DEFINING THE SHAREHOLDER'S ROLE, DEFINING A ROLE FOR STATE LAW: FOLK AT 40

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ABSTRACT

How should Delaware position its corporations statute to maintain the First State's preeminence in corporate law, which it has enjoyed throughout the four decades since the last comprehensive revision of the statute? This article suggests Delaware is vulnerable in a way that was not particularly visible in 1967, not from any of the other forty-nine states, but from the federal government. Delaware has made it too easy for the federal government, through something resembling a stealth preemption, to occupy more of corporate governance. The federal move has occurred in areas of shareholder and officer roles, which are relatively underdeveloped in the Delaware statute. Federal law has been the realm within which most of the debate has occurred regarding issues like shareholder power to initiate agenda items for a stockholder's meeting, shareholder nominations for the board of directors, and shareholder proposed bylaws. Filling the shareholder space will require a more complete specification of the shareholder role than that which has occurred until now, but should remain consistent with Delaware's traditional approach to corporate law and its trust of directors. Shareholder voting can best be seen, not by analogy to citizens in our civil polity, but as performing an error-correction function when directors are conflicted or otherwise disabled in acting for the corporation.

In the forty years since the last comprehensive revision of the Delaware General Corporation Law (the Folk Statute),[1] the Delaware bar and legislature have worked consistently to keep the statute current with the changing developments of law and finance. By amendments, both large and small,[2] Delaware's lawmakers have maintained a statute that has achieved an enviable

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[1]The name, of course, comes from Professor Ernest Folk, who was the reporter for that statute and, as particularly relevant to me, my corporations law professor.

[2]As an example of the larger changes, see DEL. CODE ANN. tit. 8, § 102(b)(7) (2006), which permits corporations to include an exculpatory provision in their certificate of incorporation removing liability for damages for their directors for any violation of the duty of care.

position as the law governing America's largest corporations.[3] Indeed, Delaware has a remarkable eighty-five percent share of the market of corporations that go outside of their home state to incorporate.[4]

The reason to deviate, however, lies elsewhere—in the seemingly relentless expansion of the federal government into all things state. The Folk Statute appeared at the cusp of what has been a fundamental transformation of American law and the American constitutional system. The civil rights laws passed in the mid-1960s broke the dam holding back federal legislation across a variety of areas. In the face of technological advancement, particularly in information and transportation, federal law extends broadly into areas relating to real property, domestic relations, and guns, which at the time of the Folk Statute would have been considered quintessential areas of state control. As the media parades a series of "crises de jour" across our screens, national politicians show little discipline in allowing relationships to be addressed by state law. After Enron and WorldCom, Congress passed the Sarbanes-Oxley Act[5] within weeks and new stock exchange listing standards took only a slightly longer time.[6] The increased interconnectedness of our economy has increased the number of transactions that cross state lines, which results in regular complaints by companies concerning the added costs of inconsistent regulation by different states or of dual regulation by state and federal laws. This led, for example, to the 1996 legislation that summarily preempted six decades of shared state-federal regulation of securities' issuances by public companies.[7] More recently, there have been increased calls for the need to preserve America's competitiveness in the world financial markets,[8] as the

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[3]Delaware is the state of incorporation for approximately sixty percent of the Fortune 500 companies. *See* Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 391 tbl.2 (2003).

[4]*Id.* at 395 tbl.3.

[5]Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, & 29 U.S.C.).

[6]Sarbanes-Oxley was signed by the President by the end of July 2002, still in the immediate aftermath of the WorldCom meltdown that came to a head in the last half of June. The stock exchanges, prodded by the Securities and Exchange Commission (SEC), proposed changes to their listing standards requiring a majority of independent directors, during the summer of 2002.

[7]*See* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

[8]For materials advocating changes to protect the U.S. financial markets, see COMM. ON CAPITAL MKTS. REG., THE COMPETITIVE POSITION OF THE U.S. PUBLIC EQUITY MARKET (2007), *available at* http://www.capmktsreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf; MCKINSEY & CO., SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP (2007), *available at* http://www.nyc.gov/html/om/pdf/ny_report_final.pdf; UNITED STATES CHAMBER OF COMMERCE, COMMISSION ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY—REPORT AND RECOMMENDATIONS (2007), *available at*

2007-2008 subprime crisis and the Bear Stearns collapse provided a platform for even broader proposals for federal control over the financial sector of our economy.[9]

Against such a challenge, Delaware starts with a framework set in the 1960s when the regulatory space looked nothing like it does today. Indeed, Delaware, at the time of the Folk Statute, faced a much weaker array of possible alternative regulators. The Securities and Exchange Commission (SEC) was just awakening from a decades' long retrenchment;[10] the New York Stock Exchange (NYSE), through its listing standards, was a limited player in regulating internal corporate governance;[11] and Bill Cary's criticism of Delaware had not yet found its way into print.[12]

