommendation. *See* Jeremy L. Goldstein, *Say on Pay 2012*, HAR. L. SCH. F. CORP. GOV. & FIN. REG, 1 (July 14, 2012, 10:28 AM), http://blogs.law.harvard.edu/corpgov/2012/07/14/say-on-pay-2012/ (reporting the effect of negative ISS recommendations).

[155]*See, e.g.*, Florin et al., *supra* note 114, at 16-17 (criticizing proxy advisor's reports on executive compensation); *id.* at 17 ("Almost none of what has been learned in the past decades about executive compensation, pay or performance is included in these sources.").

[156]*A Call for Change in the Proxy Advisory Industry Status Quo: The Case for Greater Accountability and Oversight*, CTR. ON EXEC. COMP., 60 (Jan. 2011), *available at* http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf ("Issuers are concerned that many recommendations from proxy advisors are based on a 'one-size-fits-all' governance approach that does not capture the differences in company situations or approaches.").

[157]*Id.*

[158]*Id.* at 58.

ISS's methodology for calculating the value of performance-based compensation at the time of the grant without reflecting the value of actual compensation received.[159] A recent academic paper criticizes the use of peer group data—a core component of ISS's methodology.[160]

The significance of an adverse vote on executive compensation is also unclear.[161] Under state law, the board of directors has the statutory authority to determine executive pay.[162] To what extent can or should the board be influenced by the federally-mandated advisory vote? As some commentators have noted, a substantial percentage of shareholder voting power is exercised by institutional investors – mutual funds, pension funds and unions, for example.[163] It is unclear whether institutions are voting in an effort to maximize long term firm value when they oppose compensation plans, or whether their votes reflect idiosyncratic policy preferences or political agendas.[164] Should a director be responsive to the perceived position of unions on executive pay levels or consider the possibly less visible perspective of retail shareholders?

Although the effectiveness of say on pay remains to be seen, the initial experience has not been promising. In the two proxy seasons in which shareholders could vote on executive pay (2011 and 2012), a majority of votes were cast against pay packages at just 2-3 percent of companies holding an annual meeting.[165] In both years, the average pay package was

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[159]*See* George Paulin, *Five 'Say-on-Pay' Lessons*, BLOOMBERG BUSINESSWEEK (July 29, 2011), http://www.businessweek.com/printer/management/five-sayonpay-lessons-07292011.html ("ISS uses a flawed methodology . . . [that] fails to take into account the value of actual compensation earned and realized from long-term grants.").

[160]Charles M. Elson & Craig K. Ferrere, *Executive Superstars, Peer Groups and Over-Compensation – Cause, Effect and Solution* 9-10 (Oct. 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=2125979 (arguing that executive pay practices should avoid the "mechanistic and arbitrary application of peer group data" when determining executive compensation levels).

[161]*See, e.g.*, Christopher S. Armstrong, Ian D. Gow & David F. Larcker, *The Efficacy of Shareholder Voting: Evidence from Equity Compensation Plans* 30 (Mar. 13, 2012) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2021401 (finding "virtually no statistical evidence that either lower shareholder support for, or the outright rejection of, proposed equity compensation plans leads to decreases in future CEO incentive-compensation or firm-wide stock option grants").

[162]*See* DEL. CODE ANN. tit. 8, § 141(h) (2010).

[163]*See, e.g.*, Fisch, *supra* note 19, at 878-81.

[164]*See, e.g.*, *id*. at 882-83 (identifying various interests other than maximizing firm value that institutional investors may seek to further through participation in the corporate governance of their portfolio companies).

[165]Jeffrey M. Stein & Laura O. Hewett, *Say On Pay: Analyzing The Second Year Of Shareholder Votes*, METRO. CORPORATE COUNSEL, July/August 2012 at 29, *available at* http://www.metrocorpcounsel.com/articles/19656/say-pay-analyzing-second-year-shareholder-votes. Notably, however, most companies that had received a negative vote in 2011 modified their pay

approved by more than 90 percent of votes cast.[166] Investors widely appeared to disregard both ISS recommendations against pay packages and specific instances of seemingly excessive pay.[167] Two possible explanations are possible—either executive pay levels were not truly excessive or, alternatively, investors did not view say on pay as an appropriate response.[168] With respect to the first explanation, it is worth noting that, according to some studies, median CEO pay increased by 27-40 percent in 2010.[169] CEO pay continued to increase in 2011, although less rapidly.[170]

Whatever the merits of existing pay packages, the overwhelming approval rates raise the question of whether say on pay is cost-justified. In addition to providing shareholders with a vote, say on pay requires issuers to disclose a variety of additional information about their compensation packages and policies.[171] Say on pay requires issuers to evaluate and respond to proxy advisor recommendations that may be based on inaccurate information.[172] Say on pay requires issuers to consider the significance of the shareholder vote and to disclose publicly how they intend to respond.[173]

In addition, say on pay appears to be generating new litigation. Although the SEC rules provide that say on pay votes are purely advisory,[174]

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practices and obtained shareholder approval in 2012. *Id*.

[166]*Id.*

[167]*See id*. (noting that ISS negative recommendations, in most cases, failed to prevent a company from receiving shareholder approval but that approval levels were lower for companies receiving negative recommendations).

[168]*See, e.g.*, *U.S. CEO Pay Jumps Minimum of 27 Percent Last Year, Survey Finds*, HUFFINGTON POST BUS. (Dec. 14, 2011), http://www.huffingtonpost.com/2011/12/14/ceo-pay-sees-huge-boost-survey_n_1149535.html?ref=business (citing study reporting that the vast majority of corporate shareholders say that CEOs are being compensated correctly).

[169]*Id.*; *see also* Dominic Rushe, *Revealed: Huge Increase in Executive Pay for America's Top Bosses*, THE GUARDIAN (Dec. 14, 2011), http://www.guardian.co.uk/business/2011/dec/14/executive-pay-increase-america-ceos?CMP=twt_gu (reporting results from CEO pay survey).

[170]The Guardian reported an average increase in CEO pay in 2011 of 15 percent. *See* Dominic Rushe, *American CEOs enjoy 15% pay rise in second year of double-digit hikes*, GUARDIAN, May 2, 2012, *available at* http://www.guardian.co.uk/business/2012/may/02 /american-ceos-pay-rise.

[171]*See* Marcia Berss, *Say-On-Pay in 2012, A Picture Is Worth a Thousand Words*, KROLL CONSULTING GLOBAL FRAUD REPORT 2011/12, http://www.krolladvisory.com/ media/pdfs/KRL_FraudReport2011-12_Say-on-PayIn2012.pdf. Dodd-Frank also requires shareholder approval of golden parachutes as well as increased disclosure of all elements of golden parachute compensation. *See* Item 402(t) of Regulation S-K, 17 C.F.R. § 229.402(t) (2011).

[172]*See, e.g.*, Berss, *supra* note 171 (explaining how some issuers have challenged negative recommendations by proxy advisors).

[173]Stein & Hewett, *supra* note 165, at 29 ("[SEC] rules also require companies to disclose in the Compensation Discussion and Analysis (CD&A) section of the proxy statement whether or not and, if so, how the company considered the results of the most recent say-on-pay vote.").

[174]*See* SEC Adopting Release Nos. 33-9178 & 34-63768 at 33 n.117 ("We are requiring additional disclosure so that information about the advisory nature of the vote is available to

and Dodd-Frank explicitly states that the outcome of the vote is not intended to affect directors' fiduciary duties,[175] shareholders have filed a number of derivative suits against issuers that ignore a negative say on pay vote.[176] Almost half of the companies that received a negative say on pay vote in 2011 were sued.[177] The lawsuits generally allege breach of fiduciary duty on the part of the directors who approved the compensation plan and waste.[178] Although it seems unlikely that these suits will be successful,[179] the litigation increases the cost of say on pay.[180]

Whether say on pay will have the effect of improving compensation policies and practices remains unclear. Importantly, however, the provisions of Dodd-Frank impose a mandatory one-size-fits-all approach on all public companies. Issuers must make the required disclosures and obtain the required shareholder vote regardless of the pay level of their executives, their operating performance, their shareholder base, or their overall governance structure. Say on pay offers a blunt tool in that it allows a referendum only on an issuer's overall pay package. It does not consider the utility of alternative accountability mechanisms such as issuer-specific bylaw provisions, the use of alternative compensation methods, or increased accountability of compensation committee members. Finally, and most importantly, the mandated say on pay vote was explicitly adopted in a manner that forecloses investor ability to choose among these or alternative

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shareholders before they vote.").

[175] *See* Dodd-Frank § 951(c).

[176] Peter M. Saparoff, Pamela B. Greene, Breton Leone-Quick, & Ari N. Stern, *Lessons Learned from Initial "Say-on-Pay" Litigation, Plaintiffs' Attorneys Start Utilizing "No" Votes as a Basis for Claims Against Directors*, MINTZ LEVIN SEC. LITIG. ALERT (July 18, 2011), http://www.mintz.com/newsletter/2011/Advisories/1251-0711-NAT-LIT/web.htm (noting that of the forty-one companies that received a "no" vote, eight involved derivative litigation). Typically, plaintiffs allege that the low approval rate is evidence that the board's compensation decision was not a valid exercise of its business judgment. *See, e.g.*, Kyoko Takahashi Lin & Lawrence Portnoy, *Say-on-Pay Litigation Update*, DAVIS, POLK & WARDWELL, LLP, Sept. 5, 2012, http://www.davispolk.com/briefing/corporate governance/?entry=212.

