THE DIRECTION OF CORPORATE LAW: THE SCHOLARS' PERSPECTIVE

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MR. BALOTTI: Good afternoon. My name is Frank Balotti and I've been asked to be the moderator for this afternoon's program. And one of the privileges that I get is to introduce the panel and to call them up to speak in some kind of order, I hope. And I hope that you and the audience will participate by asking questions towards the end of our panel and get involved in the discussion which we hope to promote.

The topic for this afternoon's panel is a scholar's approach to corporation law. And we are fortunate to have some scholars with us this afternoon and I refer to the people immediately to my left. Those of you who know the other two way down at the end of my left-hand side will have doubts, of course, about the scholar's approach.

But let me introduce first the two scholars who are with us today. First, to my immediate left is Professor John Coffee from Columbia University in that place in New York City where they don't learn very much as we learned from Chancellor Allen a little bit ago.

He is the Adolf A. Berle Professor at Columbia. And those of you who watch television know that he is the most televised corporation law professor in the United States. He is frequently quoted both on matters on TV, radio and before Congressional committees and his opinion is often sought by the policymakers of our country.

He has served as the reporter for the ALI project on corporate governance. He is the author or co-author of another number of case books and other books for student use. He is the author of too many Law Review articles to mention. And he is a frequent expert witness on corporate matters in courts around the country.

Next to Jack Coffee is Rich Booth. Roberta Romano was unable to be with us today. And Rich is going to present a scholar's view in place of Roberta. He is a professor at the University of Maryland School of Law; received his bachelors degree from the University of Michigan and a J.D. from one of those second tier Ivy League law schools, Yale.

He spent several years as a litigator at Donovan Leisure and then taught at SMU, Case Western, Chicago Kent. Now teaches business association, securities regulation, corporate finance, business planning at the University of Maryland, where he also serves as the faculty advisor to the Business Lawyer which is now put together by students at the University of Maryland Law School.

He is a prolific writer, writes for the popular press such as the *Wall Street Journal*, *New York Times*, *National Law Journal* and also for the serious press. Again, he is the author and co-author of case books and other materials for student use and, like Jack Coffee, the author of many, many law reviews.

And next to Rich Booth we have Dave McBride from Young, Conaway, Stargatt & Taylor. Are you a scholar, Dave?

MR. McBRIDE: Absolutely not, Frank.

MR. BALOTTI: And next to Dave McBride we have Rod Ward — that's Ed Welch who is going to be here in place of Rod Ward. And Ed, I hope you don't feel like the young aide to Governor Woodrow Wilson who ran into the Governor at 2:00 in the morning one night, woke him up and said, "Governor Wilson, I have bad news for you. The Secretary of Agriculture has died."

And the Governor said, "Well, I'm very sorry to hear that. But why are you waking me at 2:00 in the morning to tell me that?"

And the young aide said, "Well, Governor, I'd like to take his place."

And the governor is reported to have answered, "That's fine by me if it's all right with the undertaker."

But Ed will be here to help us by asking some questions of our speakers. He has prepared a long dissertation in the thirty to forty-five seconds notice that he had that he was going to participate. But I look forward to the presentations of our panelists and then hopefully some lively discussion afterwards. And with that, I'd like to turn it over to Rich Booth to lead us off.

MR. BOOTH: Thanks, Frank.

I have titled my presentation "Investor Diversification and Corporation Law (or Roll Over Berle and Means)." I hope to answer some of the questions raised by Chancellor Allen.

There is probably no more readily accepted tenet of corporation law than that the shareholders own the company. But the question is just who are the shareholders and what are they like? What are their interests? How would one characterize them?

Some of these issues have been raised in the panels from this morning. Repeated references to institutional investors gave me some confidence that what I was going to say here was at least vaguely connected to what else was going on at the conference.

Public shareholders these days tend to be highly diversified. Certainly, institutions are highly diversified. And institutions own roughly half of the stock that's out there.

Individuals are also relatively diversified shareholders, or at least can be. And so that's one way of looking at who the shareholders are, diversified shareholders as opposed to the traditional view of a shareholder who is focused on the business of the company and treats the investment of the company as if it is his or her only investment.

There is, however, another class of shareholders: management.

Recent compensation statistics are rather telling. Among the top 200 companies in the United States, most of which are presumably incorporated in Delaware, only fourteen percent of executive compensation comes in the form of salary. The rest comes in some form of equity participation either in the form of stock options or stock appreciation rights or outright grants of equity.[1]

For example, during its 1997 fiscal year, two-thirds of the earnings that Microsoft booked were devoted to the costs of stock options. That is, two-thirds of Microsoft's earnings went to buying back shares to reduce the dilution that was being visited on the public shareholders, as a result of so much equity being granted to management.[2]

So the question is who exactly are the shareholders? Are they diversified institutions? Are they traditional undiversified investors who focus on the company but are not involved in management? Or are they managers who own increasingly large chunks of their companies? And what difference does that make in terms of how corporation law has evolved or will evolve over the next several years and decades?

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[1]*See* PEARL MEYER & PARTNERS, EXECUTIVE PAY TRENDS 4 (1999).

[2]*See* Roger Lowenstein, *Microsoft and Its Two Constituencies*, WALL ST. J., Dec. 4, 1997, at C1. *See also* PEARL MEYER & PARTNERS, THE EQUITY STAKE 5 (1998) (listing 15 companies in which more than 25% of equity is set aside for compensation, and 5 (including Microsoft) in which more than 40% is set aside).