More dramatically, there have been tremendous market and technological changes that have reshaped the players in corporate law and their incentives. The shareholder census looks nothing like it did in 1967 when individual, dispersed, passive shareholders were assumed to populate the shareholder roster. Information advances and the growth of intermediaries have empowered shareholders in a way that could not have been contemplated in the 1960s. Officers exercise more real power than is visible in the Folk Statute and the compensation of chief executive officers has reached heights that would not have seemed possible in 1967. Successive waves of merger transactions have redefined the role of markets and corporate governance and led to new federal laws such as the Williams Act.[13] Most importantly, the SEC has become a much larger presence and a challenge to Delaware's position as the prime regulator of corporate governance.[14]

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http://www.uschamber.com/publications/reports/0703capmarketscomm.htm (follow "download the full report" hyperlink); COMM. ON CAPITAL MKTS. REG., INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 8-9 (2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

[9]The immediate proposals after the Bear Stearns collapse would have consolidated various federal agencies, including the SEC, and reorganized their functions. While state corporate law was not specifically mentioned, it would be foolish for Delawareans to think there is an invisible fence of restraint that separates those proposals from also including the state law corporate function. *See* Massimo Calabresi, *The Politics of Paulson's Proposal*, TIME, Mar. 31, 2008, http://www.time.com/time/nation/article/0,8599,1726762,00.html?xid=feed-cnn-topics (discussing the sweeping changes proposed by the Secretary of the Treasury for the financial regulatory system after the collapse of Bear Stearns).

[10]JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE (3d ed. 2003).

[11]*See generally* Douglas C. Michael, *The Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 BUS. LAW. 1461, 1469-70 (1992) (describing modifications to the NYSE listing standards during the 1950s).

[12]*See* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

[13]15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2000) (codifying the Williams Act of 1968).

[14]*See generally* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 601

Even in this setting, Delaware retains unique advantages that define its place in corporate governance. The cost of dual levels of regulation, a frequently raised criticism against state law in areas such as securities regulation and financial oversight in our shrinking global economy, has less impact on corporate law where the widespread acceptance of the internal corporate affairs doctrine means that only one law—the law of the place of incorporation—governs corporate transactions.[15] The broader space given to private ordering in corporate transactions, where markets provide an alternative regulator to law, lessens the impetus for federal preemption. Congress has persistently rejected calls for a federal corporation law and the Supreme Court for three decades has said that in the absence of such legislative action, courts should not federalize state corporate law by broad interpretations of Rule 10b-5.[16]

The Cary article in 1974 voiced the still widespread concern that Delaware would lean too much toward managers at the expense of other stakeholders;[17] a concern that is likely to continue as a constraint on Delaware's law so long as the possibility of federal law supplanting Delaware remains.[18] In comparing the incentives of Delaware or the federal government to keep its law responsive to the needs of the overall economy, each side can claim advantages. Corporations provide a sufficiently large share of the Delaware state budget (paid almost entirely by out-of-state entities and thereby reducing the tax burden on local residents) that the Delaware legislature has an incentive to pay regular attention to its law. In contrast, Congress takes up securities law sporadically, almost always after a crisis.[19] The Delaware bar and other service providers who benefit from Delaware's outsized place in the corporate world similarly have an incentive to monitor the status of the corporate law. These providers, however, and the state itself, arguably have an incentive to slant their product to the interests of managers who typically make decisions as to where to incorporate or reincorporate. The increased monitoring ability of institutional shareholders, increased activism by hedge funds and other institutional investors, and more widespread production of information as to the performance of Delaware companies versus those

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(2003) (describing how Delaware makes law only in the space the federal government chooses not to preempt).

[15] *See id.* at 598-600 (explaining how Congress, the SEC, the NYSE and, to some extent, federal courts regulate the internal affairs of corporations).

[16] *See, e.g.*, Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479-80 (1977) (holding that Rule 10b-5 cannot apply to allegations of unfairness that do not include nondisclosure).

[17] *See* Cary, *supra* note 12, at 698-99.

[18] Roe, *supra* note 14, at 601 ("Even if Delaware made its rules oblivious to any possible federal trump, the theory of federal displacement . . . would still be in play . . . .").

[19] The Congressional action after Enron and WorldCom is an example. *See supra* note 6 and accompanying text.

incorporated elsewhere, have given the traditional Cary debate a new look, and one that is more favorable to Delaware.

The most dramatic advantage for Delaware, when compared to a federal corporation law, comes in providing the gap filling that is necessarily required for any law. Today, most American judge-made corporate law occurs in Delaware and it is not likely that the federal system can match what Delaware creates in this realm. Ten judges, located for the most part along two hallways in one city, make and develop Delaware corporate law. These jurists are repeat players, in that most of the workload of the five members of the Delaware Court of Chancery arises in corporate law and a significant part of the workload for the five Delaware Supreme Court justices derives from corporate law as well.[20] Because of this work and their own prior experiences, these judges have an expertise in corporate law that can be seen, for example, in discussions of valuation and other deal-related issues that arise. The typical federal judge who gets an occasional corporate case as part of a docket dominated by criminal and immigration matters is simply not going to have the same expertise to bring to a dispute about corporate issues. Delaware judges interact with the corporate academic and professional community in a way that is not replicated in other fields.