[177] Michele D. Johnson & Colleen C. Smith, *The Future of Say-on-pay Derivative Litigation*, 45 REV. SEC. & COMMOD. LITIG. 69, 69 (2012).

[178] Michael Blanchard et al., *"Say on Pay": Shareholder "No" Votes Now Leading to Derivative Actions Challenging Executive Compensation*, BINGHAM ALERT (July 7, 2011), http://www.bingham.com/Media.aspx?MediaID=12582&eID=12582.

[179] *See* Lin & Portnoy, *supra* note 176 (noting that, despite the failure of most of the lawsuits to date, plaintiffs continue to file them). *Compare* Plumbers Local No. 137 Pension Fund v. Davis, 2012 WL 104776, at *1 (D. Or. Jan. 11, 2012) (dismissing say on pay challenge), *with* NECA-IBEW Pension Fund v. Cox, 2011 WL 4383368, at *5 (S.D. Ohio, Sept. 20, 2011) (refusing to grant motion to dismiss).

[180] One company paid nearly $2 million to settle a suit based on the say on pay provision of the Troubled Asset Relief Program. Saparoff et al., *supra* note 176 (citing Amended Stipulation and Notice of Settlement, *In re* KeyCorp Deriv. Litig., No. 1:10-cv-01786 (N.D. Ohio Apr. 26, 2011)).

mechanisms through private ordering. Notably, when the SEC adopted the rules implementing say on pay, it packaged with them a new instruction to the shareholder proposal rule that authorizes the exclusion of shareholder proposals for advisory votes on executive compensation so long as the issuer offers a say on pay vote that is consistent with the most recent "say on frequency" vote.[181] Federalism thus directly interferes with Delaware's private ordering approach.

B. *Proxy Access*

1. The Role of Shareholder Nominating Power

Although the board's authority over corporate decision-making is extensive, historically managers rather than independent directors populated corporate boards.[182] Delaware law does not provide a robust procedure for shareholder election of directors, nor does Delaware law require that directors be independent of management. Management control over the composition of the board was aided by its control over the proxy solicitation process, the financing of corporate elections, and the mechanism of plurality voting.[183]

The federal securities laws largely usurped the regulation of the shareholder voting process. In addition to mandating disclosure, the federal proxy rules dictate the required form of proxy,[184] provide limited federal rights to a shareholder list,[185] and offer shareholders access to the issuer's proxy for shareholder proposals.[186] Although federal law does not purport to address shareholders' substantive voting rights,[187] the SEC's extensive rule-

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[181]*See* 17 C.F.R. § 240.14a-8(i)(10) (2011).

[182]*See* P.M. Vasudev, *Default Swaps and Director Oversight: Lessons from AIG*, 35 IOWA J. CORP. L. 757, 781 (2010) (citing ALFRED D. CHANDLER, VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (Belknap Press 1977)) ("[I]n the last several decades, the business and affairs of the corporations were actually managed by full-time executives."); *see also* Gordon, *supra* note 20, at 1471-73 (describing the move toward monitoring boards consisting of independent directors).

[183]*See* Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291, 292-93 (N.Y. 1955) (upholding power of directors to use the corporate treasury to defend themselves in an election contest).

[184]Securities Exchange Act of 1934, 17 C.F.R. § 240.14(a)(4) (2011).

[185]17 C.F.R. § 240.14(a)(7).

[186]17 C.F.R. § 240.14(a)(8).

[187]*See* Bus. Roundtable v. SEC, 905 F.2d 406, 411 (D.C. Cir. 1990) (holding that the SEC lacked the authority to extend its regulation beyond controlling the voting procedure and into the distribution of voting power).

making effectively occupied the procedural regulation of shareholder voting.[188]

The *Blasius* decision in 1988 demonstrated Delaware's renewed attention to the issue of shareholder voting.[189] Although *Blasius* did not afford shareholders greater control rights over operational decision-making, the opinion for the first time articulated the view that the broad delegation of authority to the board was premised on effective shareholder election rights. As the court explained: "[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."[190] *Blasius* paved the way for subsequent developments in Delaware decisional and statutory law that distinguished the exercise of managerial and director authority in the election context from that in other business decisions.

At the same time, market developments led to greater shareholder power.[191] Institutional investors became increasingly proactive in asserting their governance rights through a range of mechanisms—introducing shareholder proposals, participating in campaigns to withhold votes from incumbent directors, and even mounting proxy contests.[192] *Blasius* signaled to investors that voting-based activism was an appropriate way to address their concerns about corporate governance. The resulting activism led to changes in governance practices–most visibly a shift in board composition to reflect the growing importance of the independent director.[193] Shareholders also sought issuer-specific structural changes to enhance their voting power.[194] As a result of efforts by institutional investors, a majority of large public companies shifted from plurality voting to some form of majority voting procedure.[195] Shareholders also sought to adopt procedures

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[188] *See* Fisch, *supra* note 38, at 1130-31, 1139-41.

[189] Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 652, 658-63 (Del. Ch. 1988).

[190] *Id*. at 659.

[191] *See* FISCH, *supra* note 127, at 67-68; Choi et al., *supra* note 130, at 874.

[192] *See* State of Wis. Inv. Bd. v. Peerless Sys. Corp., 2000 WL 1805376, at *66-*67 (Del. Ch. Dec. 4, 2000), *reprinted in* 27 DEL. J. CORP. L. 726, 756 (2002) ("Since the *Blasius* opinion was issued over a decade ago, several large institutional stockholders, including SWIB, have become increasingly proactive in challenging management proposals by asserting their rights as stockholders. This is a wholesome development for purposes of corporate governance under Delaware's corporation law."); Choi et al., *supra* note 130, at 874 (describing results of empirical study of votes withheld in uncontested director elections); FISCH, *supra* note 127, at 68 (describing emergence of "vote no" campaigns).

[193] *See* Gordon, *supra* note 20, at 1468 (detailing shift to majority-independent boards).

[194] *See, e.g.*, Am. Fed'n of State, Cnty. & Mun. Emp. v. Am. Int'l Grp., Inc., 462 F.3d 121, 123-24 (2d Cir. 2006); CA, Inc. v. AFSCME Emp. Pension Plan, 953 A.2d 227, 229-30 (Del. 2008).

[195] *See* FISCH, *supra* note 127, at 67-68 (describing shift to majority voting).

designed to reduce the cost of election challenges, including proxy access[196] and expense reimbursement bylaws.[197]

Delaware courts reacted to these developments with ambivalence. On the one hand, the courts repeated general statements favoring broad shareholder voting power.[198] For example, the courts articulated a "rule of construction in favor of franchise rights."[199] Similarly, they noted that the "Delaware courts have long recognized that the 'right of shareholders to participate in the voting process includes the right to nominate an opposing slate.'"[200] On the other hand, courts upheld management efforts to constrain shareholder nominating and voting power.[201]

2. *Computer Associates*

Perhaps the clearest example of the ambivalence of the Delaware courts toward shareholder voting rights is the Supreme Court's decision in *Computer Associates*, *Inc. v. AFSCME*.[202] *Computer Associates* concerned a shareholder proposal seeking to amend the AFSCME bylaws to require it to reimburse the proxy solicitation expenses of shareholders whose candidates are successfully elected to the board.[203] The SEC certified two questions to the Delaware Supreme Court:

1. Is the AFSCME Proposal a proper subject for action by shareholders as a matter of Delaware law?

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[196] *See, e.g.*, *Am. Fed'n of State, Cnty. & Mun. Emp.,* 462 F.3d at 123-24 (seeking to introduce proxy access bylaw amendment).

[197] *See, e.g.*, *CA, Inc.*, 953 A.2d at 229-30 (seeking to amend bylaws to include proxy reimbursement provision).

[198] Harrah's Entm't, Inc. v. JCC Holding Co., 802 A.2d 294, 310 (Del. Ch. 2002).

[199] *Id*.

[200] JANA Master Fund, Ltd. v. CNET Networks, Inc., 954 A.2d 335, 345 (Del. Ch. 2008), *reprinted in* 33 DEL. J. CORP. L. 565, 577 (2008) (quoting Linton v. Everett,1997 WL 441189, at *9 (Del. Ch. July 31, 1997), *reprinted in* 23 DEL. J. CORP. L. 886, 901 (1998)).

[201] *See* Openwave Sys. Inc. v. Harbinger Capital Partners Master Fund I, Ltd., 924 A.2d 228, 238-39 (Del. Ch. 2007); Accipiter Life Scis. Fund, L.P. v. Helfer, 905 A.2d 115, 124-25 (Del. Ch. 2006).

[202] CA, Inc. v. AFSCME Emp. Pension Plan, 953 A.2d 227 (Del. 2008).

[203] *Id.* at 231. This Article discusses the certification procedure, which was adopted by the Delaware legislature just prior to the AFSCME case. *See infra* Part IV.A.