Given these realities, what should a twenty-first-century corporations code for Delaware look like? First, it should start with the essential characteristics like entity creation and merger which, if not provided by the state, would be expensive for parties to replicate by contract. Corporate law provides a quick and efficient means for private parties to form legal entities, often with valuable characteristics such as limited liability, enduring life, and centralized control. Similarly, corporate law provides an efficient means to combine assets through a merger. After only a few simple steps—preparing a plan of merger, approval by the directors of each company, approval by the shareholders, and a filing with a state employee—one corporation goes out of existence, another acquires all of the assets and liabilities with no other transfer document required, and all shareholders automatically receive the consideration provided for in the plan of merger. The result can seem almost magical in what happens instantaneously by operation of law.[21]

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[20] *See* Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 166 (2004) (reporting that seventy-five percent of the cases filed in the Delaware Court of Chancery over a two year period were corporate cases). The corporate cases make up a smaller share of the Delaware Supreme Court docket.

[21] *See* DEL. CODE ANN. tit. 8, § 251 (2006).

The corporations statute should build upon one of its most distinctive features—the state's power to name the key governance players (directors, shareholders, and officers)—and to specify the relative governance rights among the named groups. This is something the Folk Statute does very well—defining a consistent mission statement as to corporate governance based on three core principles.[22] First, it establishes a straightforward, predictable governance system whose central tenet is to trust directors. Second, this statutory governance system is designed to operate in tandem with a rich array of constraints available in the private sector. Directors can deploy various gatekeepers, contracts, and market constraints to achieve the most effective combination (or can decide not to use them). Third, shareholder voting and judicial review via fiduciary duty provide a necessary check on the agency costs that can arise when directors control other people's money. Voting provides shareholders a form of self-help, and fiduciary duty is the vehicle that Delaware provides for an effective dispute resolution system by which a group of expert jurists speedily resolve litigation brought by private parties.

In developing this core mission statement, Delaware has specified much of the director space,[23] but has been less diligent in setting out comparable details for the other two groups named in the corporations statute—officers and shareholders. Delaware's statute says almost nothing about the role of officers, who have become the most important individual actors in large corporations.[24] The statute is somewhat better as to shareholders, specifying voting and litigation roles,[25] but it is surprisingly silent on core questions such as shareholders' ability to propose agenda items, to use the bylaws to change corporate policy, and to nominate directors. In the face of Enron and other scandals, the federal government and the stock exchanges have moved to fill in some of the empty space left by the Delaware statute, particularly as to the roles of shareholders and officers.[26] It has been a stealth preemption, filling in the gaps and shifting the overall line between shareholders and directors in corporate governance without explicitly overturning any state law rule.

This asymmetry in filling out the roles of the three named governance parties is easily visible in the basic structure of the statute. I ask students on

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[22]*See* 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, 780-83 (2004) (suggesting a proposed mission statement for Delaware corporate law along the lines set out in the text).

[23]*See* DEL. CODE ANN. tit. 8, § 141(a) (2006) ("The business and affairs of every corporation . . . shall be managed by or under the direction of the board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.").

[24]See *id.* § 142, for one of the rare statutory mentions of officers.

[25]*See id.* §§ 211-212, 327.

[26]*See* Thompson, *supra* note 22, at 791-96.

the first day of a corporations class to open the statute to the table of contents and tell me what each of the three named governance participants do. The answer as to the director's role comes almost immediately with a reference to section 141's statement empowering directors.[27] It is much more difficult to locate a comparable statement about shareholders within the statute. Indeed it is harder to get to the Delaware provisions regarding the shareholders' role.[28] A clearer approach would be to follow the lead of the Model Business Corporation Act with separate chapters or subchapters for each group.[29] Within the shareholder segment, it would be easy enough to specify the voting and litigation rights that are currently provided to shareholders.

In addition, it is time for the statute to explicitly acknowledge that shareholders also act in a governance role by selling their shares. That right to sell derives from property law incident to owning shares as a species of property and traditionally has not been the subject of the corporations statute.[30] That means that tender offers are not recognized at all in the Delaware statute as a shareholder governance role, and board defensive actions, such as poison pills, are likewise omitted from the statute.[31] Delaware courts have done an admirable job of responding to innovations in the takeover world, but they have yet to develop a comprehensive and consistent view of voting and selling as alternative ways for shareholders to participate in governance. For example, do shareholders have different interests when they are asked to vote as contrasted to when they sell? A recent opinion by Justice Jacobs of the Delaware Supreme Court suggests differences.[32]

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[27]DEL. CODE ANN. tit. 8, § 141 (2006). For an example of a section with even more clarity as to the directors' role, see the MODEL BUS. CORP. ACT § 8.01(b) (2008) ("All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors, subject to any limitation set forth in the articles of incorporation . . . .").

[28]Subchapter IV of the Delaware General Corporation Law is entitled "Directors and Officers"; there is no comparable title for shareholders, although subchapter VII on "Meetings, Elections, Voting and Notice" covers many shareholder rights.

[29]Chapter 8 of the Model Business Corporation Act is also entitled "Directors and Officers" and Chapter 7 is entitled "Shareholders."

[30]An exception has been the statutory provisions that authorize restrictions on the transfer of shares, a topic usually of value in closely held enterprises. *See* DEL. CODE ANN. tit. 8, § 202 (2006).

[31]*See* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1351 (Del 1985) (upholding a board's decision to authorize an issuance of shares as the defense mechanism even though "the General Corporation Law is silent") (quoting Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 957 (Del. 1985)).

[32]*See In re* Emerging Commc'ns, Inc. S'holders Litig., No. 16,415, 2004 Del. Ch. LEXIS 70, at *114-15 (Del. Ch. May 3, 2004) (revised June 4, 2004) ("Stockholders have materially different interests at stake when tendering, as opposed to voting their shares.").

Apart from whether these interests may be different, the Delaware Supreme Court's opinion in *Unitrin, Inc. v. American General Corp.*[33] suggests a different vulnerability and provides boards with greater freedom to protect shareholders when the shareholders make a selling decision than when they make a voting decision.[34] Within two pages of the opinion, the court sets out conflicting views as to shareholder participation, first accepting the defendant's contention that it is hard to imagine a corporation where the shareholders would be better able to exercise their voting power and then, just nine paragraphs later, concluding that the vulnerability of these same shareholders in a selling capacity justifies the defensive actions taken by the board to block shareholder action regarding a takeover.[35] The diminished capacity of these same shareholders in selling, as opposed to voting, is not clear in the facts of the case. The asymmetry of the statute in addressing voting but not selling likely has fostered such incomplete, if not contradictory, discussion by the judiciary.

The scattershot way in which the shareholder role is described in the current statute leaves us with no complete statement of the shareholder role even as to voting. Perhaps the clearest and broadest articulation of the shareholders' role is Chancellor Allen's statement in *Blasius Industries, Inc. v. Atlas Corp.*[36] that the corporate franchise is the ideological underpinning on which the core premise of Delaware law rests as the justification for permitting directors such broad control over other people's money.[37] But even such broad judicial statements leave large unfilled gaps in the space defined by the statute which the federal government has been increasingly willing to fill. Delaware's statute mandates that shareholders vote on only two subjects: election of directors[38] and fundamental corporate changes such as mergers.[39] The statute also provides for two kinds of permissive shareholder voting, one to cleanse insider self-dealing transactions[40] and the other to amend the bylaws.[41]

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[33]651 A.2d 1361 (Del. 1995).

[34]*Id.* at 1389.

[35]*Id.* at 1383, 1385.

[36]564 A.2d 651 (Del. Ch. 1988).

[37]*Id.* at 659 ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."); *see also* MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003) (explaining that Delaware courts "have remained assiduous in carefully reviewing any board actions designed to interfere with or impede the effective exercise of corporate democracy by shareholders, especially in an election of directors").

[38]DEL. CODE ANN. tit. 8, § 211(b) (2006) ("[A]n annual meeting of stockholders shall be held for the election of directors . . . .").

[39]*Id.* § 251(c) (requiring merger agreements to be submitted to stockholders for the purpose of acting on the agreement).

[40]*Id.* § 144(a)(2) (stating that a contract or transaction between a corporation and an

Delaware attorneys, for the most part, have long interpreted this latter provision to be bounded by the plenary grant of authority to the board in section 141 to manage the business unless a contrary rule is set out in the certificate of incorporation. Until the Delaware Supreme Court's 2008 opinion in *CA, Inc. v. AFSCME Employees Pension Plan*,[42] discussed in detail below, neither the statute nor interpretation by that court had clarified the overlap of the various sections of the statute. Over the last few years, there has been a spike in the number of bylaw provisions proposed by individual shareholders to be voted on at shareholder meetings pursuant to the federal proxy rules. Some of these bylaws purport to be binding by shareholder action alone and some appear to be precatory in line with the Rule 14a-8 discussion below. The result is that questions of the scope of the shareholder franchise under Delaware law have been developing in the federal realm or in the shadow of federal law and SEC action.

The broadened reach of federal law in shareholder voting can be traced in the expansion of federal Rule 14a-8.[43] The Securities Exchange Act of 1934 (Act), particularly section 14(a), did not seek to federalize the rights that shareholders have in a corporation, but rather to require disclosure when managers and others seek to obtain shareholder votes on those things for which state law required a shareholder vote.[44] The reports accompanying the Act show Congressional concern about shareholder votes being obtained by incomplete or misleading information.[45] Within the first decade after passage of the statute, the SEC promulgated Rule 14a-8, providing a federal means for individual shareholders to put forth a proposal that would be included in the proxy statement sent out by management for the annual meeting.[46] Delaware's statute is silent on such shareholder action.

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interested director or officer is not void or voidable solely because of the conflict if "[t]he material facts as to the [conflicted transaction] are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders").