2. Would the AFSCME Proposal, if adopted, cause CA to violate any Delaware law to which it is subject?[204]

The court answered the first question in the affirmative.[205] The court initially conducted an extensive analysis of the proper role of shareholder-adopted bylaws.[206] In particular, the court identified an inherent tension between the shareholder power to adopt bylaws and director authority to run the company, a tension that limited the scope of permissible bylaws.[207] Nonetheless, the court explained shareholders could properly use their authority over the bylaws "to define the process and procedures" by which boards make operational decisions.[208] The court characterized the reimbursement bylaw as "procedural," because it had "both the intent and the effect of regulating the process for electing directors of CA."[209] As such, the court found that the proposal was a proper subject for shareholder action, stating:

> The shareholders of a Delaware corporation have the right "to participate in selecting the contestants" for election to the board. The shareholders are entitled to facilitate the exercise of that right by proposing a bylaw that would encourage candidates other than board-sponsored nominees to stand for election. The [b]ylaw would accomplish that . . . .[210]

Nonetheless, the court advised the SEC that the proposed bylaw was invalid.[211] Although the bylaw addressed a proper subject for shareholder action, it was, according to the court, inconsistent with Delaware common law because it would commit the directors to a course of action—reimbursing an insurgent's proxy expenses—in circumstances in which that

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[204] *CA, Inc.*, 953 A.2d at 231.
[205] *Id.* at 237.
[206] *See id.* at 231.
[207] *See also id.* at 231. Additionally, Larry Hamermesh has argued that the statutory change in 1967 to Section 109 meant that "[S]ection 109(b) should no longer be viewed as general authority for direct stockholder governance through the adoption of by-laws." Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 452 (1998).
[208] *CA, Inc.*, 953 A.2d at 234-35.
[209] *Id.* at 236.
[210] *Id.* at 237.
[211] *Id.* at 240.

action constituted a breach of fiduciary duty.[212] The court held that shareholders could not use a bylaw to constrain director authority.[213]

Given the court's contractual analysis, it is unclear why the absence of an explicit fiduciary out should invalidate AFSCME's proposed bylaw.[214] It is well established under Delaware law that directors cannot undertake contractual commitments that preclude them from exercising their fiduciary obligations,[215] yet most standard corporate contracts do not contain an explicit reservation of a fiduciary out. Indeed, this is what makes *Omnicare*'s discussion of a fiduciary out puzzling.[216] As a result, although a proxy reimbursement bylaw could easily address the court's concern by including a similar fiduciary out, the *Computer Associates* decision must be understood as expressing skepticism about the scope of shareholder authority under Section 109. This skepticism appears problematic in light of both *Blasius* and the increasing efforts by institutional investors to increase director accountability through the election process.

Is the *Computer Associates* decision then a failure of Delaware law? Richard Ferlauto observed that the *Computer Associates* decision "makes Delaware less relevant to the discussion about shareholder election rights" and increased the need for "an appropriate right of . . . access at the federal level."[217] Broc Romanak noted that the decision was "very significant" and that many would "likely view this as a loss for stockholders," adding that the decision would have important implications for other private ordering efforts such as pill redemption bylaws.[218]

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[212]*CA, Inc.*, 953 A.2d at 239-40.

[213]The court referenced its prior decisions *Paramount Commc'ns, Inc. v. QVC Network, Inc.* (invalidating a no shop provision in merger agreement because of the possible inconsistency with board's fiduciary duties) and *Quickturn Design Sys., Inc. v. Shapiro* (invalidating delayed redemption provision in a poison pill). *Id*. at 238.

[214]*See generally* Sabrina Ursaner, *Keeping "Fiduciary Outs" Out of Shareholder-Proposed Bylaws: An Analysis of* CA, Inc. v. AFSCME, 6 N.Y.U. J.L. & BUS. 479, 482 (2010) (arguing that a fiduciary out should not be required in shareholder-proposed bylaws).

[215]*See, e.g.,* Paramount Comm'ns v. QVC Network Inc., 637 A.2d 34, 51 (Del. 1994) (citing Wilmington Trust v. Coulter, 200 A.2d 441, 448 (Del. 1964)) ("To the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable.").

[216]Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 , 936-39 (Del. Sup. 2003).

[217]Kara Scannell & Judith Burns, *Delaware Court Rules for CA in Suit*, WALL ST. J., July 18, 2008 (quoting Richard Ferlauto, director of pension investment policy for AFSCME).

[218]Broc Romanak, CA v. AFSCME*: The Delaware Supreme Court Giveth and the Supreme Court Taketh Away*, THECORPORATECOUNSEL.NET BLOG (July 18, 2008), http://www.thecorporatecounsel.net/Blog/2008/07/ca-v-afscme-the-supreme-court-giveth-and-the-supreme-court-taketh-away.html.

Although the *Computer Associates* decision itself might be subject to criticism, the resolution of the issue of shareholder power to adopt proxy reimbursement bylaws demonstrates not that Delaware courts are infallible, but rather that the Delaware lawmaking system contains checks and balances to address potential concerns.[219] In the case of *Computer Associates*, the Delaware legislature acted swiftly. In a move that insiders have characterized as a direct response to the need to "clarify" the *Computer Associates* decision, the legislature amended the Delaware corporate code in April 2009.[220]

The amendments added two new sections to the Delaware statute – Section 112 which authorizes issuers to adopt proxy access bylaws,[221] and Section 113 which authorizes issuers to adopt proxy expense reimbursement bylaws.[222] Notably, although both sections allow the bylaws to prescribe conditions and procedures governing their application, in neither case does the statute require the bylaws to contain a fiduciary out. The Corporate Law Section of the Delaware State Bar Association explained the amendments as an effort to "clarify further the validity and flexibility of bylaws establishing . . . proxy access."[223] The legislation has the effect of removing any potential concern about the second part of the *Computer Associates* court's analysis as well as any constraint that might have been inferred from the court's discussion of substantive versus procedural bylaw provisions.

In addition to highlighting the value of the checks and balances implicit in Delaware's dual lawmaking structure, the amendments are consistent with the overall approach of Delaware law. The amendments facilitate private ordering by enabling but not requiring individual issuers to

[219] Previously, when institutional investors began to seek majority voting provisions, the Delaware Legislature amended the corporation statute to clarify both the legitimacy of majority voting and a number of issues concerning the operation of majority voting bylaws. *See Delaware Legislature Adopts Amendments to Facilitate Majority Voting for Director Elections*, MILBANK, TWEED, HADLEY & MCCLOY LLP (July 17, 2006), http://www.milbank.com/images/content/5/6/569/060717.pdf (explaining Delaware amendments).

[220] *See* Yin Wilczek, *Proxy Access Amendments to Del. Code Signed Into Law; Provisions Effective Aug. 1*, 41 SEC. REG. & L. REP. 728 (2009) (indicating that Delaware Bar Association's Council of the Corporation Law Section member, Larry Hamermesh, reported that the amendments were prompted by Delaware's recent decision in *CA, Inc. v. AFSCME*); *see id.* (quoting Larry Hamermesh) ("The decision was a primary catalyst for the proposed amendments, which go a long way to clarify what the impact of the court's decision was.").

[221] DEL. CODE ANN. tit. 8, § 112 (2012).

[222] *Id*. § 113.

[223] Comment Letter from James L. Holzman, Del. State Bar Ass'n: Council of the Corp. Law Section, to Elizabeth Murphy, U.S. Sec. & Exch. Comm'n, at 4 (July 24, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-65.pdf.

adopt bylaws concerning election procedures, to experiment with varying conditions for their use, and to facilitate shareholder power to obtain board representation through proxy access, financial support, or a combination of the two. Indeed, the amendment package implicitly suggests that proxy access and reimbursement of proxy expenses may function as complements or substitutes and offers issuers a menu of options for increasing shareholder participation in the election process.

3. Federal Proxy Access

These options were notably absent from the short-lived federal proxy access rule. For many years, shareholders had urged the SEC to increase shareholder power in director elections by explicitly authorizing shareholders to nominate director candidates.[224] The SEC considered adopting a proxy access rule for 70 years, but critics questioned its power to do so.[225] In 2010, Dodd-Frank authorized the SEC to adopt a federal proxy access rule.[226] The Dodd-Frank provision was highly controversial and subject to a last minute effort to remove the statutory authorization.[227] Nonetheless, the provision was included, and a month later, the SEC adopted Rule 14a-11.[228]

Rule 14a-11 created a federal right for shareholders to nominate corporate directors, subject to a complex set of conditions.[229] In order to qualify to use federal proxy access, shareholders were required to own at least 3 percent of an issuer's stock for at least three years and to commit to continue to hold that stock through the date of the annual meeting.[230] Shareholders were required to file a Schedule 14N and to provide disclosure

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[224] *See, e.g.*, Fisch, *supra* note 17, at 441-42 (detailing history of proxy access).

[225] *See, e.g.*, DIV. OF CORP. FIN., U.S. SEC. & EXCH. COMM'N. STAFF REPORT: REVIEW OF THE PROXY PROCESS REGARDING THE NOMINATION AND ELECTION OF DIRECTORS 6 (2003), *available at* http://www.sec.gov/news/studies/proxyreport.pdf (noting questions raised about SEC's legal authority to adopt a proxy access rule).

[226] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971, 124 Stat. 1915 (2010).

[227] *See, e.g.*, Jonathan B. Cohn, Stuart L. Gillan & Jay C. Hartzell, *On Enhancing Shareholder Control: A (Dodd-) Frank Assessment of Proxy Access* 9 (unpublished manuscript) (Dec. 7, 2012), *available at* http://ssrn.com/abstract=1742506 (describing last minute negotiations in conference committee about the proxy access provision in Dodd-Frank).

[228] According to the SEC, the agency spent $2.5 million writing and defending Rule 14a-11. Ellen Rosen, *Proxy Access, Deere-FCPA, Basel Capital Rules: Compliance*, BLOOMBERG (Aug. 12, 2011), http://www.bloomberg.com/news/2011-08-12/proxy-access-rule-deere-fcpa-basel-capital-rules-compliance.html.

[229] *See* Fisch, *supra* note 17, at 447-48.