[41] *Id.* § 109 (granting shareholders the power to adopt, amend, or repeal bylaws; the certificate may also confer the same power on directors, which shall not divest shareholders of their power; "bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees").

[42] 953 A.2d 227 (Del. 2008).

[43] 17 C.F.R. § 240.14a-8 (2008).

[44] *See* 15 U.S.C. § 78n(a) (2000).

[45] *See* H.R. REP. No. 73-1383, at 14 (1934) (proclaiming that section 14(a) intended to "control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which [had] frustrated the free exercise of voting rights of shareholders").

[46] The rule was first promulgated in 1942. *See* General Rules and Regulations, Securities Exchange Act of 1934, 7 Fed. Reg. 10,655, 10,656 (Dec. 22, 1942) (amending sections 240.14a-1 to 240.14a-8).

The federal rule ostensibly defers to the primacy of state corporate law. Leading off a long list of reasons why a shareholder's proposal may be excluded from a company's proxy statement is if it is improper under state law, i.e., state corporate law.[47] An SEC note to that part of the rule implicitly acknowledges that state law puts all corporate power in the hands of the board, not the shareholders. The note, however, then sets out a presumption that quickly buries the deference to state law that supposedly forms the basis for the rule: any proposal framed as a precatory (i.e., a nonbinding) suggestion by the shareholders to the board, is presumed to be consistent with state law.[48] The result is hundreds of annual shareholder proposals regarding a variety of matters, some internal to the workings of the corporations and many with only a tangential connection to the entity.[49] The SEC has, by rule, imposed certain limits on these proposals—the proposer must own a minimum amount of shares and have held the shares for a specified time period, the proposal and the supporting statement are subject to a maximum word limit, an elaborate procedure is set out including a timetable for submission, the proposal has to be within the issuer's power to effectuate, it cannot relate to ordinary business, and it cannot relate to an election contest.[50]

The shareholder's proposal process requires that the proponent submit a proposal to the company's management for inclusion in the proxy statement anticipated to be distributed by management soliciting proxies for the annual meeting. If management opposes the inclusion of the proposal, which is often the case, management asks the SEC staff for a no-action letter, in effect, the staff's announcement that it would bring no enforcement action against the company were the proposal to be omitted from the company's proxy statement.[51] The agency's response comes in a letter sent by a SEC staff member to the parties; the issue never gets to the five commissioners and the

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[47]General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.14a-8(i)(1) (2007) (explaining that a company may exclude a proposal if it is "not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization").

[48]*Id.* § 240.14a-8(i)(1) note ("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.").

[49]*See, e.g.*, Lovenheim v. Iroquois Brands, Ltd., 618 F. Supp. 554, 556 (D.D.C. 1985) (granting a motion for preliminary injunction where a shareholder proposal related to "procedure used to force-feed geese for production of pate de foie gras in France" and imported by the company).

[50]See the various requirements of Rule 14a-8 set out in 17 C.F.R. § 240.14a-8 (2008).

[51]For an example of the shareholder's request to the company, the company's request to the SEC, and the SEC staff's answer, see U.S. Bancorp, SEC No-Action Letter, 1998 SEC No-Act. LEXIS 156 (Feb. 8, 1998).

procedural posture of the process means that any appeal to the courts usually is not realistic. All in all, this is the SEC's most encompassing and continual involvement with corporate governance, albeit one that lacks a specific statutory mandate.

A parallel process has been developing recently as to shareholder nominations of candidates for election as director. Again, Delaware's statute is silent as to any specific shareholder role in this process. During William Donaldson's tenure as chair of the SEC, the agency proposed rules to permit shareholders to nominate candidates for the election of directors. The proposal was elaborate and built off of the existing Rule 14a-8 participation rights granted by the federal agency to shareholders. The federal right to nominate would come into existence when the company had shown itself to be nonresponsive to the existing federal shareholder participation system; if a precatory shareholder proposal had received a majority of shareholder votes, but the directors, acting within their state law power had not responded, the proposed federal nomination rule would have then provided the additional shareholder participation rights as to nominations.[52] These proposals languished with no further action once SEC Chairman Donaldson returned to the private sector in 2005.

A federal court of appeals ruling in 2006, throwing out one of the traditional Rule 14a-8 exclusions that prevented shareholder proposals relating to election contests, led to additional federal proposals as to shareholder voting. Again Delaware law has remained silent on the subject.[53] After the Second Circuit set aside the portion of Rule 14a-8 that blocked shareholder proposals relating to the entity's voting process, the SEC put out two versions of a replacement rule, one that would have provided a broad space for shareholder proposals and one that would have continued what had been the agency's more restrictive role.[54] Chairman Christopher Cox provided the third vote to send

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[52]Security Holder Director Nominations, Exchange Act Release No. 34-48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (proposing a rule that would have required public companies to provide a mechanism mandating inclusion of director nominations received from shareholders where evidence suggested companies had been unresponsive to shareholder opinions in the 14a-8 process).

[53]Am. Fed'n of State, County & Mun. Employees v. Am. Int'l Group, Inc. 462 F.3d 121, 126 (2d Cir. 2006) (holding that American International Group could not rely on Rule 14a-8(i)(8) to exclude a shareholder bylaw proposal under which the company would be required, under specified circumstances, to include shareholder nominees for director in the company's proxy materials at subsequent meetings).

[54]*See* Shareholder Proposals, Exchange Act Release No. 56,160, Investment Company Act Release No. 27,913, 72 Fed. Reg. 43,466 (proposed Aug. 3, 2007) (to be codified at 17 C.F.R. pt. 240), *available at* http://www.sec.gov/rules/proposed/2007/34-56160.pdf (proposing changes to Rule14a-8 and a suggested new Rule 14a-17); Shareholder Proposals Relating to Election of

each proposal out for comment. The Commission's other four members divided along party lines, with two backing each proposal. After the comment period, and the departure of one Democratic member and the impending departure another, the Commission promulgated the more restrictive rule in late 2007.[55]

Thus, on the key issues of shareholder voting—individual shareholder power to initiate agenda items for a shareholders' meeting, shareholder nominations for the board of directors, and shareholder proposed bylaws—federal law has been the realm within which most of the debate has taken place. The Delaware Supreme Court's 2008 opinion in *CA, Inc.* marks Delaware's reentry into lawmaking on this topic, spurred by the SEC's certification of questions as to whether a shareholder proposal to amend the bylaws was within state law.[56] The court's answers seemed to simultaneously point in two directions. First, the court reaffirmed the importance of shareholder role in the governance of the corporation by stating, "[T]he process for electing directors [is] a subject in which shareholders of Delaware corporations have a legitimate and protected interest."[57] More specifically, the court held that "[t]he 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."[58] The court quoted approvingly from a Delaware Chancery Court decision that "'[t]he unadorned right to cast a ballot . . . is meaningless without the right to participate in selecting the contestants. . . . To allow for voting while maintaining a closed selection process thus renders the former an empty exercise.'"[59]

Yet, the court found that if the CA shareholders were to enact the bylaw in question, it would violate Delaware law.[60] The bylaw sought to require the

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Directors, Exchange Act Release No. 56,161, Investment Company Act Release No. 27,914, 72 Fed. Reg. 43,488 (proposed Aug. 3, 2007) (to be codified at 17 C.F.R. pt. 240), *available at* http://www.sec.gov/rules/proposed/2007/34-56161.pdf (proposing changes to Rule14a-8 to continue the status quo).

[55]*See* 17 C.F.R. § 240.14a-8(i)(8) (2007) (effective Jan. 10, 2008), *available at* http://www.sec.gov/rules/final/2007/34-56914.pdf.

[56]CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227 (Del. 2008). A Delaware constitutional amendment effective in 2007 added the SEC to those permitted to certify questions to the Delaware Supreme Court. *See* DEL. CONST. art. IV, § 11(8). This was the first SEC use of the provision. *CA, Inc.*, 953 A.2d at 229 n.1.

[57]*CA, Inc.*, 953 A.2d at 237.

[58]*Id.* (quoting Harrah's Entm't, Inc. v. JCC Holding Co., 802 A.2d 294, 311 (Del. Ch. 2002)).

[59]*Id.* (quoting *Harrah's*, 802 A.2d at 311).

[60]*Id.* at 238.

board to reimburse a shareholder who nominated a candidate that prevailed in an election.[61] The court held the bylaw impermissible as it would interfere with the board's ultimate responsibility for managing the corporation and the exercise of the board's fiduciary duty in determining whether reimbursement was permissible in particular circumstances.[62] The apparent shareholder power quoted in the prior paragraph turns out to be hobbled by two significant limitations. First, the court said bylaws can only decide the process for decision making but not mandate the decision itself, which must be left to directors.[63] Second, and more generally, the world of shareholder power as illustrated by this opinion is not one of shareholder self-help, but rather one of shareholders having to rely on two filters to protect their interests: the first being the board of directors and the second being the courts through enforcement of fiduciary duty.[64]

Current practice actually includes a third filter for shareholder action—the SEC. Historically this factor has not operated as much of a constraint on shareholder proponents. As an SEC official has acknowledged, "If the staff receives dueling opinions of counsel on state law,"[65] as to whether a particular proposal is a proper subject of action for shareholders, which is a likely occurrence,[66] the SEC "ha[s] traditionally deferred to the proponent . . . ."[67] Given the previous state law silence described above, the federal agency considered the proposal assuming there were no conflicts with state law and no need to develop or present any explicit discussion of the underlying purpose for shareholder voting. Now the SEC can "go to the source" as the division director put it,[68] but the likely result will be the SEC making more judgments, not fewer, about the meaning of Delaware law as expressed in cases such as *CA, Inc.*

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[61] *CA, Inc.*, 953 A.2d at 229-30 (explaining that the bylaw would have provided for reimbursement only in partial slate elections (i.e., where fewer than half of the positions to be filled were contested) and only where the shareholder seeking reimbursement was successful in having at least one nominee elected; the amount reimbursed could not exceed the amount expended by the corporation in connection with the election).