[230] *See id.*

about themselves, their shareholdings, and their relationships with the nominees and the issuer.[231] Shareholders were limited to nominating candidates for 25 percent of the available director positions.[232] Rule 14a-11 was not available for shareholders seeking to influence the control of the issuer or for shareholders that wished to engage in any activity other than passively nominating director candidates, such as meeting with management.[233]

In adopting Rule 14a-11, the SEC explicitly rejected an alternative approach that would have enhanced private ordering. Commentators argued to the SEC that issuers should be able to opt in or out of proxy access or adjust the holding requirements through individual charter or bylaw provisions.[234] In light of the considerable debate within the SEC about the appropriate thresholds for allowing a shareholder to nominate director candidates, specifically the required shareholdings and holding period, one might have thought that the SEC would favor a system that allowed issuers to experiment with different thresholds. Instead, the SEC refused to adopt a private ordering approach. Instead, it specifically prohibited issuers from adopting charter or bylaw provisions that would have imposed stricter requirements than Rule 14a-11.[235] Similarly, although Rule 14a-11 did not forbid issuers from voluntarily adopting less stringent requirements, shareholder nominations pursuant to issuer-specific provisions would have received less favorable regulatory treatment.[236]

In adopting proxy access, the SEC retained its prior regulatory impediments to issuer-specific experimentation in connection with the director nomination process—impediments that frustrate shareholder and issuer attempts to experiment through private ordering. The SEC's proxy solicitation rules, for example, require disclosure and filing, with few exceptions, for all shareholders who wish to engage in collective action with respect to the nominating process, even those shareholders who want to join in or second a nomination by a fellow shareholder.[237] The SEC's bona fide

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[231] *See id.* at 448.

[232] *See, e.g.*, *id.*

[233] *See* Fisch, *supra* note 17, at 450.

[234] *See, e.g.*, Comment Letter from Seven Law Firms to Elizabeth Murphy, Sec'y of SEC, at 1-3 (Aug. 17, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-212.pdf (observing that private ordering would be superior in accommodating the various issuer-specific factors that determine the appropriate form of proxy access).

[235] *See* Fisch, *supra* note 17, at 451.

[236] *See id.* at 469 (observing that shareholders who attempted to nominate a candidate through other mechanisms were ineligible for certain exemptive provisions).

[237] *See id.* at 448-49 ("The federal securities laws have traditionally treated collective shareholder action with suspicion.").

nominee rule precludes shareholders from distributing a proxy card that includes the names of both issuer and shareholder nominees.[238] Regulation 13D requires disclosure by shareholders who engage in collective action with respect to the election of directors and may be triggered by as little as a telephone call or a meeting to discuss the possibility of nominating a director candidate.[239] While Rule 14a-11 offered, at least temporarily, a mechanism for shareholders to exercise nominating power, it offered a single, highly restrictive mechanism that could not be tailored to address issuer-specific needs.

Whatever its deficiencies, Rule 14a-11 did not survive judicial scrutiny. Congress may have viewed Dodd-Frank's authorization of proxy access as adequately addressing any concerns about the SEC's lawmaking power, but the strategy appears to have backfired. Immediately after the SEC adopted Rule 14a-11, the U.S. Chamber of Commerce and the Business Roundtable filed suit, raising a number of challenges to the rule.[240] In July 2011, the DC Circuit invalidated Rule 14a-11.[241]

The DC Circuit's decision was narrow. The court did not find fault with the rule's limited scope, vagueness, or internal contradictions—all problems that I have identified elsewhere.[242] Rather, the court invalidated the rule as arbitrary and capricious, finding that the SEC had failed adequately to "'apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation.'"[243] Specifically, the court criticized the SEC for giving insufficient weight to opponents' estimates of the costs of the new rule, for rejecting various empirical studies concerning the potential effects of proxy access, and for relying on other research deemed by the court to be "unpersuasive."[244]

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[238]*See id.* at 496 (arguing that the SEC should amend federal proxy rules to authorize a universal ballot).

[239]*See* Fisch, *supra* note 17, at 470-71.

[240] Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).

[241]*Id.* at 1156. Interestingly nowhere in the DC Circuit's opinion did the court reference Dodd-Frank's statutory authorization for the rule or the congressional determination that "it is proper for shareholders, as the owners of the corporation, to have the right to nominate candidates for the Board using the issuer's proxy under limited circumstances." S. Rep. No. 111-176, at 146 (2010).

[242]Fisch, *supra* note 17, at 457-74.

[243]*Bus Roundtable,* 647 F.3d at 1148 (quoting Chamber of Commerce v. SEC, 412 F.3d 133, 144 (D.C. Cir. 2005)). The court noted that the SEC has a unique obligation under the APA not merely to ensure that its rules are not arbitrary and capricious but to consider the effect of a new rule upon "efficiency, competition, and capital formation . . . ." *Id.* at 1146.

[244]*Id*. at 1151.

The *Business Roundtable* decision sounded a threatening note for SEC regulation of corporate governance.[245] Since the SEC first considered some form of proxy access, its proposals have been highly controversial. When the SEC held a series of hearings in the 1970s on a possible shareholder nomination rule, it was deluged with comments and objections, largely from business interests.[246] Indeed, proxy access offers an example of the type of interest group politics that Romano and others have warned is inconsistent with effective corporate regulation.[247] Interest groups flooded the SEC with hundreds of comment letters in response to its most recent proposals.[248] The supposed openness of the rule-making process was marred by the fact that SEC officials held dozens of meetings with concerned parties.[249] The SEC disclosed the fact that these meetings occurred, but not the substance of the discussions.[250]

Interest group pressure is particularly problematic in the context of regulatory proposals that reduce the power of corporate management. Powerful corporate managers can fund their opposition to such proposals from the corporate treasury, while dispersed investors may have limited resources with which to convey their support. As a result, regulators may receive skewed information about the potential effects of the proposals.[251] The situation may be exacerbated by the tendency of regulators to rely heavily on data collected and presented by industry groups, submitted through the largely unfiltered framework of the notice-and-comment process. The DC Circuit's apparent expectation that the SEC develop

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[245]The legal standard applied by the *Business Roundtable* court also threatens the ability of the SEC to engage in future rule-making. *See generally* Jill E. Fisch, *The Long Road Back:* Business Roundtable *and the Future of SEC Rulemaking*, 37 SEATTLE UNIV. L. REV. (forthcoming 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2164423 (exploring implications of the *Business Roundtable* decision for future SEC rule-making); *see also* Petition for Review, Nat'l Ass'n of Mfrs. v. SEC, No. 12-1422 (Oct. 19, 2012), *available at* http://www.srz.com/files/upload/Conflict_Minerals_Resource_Center/Petition_for_Review.pdf (challenging the SEC's adoption of rules governing conflict minerals).

[246]*See* Fisch, *supra* note 17, at 441.

[247]*See* ROMANO, *supra* note 41, at 95-96.

[248]*See, e.g.,* Fisch, *supra* note 17, at 440-47.

[249]*See id*. at 477 n.255.

[250]*See id.*

[251]Consider, for example, the two event studies that were presented to the SEC on proxy access, both of which employed questionable methodologies with respect to the classification of events and the treatment of confounding events. *See, e.g.*, Steven M. Davidoff, *The Heated Debate Over Proxy Access,* N.Y. TIMES DEALBOOK (Nov. 2, 2010), http://dealbook.nytimes.com/2010/11/02/the-heated-debate-over-proxy-access/ (offering some criticisms of the studies).

convincing data-based responses to all objections to its proposed rules heightens the prospect of regulatory paralysis.[252]

At the same time, it is not clear that the result in the *Business Roundtable* case was wrong on the merits. Although the court's command that the SEC quantify the effect of a hitherto untested but exceedingly modest revision to the required disclosures on an issuer's proxy statement is difficult to defend, the politics and procedural requirements of the notice-and-comment rule-making process and the justifiable anticipation of a litigation challenge resulted in a twisted and complicated proxy access rule that offered little prospect of providing shareholders with an increased role in the nomination of corporate directors. Most problematically, the SEC insisted on adopting a mandatory one-size-fits-all rule despite the lack of experience with any form of shareholder nomination rule and its consequent inability to predict the extent to which shareholders would use proxy access or to anticipate its effects on director accountability.

The final point bears emphasis. Unlike the Delaware courts and legislature, which have expertise in corporate governance, the functions and operations of the corporate board, and the relationship between the election process and other structural components of shareholder voting power,[253] the SEC lacks any institutional competence to assess the value of increased shareholder voting power or enhanced director accountability. In this regard, one may contrast the SEC, institutionally, to the Delaware Committee on Corporate Law. The Committee, unlike the SEC, is made up of practitioners who advise and represent corporations, understand the dynamics of the boardroom, and are intricately involved in the ongoing debates between shareholders and managers.[254] It is notable that, when the SEC adopted Rule 14a-11, it made no independent findings regarding the adequacy of shareholder voting power or the quality and composition of corporate boards.

In the wake of the DC Circuit's decision, which removed the federalism imposed by Rule 14a-11, efforts at private ordering have

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[252]Bureaucratic delays are not unique to securities regulation. Compare the federal regulation of egg safety which was adopted in 2010. According to the New York Times, the core of the new rules was developed two decades earlier, but then "languished . . . because of internal sniping in the federal bureaucracy and a general deregulatory atmosphere" Andrew Martin, *Egg Recall Exposes Flaws in Nation's Food Safety System*, N.Y. TIMES (Aug. 25, 2010), http://www.nytimes.com/2010/08/25/business/25eggs.html.