[62] *Id.* at 238.

[63] *Id.* at 237-38.

[64] The court, in the final footnote, states, "A decision by directors to deny reimbursement on fiduciary grounds would be judicially reviewable." *Id.* at 240 n.35.

[65] John W. White, Director, Div. of Corp. Fin., U.S. Sec. Exch. Comm'n., Address at the American Bar Association, Section of Business Law, Committee on Federal Regulaton of Securities: Corporation Finance in 2008—A Year of Progress (Aug. 11, 2008), *available at* http://www.sec.gov/news/speech/2008/spch081108jww.htm

[66] *See, e.g.*, *CA, Inc.*, 953 A.2d at 230 (describing dueling opinions).

[67] White, *supra* note 65.

[68] *Id.* (adding that the SEC is "very excited to have this tool at our disposal, and look forward to using it further, as appropriate, in coming years").

Even with this new route of communication, Delaware is not talking about the key questions in a way that would persuade future federal lawmakers to leave room for state law. In *CA, Inc.*, the Delaware Supreme Court accepts as well-established law that shareholders get to vote on the less important matters of process in bylaws with no barrier permitted to be inserted by directors, but can only speak on the more important matters if the directors first propose an amendment to the corporation's charter.[69] What theory explains the relative advantage of shareholders over directors in making process decisions in the bylaws, but not on being able to elect and replace directors? The court's opinion is *CA, Inc.* sees no difference between director-initiated defensive action, as in *Paramount Communications Inc. v. QVC Network Inc.*[70] or *Quickturn Design Systems, Inc. v. Shapiro,*[71] to close off shareholder acceptance of a takeover unwanted by management and shareholder initiated bylaws that are part of a shareholder effort to preserve a viable shareholder avenue to elect and replace directors.[72] What is the role of shareholder participation in corporate governance in a world that conflates those two sets of actions? The court tells us, in effect, that section 141 trumps section 109 but there is little in the opinion in the way of explicit discussion of what governance function that leaves for shareholder voting, or more generally, the role for shareholder participation in corporate governance by voting, selling, or suing.[73]

This silence at both levels of government means that the gap will be filled by assumptions imported from elsewhere. For shareholder voting, the most convenient analogy is to look to public voting. Shareholder voting discussions often import core assumptions from our political democracy by which shareholders are put into the role of citizens. Shareholders are assumed to vote because they are owners in the way that citizens are the ultimate decision makers in our civil society. When the federal government is specifying rules as to letting individual shareholders set agenda items, to nominate directors, or to facilitate direct shareholder initiatives, the proposals

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[69] *See CA, Inc.*, 953 A.2d at 235

[70] 637 A.2d 34 (Del. 1994) (holding that a board could not contract away their fiduciary duty by agreeing to a "no shop" provision).

[71] 721 A.2d 1281 (Del. 1998) (holding that a board could not adopt a delayed redemption poison pill that would deprive a newly elected board from fulfilling its fiduciary duty).

[72] *CA, Inc.*, 953 A.2d at 239 ("[T]he distinction is one without a difference.").

[73] The court states that a similar provision to the bylaws contained in the certificate would be binding. *Id.* at 239 n.32. Of course, such an amendment cannot be done by the shareholders alone, but requires board approval prior to the shareholders having an opportunity to vote. *See* DEL. CODE ANN. tit. 8, § 242 (2006). The result is to prevent any shareholder action not agreed to by the board and thus to route all such shareholder action through the filter of board discretion.

can draw on unstated deep-felt democratic principles with little need to discuss theory.

This political patina draws additional strength given its congruence in result with the most developed theory of corporate voting. Easterbrook and Fischel's contractorian-based approach to gap-filling in decision making posits shareholders as possessing the best economic incentives to make decisions for the enterprise and unambiguously places all manager power at the sufferance of the shareholders.[74] Their advocacy of director passivity in the face of takeovers follows from this construct.[75] The result, under the political analogy or the contractarian model, is to provide a wide berth for proposals for shareholder nominations, shareholder bylaws, or shareholder agenda items.

Neither the political analogy nor the contractarian gap-filling function fully describes the shareholders' role in corporate governance in Delaware.[76] Although one share/one vote may have a similar ring to one man/one vote, there are fundamental differences in the two decision-making systems. First, the vote in the corporate context is tied to shares, not shareholders, introducing an economic element that does not exist in our political system. Second, these shares can be bought and sold even during the midst of an election contest, explicitly providing a crucial role for markets in corporate voting and also introducing a form of intensity voting that simply does not exist in our public sphere.

Most importantly, shareholder voting is explicitly made part of a governance system in which shareholders are not the plenary decision makers. Rather, Delaware law, and the corporate law of the other forty-nine states, provides that all corporate powers are to be exercised by or under the authority of the board of directors.[77] Shareholders participate by voting annually for directors or voting on mergers and other fundamental corporate changes.[78] But

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[74]*See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 68 (1991) (explaining that shareholders as holders or residual claimants are best-positioned to fill gaps in contracts in the corporate setting).