[253]*See supra* notes 61-62 and accompanying text.

[254]*See supra* notes 63-68 and accompanying text; *see also Corporation Law*, DEL. STATE BAR ASS'N, http://www.dsba.org/index.php/sections-of-the-bar/corporation-law.html (last visited April 9, 2012).

reemerged. At the same time that it adopted Rule 14a-11, the SEC removed previously-enacted restrictions on the ability of shareholders to propose proxy access bylaws through Rule 14a-8. During the 2012 proxy season, for the first time, shareholder power to propose proxy access bylaws was unimpeded by either Delaware or federal law. Responding to this freedom, shareholders introduced proxy access bylaws at approximately twenty issuers.[255] The proposals varied significantly in the eligibility criteria they imposed, their sponsors, and whether they were precatory or binding.[256] As this Article goes to press, no binding proposal has received majority shareholder approval. Commentators predict that shareholders will continue their efforts, through private ordering, to obtain some form of proxy access.[257]

IV. THE FUTURE OF DELAWARE CORPORATE LAW – SOME OBSERVATIONS

A. *Rethinking the Federalization Claim*

Proxy access and say on pay offer two recent examples for comparing federal regulation to Delaware lawmaking. Some commentators have extrapolated from these examples in support of broader claims about the threat Delaware faces from federal regulation.[258] The results of congressional efforts suggest, however, that those claims may be overstated. Proxy access and executive compensation are merely the most recent of a series of corporate law challenges that have presented the opportunity for federal intervention; yet, at the end of the day, Delaware continues to dominate.

One such example is takeover regulation. Although Congress appeared to occupy a substantial part of the field with its adoption of the Williams Act in 1968, the protections of the Williams Act are now largely outdated. State law developments, such as the adoption of state antitakeover laws and issuer-specific takeover defenses, have surpassed

[255] James Morphy, *Proxy Access Proposals: Review of 2012 Results and Outlook for 2013*, HAR. L. SCH. F. CORP. GOV. & FIN. REG, 1 (June 28, 2012, 10:07 PM), http://blogs.law.harvard.edu /corpgov/2012/06/28/proxy-access-proposals-review-of-2012-results-and-outlook-for-2013/.

[256] *See id*. at 1-4 (presenting chart of proxy access proposals introduced during 2012 proxy season and voting results).

[257] *See id*. at 1, 4-5.

[258] *See, e.g.*, Bainbridge, *supra* note 6, at 1783 (describing risk posed to Delaware from Congress efforts at "quack corporate governance").

the restrictions of the Williams Act in importance.[259] Similarly, market developments, including the shift from corporate raiders to shareholder activists, have decreased the economic significance of the hostile tender offer.[260] From the perspective of the takeover market, the recent Delaware decisions in the *Air Products* litigation[261] were far more significant than the Second Circuit's decision in the *CSX* case.[262]

Another example is the enforcement of officer and director fiduciary duties. At one point, it appeared that the federal courts would expand the scope of private securities litigation as a means of filling a perceived gap in corporate governance due to the limited liability exposure of directors under state fiduciary duty law.[263] The federal government has retreated from that position, both through decisions by the U.S. Supreme Court limiting the scope of private securities fraud claims[264] and through the legislative restrictions contained in the Private Securities Litigation Reform Act of 1995.[265] That retreat is unlikely to be reversed in light of ongoing criticism of private securities fraud litigation.[266] As a result, Delaware decisional law is the primary source of the legal standards for officer and director conduct. The contextual approach in which Delaware develops and applies these standards is evident in one of its most recent applications—the evaluation of the Citigroup board's risk management policies in the transactions leading up to the financial crisis.[267]

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[259] *See* Andrew E. Nagel, Andrew N. Vollmer & Paul R.Q. Wolfson, *The Williams Act: A Truly "Modern" Assessment*, HAR. L. SCH. F. CORP. GOV. & FIN. REG. (Apr. 7, 2012, 12:42 PM), http://blogs.law.harvard.edu/corpgov/files/2011/10/The-Williams-Act-A-Truly-ModernAssessment.pdf (noting how antitakover laws and corporate defense mechanisms have limited the importance of the Williams Act).

[260] John Armour, Jack B. Jacobs & Curtis J. Milhaupt, *The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework*, 52 HARV. INT'L L.J. 219, 240 (2011) (observing that the hostile tender offer was "a byproduct of three economic and market developments" that amassed during the 1970s and 1980s).

[261] Airgas, Inc. v. Air Prods. & Chems., Inc., 8 A.3d 1182 (Del. 2010); Air Prods. & Chems., Inc. v. Airgas, Inc. (*In re* Airgas Inc. S'holder Litig.), 16 A.3d 48 (Del. Ch. 2011).

[262] CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 654 F.3d 276 (2d Cir. 2011).

[263] *See, e.g.*, Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 865 (2003).

[264] *See, e.g.*, Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc., 552 U.S. 148, 166-67 (2008) (holding that Rule 10b-5 did not permit a cause of action against defendants upon whose conduct market participants did not rely); Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 346 (2005) (rejecting artificial price inflation as a recoverable economic loss).

[265] Private Securities Litigation Reform Act, Pub. L. No. 104-67, § 101, 109 Stat. 737 (1995).

[266] *See, e.g.*, William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 722-23 (2010).

[267] *In re* Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106, 123-24 (Del. Ch. 2009).

Indeed, one of Delaware's most recent structural changes, the adoption of a procedure for accepting certification from the SEC, enhances its lawmaking authority. The SEC has traditionally been confronted with the task of interpreting state corporate law in connection with its no-action decisions regarding issuer attempts to exclude shareholder proposals.[268] This task is complicated by the fact that state corporate law is in many cases unclear, particularly with respect to issues that are litigated infrequently, such as shareholder authority to adopt certain types of bylaw provisions.[269] Historically the SEC has relied on legal opinions from local practitioners. In the case of conflicting opinions, the SEC staff has generally allowed the issuer to exclude the proposal.[270] This both frustrates shareholder innovation with respect to bylaw proposals and limits the evolution of Delaware law, because doctrines such as ripeness limit the opportunity for the courts to consider the validity of bylaws that have never been adopted.[271]

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[268] Rule 14a-8(i)(1) allows an issuer to exclude a shareholder proposal that is "not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization." 17 C.F.R. § 240.14a-8(i)(1) (2011). Rule 14a-8(i)(2) allows the exclusion of a proposal that "if implemented, [would] cause the company to violate any state, federal, or foreign law to which it is subject." *Id.* at § 240.14a-8(i)(2); *see also* Robert B. Ahdieh, *From Federal Rules to Intersystemic Governance in Securities Regulation*, 57 EMORY L.J. 233, 235-36 (2007).

[269] *See* Hamermesh, *supra* note 207, at 487-89 (describing then-current law as providing significant uncertainty as to whether a shareholder rights bylaw was consistent with Delaware law, but arguing that it was not); Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 256-58 (2005) (arguing that both poison pills and proxy access bylaws were valid under then-existing Delaware law).

[270] *See* Robert B. Ahdieh, *The Dialectical Regulation of Rule 14a-8: Intersystemic Governance in Corporate Law*, 2 J. BUS. & TECH. L. 165, 173 n.56 (2007) (citing a statement by then-Division of Corporation Finance Deputy Director Martin Dunn describing this as the SEC's position). Shareholders can challenge the exclusion in court, but rarely do so. *See id.* at 178 n.80. Moreover, such litigation typically occurs in federal court. *See, e.g.*, Am. Fed'n of State, Cnty. & Mun. Emps.v. Am. Int'l Grp., 462 F.3d 121, 124 (2d Cir. 2006). In some cases, an alternative is for the proponent to frame the proposal as a non-binding request or recommendation. *See* 17 C.F.R. § 240.14a-8(i)(1) (2011) ("Depending on the subject matter, some proposals are not considered proper under state law if they would be binding on the company if approved by shareholders. In our experience, most proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law. Accordingly, we will assume that a proposal drafted as a recommendation or suggestion is proper unless the company demonstrates otherwise."). *But see* Lewis S. Black, Jr. & A. Gilchrist Sparks III, *The SEC as Referee—Shareholder Proposals and Rule 14a-8*, 2 J. CORP. L. 1, 6 (1976) (criticizing the distinction between mandatory and precatory proposals as elevating form over substance).

[271] *See, e.g.*, Bebchuk v. CA, Inc., 902 A.2d 737, 738 (Del. Ch. 2006) (rejecting, on ripeness grounds, shareholder's request for a determination that proposed bylaw was valid under Delaware law). Commentators have identified a variety of possible bylaw innovations that, potentially, could affect the allocation of decision-making power within the corporation, but have raised questions about the extent to which such bylaws would be legal under DCL 141(a). *See, e.g.*, Hamermesh, *supra* note 207, at 469-470 (discussing potential validity of a shareholder-adopted bylaw that could not be amended by the board). The Delaware courts have rarely had the

In 2007, Delaware amended its constitution to allow the SEC to certify questions to the Delaware Supreme Court.[272] According to one news report, "the idea for the amendment emerged out of a brainstorming session between Delaware Supreme Court and Chancery Court judges and the SEC."[273]

Although virtually every state allows federal court judges to certify questions of state law to the state supreme court,[274] the SEC certification procedure was unprecedented, reflecting another example of Delaware's innovation in its lawmaking structure. Importantly, the certification procedure preserves Delaware's authority over the development of an important body of corporate law that, as described above, had previously been beyond the scope of the Delaware courts. Delaware's adoption of the new certification procedure can be understood as a form of reverse federalization. Rather than allowing the SEC, through its no-action process, to offer interpretations of Delaware corporate law, the procedure enabled the Delaware Supreme Court to provide input into the proper scope of shareholder governance power under SEC Rule 14a-8.

Certification also expands the scope of authoritative resolutions of Delaware law, allowing for both greater predictability and increased responsiveness to problematic legal issues. *Computer Associates* offers an example. The judicial attention to proxy reimbursement bylaws in the *Computer Associates* case highlighted the significance of the issue.[275] In turn, the visibility and analysis reflected in the court's decision—as contrasted with the limited analysis and transparency associated with an SEC no-action letter—generated public debate and a legislative response.

The opportunity for Delaware to explore new legal issues through the certification process depends, of course, on the SEC's willingness to use the procedure.[276] Nonetheless, certification offers the opportunity for increased

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opportunity to consider such questions.

[272]S.B. 62, 144th Gen. Assem., Reg. Sess. (Del. 2007), *available at* http://delcode.delaware.gov/sessionlaws/ga144/chp037; *see also* Press Release, Supreme Court of Delaware, Delaware Constitutional Amendment Enacted Allowing the Securities and Exchange Commission to Bring Questions of Law Directly to the Delaware Supreme Court (May 17, 2007), *available at* http://courts.delaware.gov/Forms/Download.aspx?ID=41628.

[273]Maureen Milford, *New state law expands Delaware's role in corporate governance*, THE NEWS J. (Wilmington, Del.), May 19, 2007, *available at* http://news.lawreader.com/2007/05/19/new-state-law-expands-delawares-role-in-corporate-governance.

[274]*See* Rebecca A. Cochran, *Federal Court Certifications of State Law to State Courts: A Theoretical and Empirical Study*, 29 J. LEGIS. 157, 159 (2003) (citations omitted) ("Today, in forty-seven states, the District of Columbia, and Puerto Rico, some or all federal judges can certify a question to the state's highest court, asking that court to answer the question.").

[275]CA, Inc. v. AFSCME Emp. Pension Plan, 953 A.2d 227, 229 (Del. 2008).

[276]J.W. Verret, *Federal vs. State Law: The SEC's New Ability to Certify Questions to the Delaware Supreme Court*, CORP. GOV. ADV. 14 (2008), *available at* http://papers.ssrn.com/sol3/

shareholder experimentation with bylaw proposals because it enables the Delaware court rather than the SEC to evaluate the complex corporate governance questions and underlying policy concerns involved.

B. *Other Challenges to Delaware's Dominance*

Future challenges to Delaware corporate law are likely to come from different sources than the federal government. This subpart explores a few current challenges and explains the threat that each poses to Delaware's dominance in corporate law.

1. Private Dispute Resolution

As this Article and many others have noted, the Delaware courts play a critical role in the making of Delaware corporate law and in Delaware's dominant role in corporate law.[277] To the extent that litigants choose to resolve their disputes through non-Delaware fora, that decision threatens Delaware's role—first because Delaware corporations may lose the opportunity to benefit from the involvement of the Delaware judiciary; and second because the Delaware courts may lose the opportunity to resolve the legal issues raised by important business disputes.

Litigants may flee Delaware in favor of two alternatives.[278] One is litigation in other courts, state or federal. Another is private dispute resolution, such as arbitration. Litigants' choices between these two alternatives have different implications for Delaware's role in the making of corporate law.

The evidence is unclear as to whether litigants are fleeing Delaware in favor of litigating in other courts. In a provocative article published in 2006, Ted Eisenberg and Geoffrey Miller studied choice of law and choice of forum in merger agreements.[279] Their study found that "there is a flight from

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papers.cfm?abstract_id=1156527 ("[T]he likelihood that the Delaware certification capability will have a significant effect on corporate law will depend on the SEC's willingness to certify questions, and the Delaware Supreme Court's willingness to accept the appeal.").

[277] *See, e.g.*, John Armour, Bernard S. Black & Brian R. Cheffins, *Is Delaware Losing its Cases?* 2 (Northwestern Law & Econ. Research Paper No. 10-03) (Mar. 25, 2010), *available at* http://ssrn.com/abstract=1578404.

[278] For a thoughtful analysis of the ability of Delaware to address the risk of litigation flight or, more problematically, multi-forum litigation, *see* Donald F. Parsons, Jr. & Jason S. Tyler, *Docket Dividends: Growth in Shareholder Litigation Leads to Refinements in Chancery Procedure*, 70 WASH. & LEE L. REV. 473 (2013) (discussing "one forum" motions and forum selection charter provisions).

[279] Theodore Eisenberg & Geoffrey Miller, *Ex Ante Choices of Law and Forum: An Empirical Analysis of Corporate Merger Agreements*, 59 VAND. L. REV. 1975 (2006).

Delaware."[280] Because mergers are high profile events and adjudication of merger disputes is an important component of corporate law, Eisenberg and Miller concluded that their findings raised doubts about the attractiveness of Delaware law and courts for the resolution of complex corporate law disputes.[281]

A more recent study by John Armour et al. raises similar concerns.[282] Armour et al. study actual lawsuit filings in connection with M&A transactions.[283] They document a movement in lawsuits from Delaware to elsewhere, as well as an increase in parallel litigation.[284] The authors identify a variety of possible explanations for the move, including increased competition among plaintiffs' lawyers for both lawsuits and legal fees.[285] The authors suggest that their study demonstrates that Delaware is losing important cases to other states and warn that "the trends present a challenge for Delaware's dominance."[286]

Other studies present conflicting results. Steven Davidoff and Matthew Cain perform a similar empirical analysis to Eisenberg and Miller, but use a different sampling methodology designed to capture more of the economically significant transactions.[287] Based on their analysis, they reach quite different conclusions.[288] They conclude that Delaware dominates the law and adjudication of merger agreements.[289] Perhaps more importantly, their statistics show Delaware as "gain[ing] ground in recent years and maintain[ing] a relative dominance over other states in the adjudication of major transactions."[290] Recent work by John Coates reaches a similar conclusion, finding that Delaware dominates as the choice of forum in M&A agreements involving publicly traded companies.[291]

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[280] *Id.*at 1982.

[281] *See id.* at 2011 ("[O]ther than corporate governance law, Delaware's appeal to sophisticated corporations does not rest primarily on its law or on its courts, however efficient or expert they may be.").

[282] Armour et al., *supra* note 277, at 43.

[283] *See id.* at 1.

[284] *See id.* at 43.

[285] *See id*. at 39.

[286] Armour et al., *supra* note 277, at 45.

[287] *See* Matthew D. Cain & Steven M. Davidoff, *Delaware's Competitive Reach*, 9 J. EMP. LEGAL STUDIES 92 (2012).

[288] *See id*. at 125 ("We thus document strong evidence in support of the continuing attractiveness of the law and forum that Delaware provides. This is in contrast to the conclusions reached by Eisenberg and Miller (2006).").

[289] *Id*. at 96.

[290] *Id*. at 125.

[291] John C. Coates, IV & John F. Cogan, Jr., *Managing Disputes Through Contract: Evidence from M&A* 2 (Feb. 27, 2012), *available at* http://ssrn.com/abstract=1975423.

Coates's article considers the second type of "flight" from the Delaware courts, the selection of arbitration as an alternative to litigation. Although it would be difficult to gather data on the extent to which corporate disputes are resolved through arbitration because many arbitration proceedings are confidential, Eisenberg and Miller found that 19 percent of merger and asset purchase agreements contained arbitration provisions,[292] a number that, although far lower than in consumer agreements, exceeded the number in material contracts filed with the SEC.[293]

Coates finds that although whole contract arbitration clauses are limited to deals involving private targets, arbitration provisions for price-adjustment clauses are quite common.[294] Coates observes that this finding presents another qualification to claims of Delaware's domination: "At least in the narrow context of disputes arising out of price adjustment clauses . . . arbitration is a more attractive option for M&A participants than litigation."[295] Coates indicates that his data suggest arbitration may be particularly attractive for non-U.S. bidders that may question the neutrality of a U.S. court.[296]

The apparent neutrality, confidentiality, and speed of commercial arbitration have led to its popularity as an alternative to litigation in many types of business disputes.[297] Congress has recognized the potential value of arbitration as an alternative to litigation,[298] and courts outside of Delaware

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[292] Theodore Eisenberg & Geoffrey P. Miller, *The Flight from Arbitration: An Empirical Study of Ex Ante Arbitration Clauses in Publicly-Held Companies' Contracts* 40 (Cornell Legal Studies Research Paper No. 06-023), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=927423.

[293] Eisenberg & Miller had previously found that 11 percent of the material contracts filed with the SEC contained arbitration clauses. Theodore Eisenberg & Geoffrey P. Miller, *The Flight from Arbitration: An Empirical Study of Ex Ante Arbitration Clauses in the Contracts of Publicly Held Companies*, 56 DEPAUL L. REV. 335, 335 (2007).

[294] Coates et al., *supra* note 291, at 2.

[295] *Id*. at 34-35.

[296] *Id*. at 37.

[297] *See* Motion of the Corporation Law Section of the Delaware State Bar for Leave to File Brief *Amici Curiae* in Support of Defendants, Delaware Coalition for Open Government v. Strine, at 2, (Dec. 21, 2011) (No. 1 11-1015) [hereinafter Motion of the Corporation Law Section], *available at* http://www.law.du.edu/documents/corporate-governance/governance-cases/delaware-coalition/Motion-of-the-Corporation-Law-Section-of-the-Delaware-State-Bar-for-Leave-to-File-Brief-Amici-Curiae-in-Support-of-Defendants.pdf (documenting increasing demand by business of ADR options and growing use of arbitration as an alternative to litigation).