[75]Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1201-04 (1981) [hereinafter Easterbrook & Fischel, *Proper Role of a Target's Management*] (explaining managerial passivity); Frank H. Easterbrook & Daniel R. Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733, 1750 (1981) ("We propose a strikingly different procedure for the board to follow when confronted with a tender offer. . . . [L]et the shareholders decide."). The Delaware Supreme Court rejected any such rule. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 n.10 (Del. 1985) (observing that even the authors conceded that no court or legislature had adopted it) (citing Easterbrook & Fischel, *Proper Role of a Target's Management*, *supra*, at 1194).

[76]This part of the discussion is adapted from Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. (forthcoming 2009) (on file with author).

[77]*See, e.g.*, DEL. CODE ANN. tit. 8, § 141 (2006).

[78]*See id.* § 251(c).

even these few voting powers are further constrained. Shareholders have no authority to initiate a merger or other fundamental corporate transactions; rather they must await those deals that have passed by the board as gatekeeper.[79] Many corporations take advantage of the provision of Delaware law which permits staggered elections for board seats spread over three years, so that successful use of the shareholder power to elect directors at an annual meeting will produce only one-third of the board.[80]

What are we to make of a shareholder voting power that is so constrained? As Paul Edelman and I develop elsewhere, this pattern reflects not a plenary decision-making status for shareholders, but rather an error-correction function for shareholder voting when director decision making is conflicted.[81] Corporate law begins with power in the directors and, most of the time, decision making will go forward within that framework recognizing, as set forth above, that directors operate in a setting in which markets constrain manager decisions and directors can make use of various gatekeepers and incentives to guide management behavior. Shareholder voting is reserved for situations when conflict or another deficiency threatens the board's decision making.

This view of shareholder voting then starts from the premise that directors get to decide corporate matters and that shareholder voting is the principal way that shareholders can monitor directors who may be conflicted or otherwise take entrenchment action. Division of opinion will remain as to how much of a shareholder check is necessary, but if framed this way, it will at least reflect a consistent purpose for shareholder voting. Under this system, the shareholders' right to replace directors is a core requirement, even more important than the initial right to nominate or elect directors. Indeed while things are going well, shareholder voting is not valued by most shareholders and often is perfunctory. But if there were not an effective right of removal, we would lose the necessary check on the ability of managers and boards to entrench themselves. Given the importance of the right to remove directors, the franchise should also include the shareholder ability to remove barriers that insulate an incumbent board from any effective check by the shareholders. Thus directors should not be able to use their gatekeeper power to block removal of a staggered board provision from the articles of incorporation or to indefinitely retain poison pill provisions that block shareholder use of their power to sell.

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[79] *Id.* § 251(b).
[80] *Id.* § 141(d).
[81] *See* Thompson & Edelman, *supra* note 76.

These powers to elect and remove directors enable shareholders to perform their distinctive role in governance. In contrast, there is less reason to think shareholders have any relative advantages in nominating directors, absent a fight for control. As to precatory issues generally, it depends on how much of an early warning signal is useful given the market and other forms of communication that are available.

Shareholders do not vote because they are like citizens in our public polity, the only and ultimate claimants to the collective interest. Rather, most often voting is an error-correcting device used when shareholders are best able to check the deficiencies that necessarily arise in the director decision-making system chosen by the Folk Statute. Thus, shareholders should be able to replace directors, approve mergers, and cleanse self-dealing transactions. Similarly, they should be given a say on pay, likely through an enabling exception to section 141. Management compensation has been the hardest issue for Delaware's courts to review effectively; directors themselves end up caught in a compensation consultant-fueled Lake Woebegone world. Shareholder voting can provide an error-correction decision-making role here as well.

While there is room for disagreement on the breadth of shareholder action, the important point for Delaware is that it has made it too easy for the federal government to decide these issues. This is a federal government whose administrative agency says it respects the primacy of state law and whose judicial system purports to take a strict constructionist view of expansions of federal securities law into state corporate law. Yet by remaining silent on core questions of the shareholder role, Delaware has made it too easy for the federal government to federalize a large part of corporate governance without asking the hard questions of why federal law is better and what is the role of shareholders in corporate governance that support the changes which have been made or proposed.

The same can be said in terms of the role of corporate officers. Delaware's statute barely even refers to officers. The statute defers almost completely to the bylaws or board resolutions as to what officers might do, how they are chosen, and how vacancies are filled; there are minimal default provisions such as saying that officers may resign at any time.[82] Other sections of the statute address loans to employees and officers,[83] and include officers along with directors and others as persons whom the corporation may indemnify.[84] The Model Business Corporation Act goes further and includes a

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[82]DEL. CODE ANN. tit. 8, § 142(b) (2006).
[83]*Id.* § 143.
[84]*Id.* § 145.