[298] Alternative Dispute Resolution Act of 1998, 28 U.S.C. §§ 651-58 (2006), *amended by* Pub. L. 105-315, § 2, 112 Stat. 2993 (1998); *see also* Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983) (holding that that the Federal Arbitration Act establishes a "federal policy favoring arbitration").

have adopted a range of ADR options.[299] Arbitration is particularly valued in the global context because arbitral awards are more easily enforced internationally than judgments of foreign courts.[300]

In response to these developments,[301] in 2009, Delaware adopted 10 Del. C. § 349 which authorized the Court of Chancery to arbitrate business disputes upon the request of the parties.[302] The statute, which was implemented through Chancery Court rules 96, 97, and 98, is available only in non-consumer disputes, requires at least one of the parties to be a Delaware entity, and requires all the parties to consent to arbitration.[303] Arbitrations under the statute, are conducted by Delaware judges,[304] but are private proceedings that do not appear on the public docket.[305]

The legislature explained that its purpose in adopting the statute was to help keep the Court of Chancery "at the cutting-edge in dispute resolution."[306] By providing the new arbitration procedure, Delaware hoped to keep disputes within the state that would otherwise go to private arbitration.[307] Notably, unlike private arbitrations, the revenues from the Delaware procedure would go to the state.[308]

The business committee reacted favorably to the adoption of the statute. As explained by Nasdaq OMX and NYSE Euronext, the principal stock exchanges in the United States, "the Delaware Court of Chancery's . . . confidential, expedited arbitration provides [an important]

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[299]*See* Motion of the Corporation Law Section, *supra* note 297, at 4 (noting that all 50 states have implemented court rules providing for some form of ADR and many of these jurisdictions have made ADR mandatory).

[300]*See id.* at 6 (discussing how there is no bilateral treaty or multilaterial international convention in force between the United States and any other country on reciprocal recognition and enforcement of judgments; and this creates the critical advantage of arbitrations being more easily enforced than foreign judgments).

[301]*See* Defendants' Opening Brief in Support of Their Motion for Judgment on the Pleadings at 26-28, Del. Coalition for Open Gov't v. Strine, CA No. 11-01015 (D. Del. Dec. 16, 2011), *available at* http://www.law.du.edu/documents/corporate-governance/governance-cases/delaware-coalition/open-govt-v-strine-strine-reply.pdf (arguing that the failure to provide arbitration would put Delaware at a "competitive disadvantage").

[302]*See id*. at 4-5 (describing the challenged legislation and its adoption).

[303]DEL. CODE ANN. tit. 10, § 347(a) (2012).

[304]*Id.* § 349(a).

[305]*Id*. § 349(b)

[306]H.B. 49 syn., 145th Gen. Assemb. (Del. 2009).

[307]*See* Peg Brickley, *Secrecy Puts Judges on Defense in Delaware*, WSJ.COM (Feb. 21, 2012), http://online.wsj.com/article/SB10001424052970204131004577235240702540000.html (explaining that legislation took into account a fear that private arbitration was draining business from Delaware and rendering its courts irrelevant).

[308]*See id*. (reporting the cost of the arbitration as $12,000 plus $6000 for each additional hearing day).

new dispute resolution forum for companies—one that affords them the opportunity to contractually agree to have certain commercial matters resolved in an alternative forum by judges nationally recognized for their experience in resolving corporate and commercial disputes."[309]

The future of the Delaware arbitration statute is unclear. On October 25, 2011, the Delaware Coalition for Open Government filed suit, challenging the arbitration statute.[310] Specifically, the Coalition argued that arbitrations conducted pursuant to the statute constituted "secret judicial proceedings" and that such proceedings violated the Civil Rights Act of 1871 and the United States Constitution.[311] Prior to the challenge, only six arbitrations had been held under the statute.[312]

In August 2012, the district court invalidated the Delaware arbitration statute.[313] The court found that the arbitrations functioned essentially as non-jury trials and that, as such, the U.S. Constitution required that they be open to the public. The court specifically identified a variety of factors that, in its view, made Delaware arbitrations more closely resemble trials than "usual arbitration proceedings." Specifically, the court rejected the Chancery's claim that the use of customized procedures and discovery tools and the insulation of the ruling from appeal distinguished the proceedings from traditional trials.

As this Article goes to press, the Delaware Court of Chancery has appealed the district court's decision to the Third Circuit.[314] Regardless of the outcome of the litigation, however, Delaware's adoption of the arbitration statute reflects its responsiveness to the needs of its corporations and other business entities.[315] The statute creates an innovative

[309]Motion of NASDAQ OMX Group and NYSE Euronext for Leave to File Brief as *Amici Curiae* in Support of Defendant's Motion for Judgment on the Pleadings at 2-3, Del. Coalition for Open Gov't v. Strine, CA No. 11-01015 (D. Del. Dec. 30, 2011), *available at* http://www.law.du.edu/documents/corporate-governance/governance-cases/delaware-coalition/chancery-open-govt-v-strine-nasdaq.pdf.

[310]Complaint, Del. Coal. for Open Gov't, Inc. v. Strine, No. 1:11-cv-01015-UNA (D. Del. Oct. 11, 2011), *available at* http://www.jenner.com/ system/assets/assets/5748/original/Delaware_20Coalition_20v._20Strine.pdf?1326223902.

[311]*Id.* ¶¶ 9, 16-19.

[312]Steven M. Davidoff, *The Life and Death of Delaware's Arbitration Experiment*, N.Y. TIMES DEALBOOK (Aug. 31, 2012), http://dealbook.nytimes.com/2012/08/31/the-life-and-death-of-delawares-arbitration-experiment/.

[313]Del. Coal. for Open Gov't v. Strine, 2012 WL 3744718, at *1 (D. Del. Aug. 30, 2012).

[314]Cheryl Soltis Martel, *Chancellors Appeal Fed Court Ruling on Transparency in Arbitration*, NACD DIRECTORSHIP (Nov. 1, 2012), http://www.directorship.com/chancellors-appeal-fed-court-ruling-on-transparency-in-arbitration/.

[315]*See, e.g.*, Defendants' Opening Brief in Support of their Motion for Judgment on the Pleadings at 27, Del. Coal. for Open Gov't, Inc. v. Strine, No. 11-01015-MAM (D. Del. Dec. 16,

mechanism that combines the reputation and expertise of the Delaware Court of Chancery with the advantages of alternative dispute resolution.

2. Globalization

A second challenge to Delaware's domination is globalization.[316] As Chris Brummer has observed, issuer constituencies are increasingly mobile.[317] Corporations can escape a jurisdiction's regulatory control simply by moving their operations or, in most cases, their domicile, to a less restrictive jurisdiction. The challenge posed by this form of mobility is that it does not require the affirmative exercise of preemptive power to strip a jurisdiction of regulatory authority.

Delaware's corporate leaders have recognized the concern posed by globalization and the risk of international regulatory arbitrage. As Chancellor Leo Strine explained, "the globalization of capital and product markets is eviscerating the strength of even the United States to effectively regulate corporate behaviour and promote economic equity."[318]

Globalization may operate in two ways. On the one hand, the threat of international regulatory competition may limit the U.S. government's willingness to preempt Delaware corporate lawmaking through extensive federal regulation, particularly if that regulation is likely to be viewed as imposing a burden on business that can be avoided by offering and listing securities in overseas markets.[319] Chris Brummer notes that, because of this

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2011). Defendants argued:

> Delaware's arbitration statute allows Delaware entities to avail themselves of the expertise of the Court of Chancery for purposes of the "[m]any federal and international statutes [that] specifically identify instances when tribunals will stay or defer to the parties' decision to have their dispute resolved by way of arbitration" and that "often deal with issues, such as intellectual property disputes, that are of importance to Delaware entities."

Id. (quoting H.B. No. 49, 145th Gen. Assemb. (Del. 2009)).

[316] Globalization also creates regulatory competition among exchanges and securities regulators. *See generally* A.C. Pritchard, *London as Delaware?*, 78 U. CIN. L. REV. 473, 489-99 (2009) (analyzing whether London is likely to become the next Delaware with respect to competition for public company listings).

[317] Chris Brummer, *Corporate Law Preemption in an Age of Global Capital Markets*, 81 S. CAL. L. REV. 1067, 1102 (2008).

[318] Leo E. Strine, Jr., *Human Freedom and Two Friedmen: Musings on the Implications of Globalization for the Effective Regulation of Corporate Behaviour*, 58 U. TORONTO L.J. 241, 268 (2008).

[319] Many commentators argued, some with empirical support, that congressional adoption of the Sarbanes-Oxley Act led issuers to flee U.S. regulatory authority. *See, e.g.,* Leonce Bargeron, Kenneth Lehn & Chad Zutter, *Sarbanes-Oxley and Corporate Risk-Taking*, 4-5 (2007), *available at* http://www.aei.org/files/2007/06/18/20070615_LehnSOX.pdf (studying more than 9000 initial public offerings conducted from 1990 to 2006 and finding the probability of an IPO

possibility, "the counterweight to regulatory competition envisioned by federal preemption is weaker than scholars have anticipated."[320]

On the other hand, globalization requires Delaware to compete, not simply at the domestic level, but on an international scale.[321] Global issuers are not limited to choosing between Delaware and Nevada; they may also consider incorporating in London or the Cayman Islands.[322] International competition will increasingly force Delaware to consider which aspects of its corporate law appeal most to an international business community.[323]

3. Evolution of Shareownership

Perhaps the biggest challenge for Delaware law, going forward, is the market-based shift in shareownership of public companies. Delaware's corporate structure relies on the Berle & Means conception of the public corporation, in which dispersed public (retail) investors allocate decision-

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being conducted in the U.K. rather than the U.S. increased sharply after SOX); *Interim Report of the Committee on Capital Markets Regulation,* 47 (Nov. 30, 2006), *available at* http://www.capmkts reg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (arguing that the difference in the U.S. listing premium in public markets after SOX increased either because the degree of SOX regulation is harmful for developing countries or because, while beneficial, it is too costly); Kate Litvak, *Sarbanes-Oxley and the Cross-Listing Premium*, 105 MICH. L. REV. 1857, 1857 (2009) (finding empirical results consistent with the notion that investors expected SOX to have greater costs than benefits for foreign firms cross-listed in the United States).

[320]Brummer, *supra* note 317, at 1104.

[321]This competition is not new for Delaware. Delaware has traditionally been the incorporation choice for foreign issuers that are not satisfied with their domestic corporation law. *See* Lesha R. Chaifetz, *The Promised Land: An Examination of the Israeli High-Tech Industry*, 23 U. PA. J. INT'L ECON. L. 385, 400 (2002) (reporting that 90 percent of Israel's high tech start-up companies have chosen to incorporate in Delaware rather than Israel).

[322]By way of example, consider National Warranty Risk Retention Group, a liability insurer located in Nebraska, which sold insurance exclusively in the United States but was incorporated in the Cayman Islands. *See In re* Bullmore, 300 B.R. 719, 723 (Bankr. D. Neb. 2003). The Cayman Islands attract foreign corporations because of their financial secrecy laws. *See* WILLIAM BRITTAIN-CATLIN, OFFSHORE: THE DARK SIDE OF THE GLOBAL ECONOMY 21 (Farrar, Straus & Giroux, 2005).

[323]When interviewed, Delaware Supreme Court Chief Justice Myron T. Steele identified some features of Delaware law that may be attractive to foreign-headquartered corporations. *See* Al Driver (Ed.), *Why Delaware's Courts Attract U.S. And Foreign Companies—Fairness, Efficiency And Doctrinal Consistency*, THE METRO. CORP. COUNSEL, at 1 (May 2006), *available at* http://www.metrocorpcounsel.com/articles/6798/why-delawares-courts-attract-us-and-foreign-companies-fairness-efficiency-and-doctrina. Delaware may also have to consider whether members of the international business community will tolerate the limited hotel and restaurant options in Wilmington and Georgetown in order to take advantages of the Delaware judiciary. *See* Sophia Pearson, *Lawyers in Delaware Disney Trial Wrestle With No-Frills Accommodations*, BLOOMBERG NEWS (Jan. 12, 2005), *available at* http://www.nysun.com/business/lawyers-in-delaware-disney-trial-wrestle-with-no/7587/ (explaining challenges posed by the location of the Disney litigation in Georgetown, Delaware, including the need for lawyers to stay in hotels located 21 miles away in Rehoboth Beach).

making authority to centralized management.[324] The primary problem for the Berle & Means type of corporation is controlling managerial agency costs that limit management's willingness to maximize the long term interests of the shareholders.[325]

Today's corporation bears little resemblance to this model. Retail investors today hold equity largely through intermediaries such as pension funds and mutual funds.[326] These institutional intermediaries own an ever-increasing majority of publicly traded equities and exercise the traditional shareholder powers such as the right to vote and the right to sue.[327] Yet institutional shareholders bring a second layer of agency issues to these decisions.[328] At the same time, institutional investors operate according to a range of incentives that may not include the maximization of long term firm value. Indeed, some commentators have argued that excessive deference to the interests of institutional shareholders was a contributing factor in the risk-taking that preceded the 2008 financial crisis.[329]

Commentators have questioned the extent to which traditional corporate law rules should consider these incentives in examining the manner in which institutional investors vote their shares, file litigation, and make trading decisions. Critics of proxy access, for example, argued that public and union pension funds would co-opt the nomination process in an effort to further employee interests.[330] Commentators claim that proxy advisory firms exercise excessive influence over shareholder voting outcomes because of the tendency of institutional investors to defer to the advisors' recommendations.[331] Chancellor Chandler, in the *Air Products* litigation, worried that shareholder responses to the proposed tender offer could not be trusted because a majority of the shares were held by

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[324] BERLE & MEANS, *supra* note 34, at 4.

[325] *Id.* at 113 (questioning whether there is any justification for assuming that those in control of a corporation will operate it in the best interests of the shareholders).

[326] Fisch, *supra* note 19, at 879-80 (describing the intermediation of the U.S. capital markets).

[327] *See id.*

[328] *See id.* at 881 (describing this second layer of agency costs).

[329] *See, e.g.*, Bratton & Wachter, *supra* note 266, at 653.

[330] *See, e.g.*, Christopher P. Skroupa, *Is Proxy Access Dead? Ask Boards, CEOs and Shareholders*, FORBES (Sept. 26, 2011), http://www.forbes.com/sites/christopherskroupa/2011/09/26/is-proxy-access-dead-ask-boards-ceos-and-shareholders/ (quoting Robert T. Clarkson, Partner of Jones Day Silicon Valley) ("Labor unions could elect directors who favor union jobs or who could prevent a company from expanding into a right-to-work state even if hiring non-union workers or expanding into a right-to-work state would be in the best interest of the company's stockholders as a whole.").

[331] Tamara C. Belinfanti, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control*, 14 STAN. J.L. BUS. & FIN. 384, 386 (2009).

arbitrageurs rather than long term investors.[332] And with respect to litigation, although courts have increasingly looked to institutions to serve as lead plaintiffs,[333] some scholars worry that institutions do not fairly represent the interests of retail investors.[334]

Perhaps the most troubling aspect of the shifting shareholder demographic is the questions it raises about the shareholder role in corporate governance. I have argued elsewhere that corporate law, in reducing managerial agency costs, relies on a hypothetical shareholder—"a shareholder who will exercise governance power knowledgably and who will deploy that power to maximize firm value."[335] In the absence of such shareholders, Delaware's fundamental conception of corporate law breaks down.

As indicated above, there are reasons to question whether existing shareholders bear any possible resemblance to this hypothetical shareholder construct. Even the Delaware courts themselves appear to be suspicious of the motivations and objectives of today's shareholders. But if institutional shareholders cannot perform the traditional shareholders functions under Delaware law in a way that is likely to maximize firm value, how should Delaware law respond? How can shareholder voting, for example, maintain board accountability in the way posited by the *Blasius* decision, if shareholders do not reliably vote in a way calculated to maximize long term shareholder value? If shareholders cannot effectively fulfill this role, who can take their place?

Delaware is already being forced to confront these questions—in the scope of the voting rights that it affords to shareholders, in the extent of deference that it affords to board decisions to retain a poison pill, and in the selection of an appropriate lead plaintiff for shareholder litigation.[336]

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[332] *See* Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 111 (Del. Ch. 2011) (observing the possibility that arbitrageurs would tender their stock regardless of the potential long term value of the company constituted a "risk" to which directors were entitled to respond by maintaining the poison pill).

[333] It should be noted that empirical evidence to date suggests that institutional lead plaintiffs are associated with higher recoveries in securities fraud litigation. *See* Stephen J. Choi, Jill E. Fisch & A.C. Pritchard, *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 WASH. U. L. Q. 869, 870 (2005); James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587, 1587-88 (2006).

[334] *See, e.g.*, David H. Webber, *The Plight of the Individual Investor in Securities Class Actions* 1 (N.Y.U. L. & Econ. Working Papers, Paper No. 216, 2010), *available at* http://lsr.nellco.org/nyu_lewp/216.

[335] *See* Fisch, *supra* note 19, at 886.

[336] *Cf.* Elizabeth Chamblee Burch, *Optimal Lead Plaintiffs*, 64 VAND. L. REV. 1109, 1110-11 (2011) (exploring selection of an appropriate lead plaintiff in shareholder litigation).

Evolving types of shareholders and developments in the way institutional shareholders exercise their governance power will test the foundations of the Delaware system. In the long term, Delaware's corporate law will have to face these questions.

V. CONCLUSION

Congress' intervention into state corporate governance through Dodd-Frank was not unprecedented. It was, however, unjustified. State regulation of corporate governance and Delaware corporate law in particular offer substantive and structural advantages over federal regulation. These advantages include specialized lawmaking structures with expertise in business law issues, the capacity to respond to market and legal developments, and the ability to tailor governance structures to firm-specific needs and characteristics.

These advantages are illustrated by comparing Delaware's approach with respect to two critical governance challenges—proxy access and say on pay—to Dodd-Frank. Although Delaware law can be criticized for proving insufficiently vigilant in monitoring managerial power, federal intervention has introduced additional costs without corresponding benefits. Perhaps most troubling is the potential that interest group politics may unduly influence congressional decisions regarding the allocation of power within the corporation, specifically in the dynamic between shareholders and managers.

Developments in business and the capital markets such as globalization and changes in equity ownership will continue to bring new challenges to business regulation. In the United States, state-based regulation has proven itself well-positioned to respond to these challenges. Although a top-down federal mandate is a tempting response to a financial crisis, members of Congress should resist the temptation to interfere with Delaware lawmaking.