There are two parts to my presentation. First, I would like to offer an explanation as to why certain decisions that may have mystified us initially seem to make more sense in retrospect if one thinks about investor diversification as a driving force in decision making. Second, I would like to offer a few predictions about issues that are likely to arise as a result of recognizing the distinction between diversified shareholders and largely undiversified management shareholders.

It is important to understand how important diversification is. I think it is safe to say that the rational investor diversifies. With diversification over as few as twenty different stocks, one can eliminate virtually all of the risk that goes with investing in any individual company. And it is fairly easy to become more diversified than that. Just buy an index fund or any mutual fund with 200 different stocks in it, and one has for very little cost eliminated virtually all risk except the risk that the market as a whole is going to go up or down. In short, diversification is incredibly cheap. It is cheap to do by investing in a mutual fund. And it is relatively cheap to do for an individual with as little as $50,000 to $60,000 in a portfolio.

Investor diversification, though, has arguably caused dramatic changes in both business and business law over the last twenty years. First of all, it is cheaper for investors to diversify than it is for companies to diversify. A shareholder can very quickly and easily adjust the mix of stocks in his or her portfolio. Today, it costs as little as $5 to sell one stock or buy another one. And the cost of trading is going down fast. Given that it is so cheap for an investor to readjust, it simply does not make sense for investors to buy into conglomerate companies that attempt to achieve diversification at the company level. That means that investors are more interested in focused companies, not companies that try to do the diversification for the shareholders.

Investing in a conglomerate company is rather like buying one of those packages of carrots and celery in the supermarket. That is a combination that suits some people at any given time. But compare the shelf space that is devoted to those packages of combinations versus the shelf space devoted to loose celery and carrots where you can mix and match and maybe buy the celery without the carrots, buy the celery with, you know, some radishes or something and forget the carrots. I have determined in a rigorous empirical study that roughly forty times as much counter space is devoted to celery and carrots individually as to the packages that are precombined.

What does this have to do with corporation law? I think that it offers a very powerful explanation for the bust-up takeovers of the 1980s and accordingly, many of the important corporation law cases of the last few years.

As we all know, takeover defenses have become virtually impenetrable. But interestingly enough, it seems as if the takeover has gone in-house. We are now into an era of spinoffs, which are really voluntary break-ups of companies, and tracking stock, both of which are ways of satisfying investor preferences for being able to invest in one part of the corporation and perhaps not another one.

Second, because an investor who is diversified does not take any significant risk with respect to the fortunes of an individual company, such investors have a strong preference for seeing companies maximize return as long as the risk is justified. Shareholders who are diversified would prefer to see companies seeking the highest return possible on a risk-adjusted basis. As far as the shareholder is concerned, you win some, and you lose some, but only the average really matters. A diversified shareholder worries very little about the fortunes of individual companies because, in the end, it all comes out in the wash.

Given that diversified investors are interested in high returns, even if it means high risk at the individual company level, managers have responded. They have responded sometimes under the threat of a takeover and of other times voluntarily by doing spin-offs and issuing tracking stock.

Shareholder preference for relatively high risk strategies has also led to increases in leverage. Leverage is not just a tax gimmick. The junk bond market is as big now as ever. And it is not for financing takeovers by any means.

In short, shareholder diversification has led to an increased taste for risk among shareholders and accordingly to some interesting developments in the law. If shareholders are relatively unworried about failures at individual companies, one would think that they would be highly in favor of the business judgment rule and that they would be opposed to actions brought by other shareholders management mistakes of intentional harm or self-dealing or something similar. If a shareholder has already adjusted for the risk of mismanagement by diversifying his or her portfolio, as far as that shareholder is concerned, lawsuits by other shareholders based on negligence are a dead weight loss. In other words, the cost of defending the company is simply a reduction in return from a risk that diversified shareholders have already hedged away.

The gradual recognition of the interests of diversified investors perhaps explains, for instance, the legislative decision to allow Delaware companies to opt out of liability for director negligence. I am referring, of

course, to Section 102(b)(7)[3] of the Delaware corporation law, which is a direct reaction to *Smith v. Van Gorkom*.[4]

So why do we have the exceptions to the business judgment rule that we have? Why do we have, for instance, cases like *Revlon*[5] that say the directors have a duty to the shareholders to get the highest price possible? I think the answer is that in the normal course of things where a company is not for sale, the board of directors cannot be required to seek more than an adequate return because they are interested in the long-term health of the company. Where the company is for sale, however, the logic of simply seeking an adequate return because of interest in the long-term health of the company no longer applies. Regrettably, a sports analogy comes to mind. It is negligent for a basketball player to shoot from the center line when there are several minutes left in the game, but it is negligent *not* to shoot from the center line if the clock is about to run out.

To bring this back to the diversification point, the diversified investor has gotten rid of the risk that the company may be badly managed in the normal course, but a diversified investor cannot get rid of the risk that the company might not be sold for the highest price. And a diversified investor cannot get rid of the risk of intentional misdeeds or of self-dealing. Every instance of self-dealing is an instance in which money is taken out of the company. So there is no you-win-some-you-lose-some effect with respect to those kinds of decisions. In other words, diversified investors get rid of some forms of risk but not others. Delaware law has responded by allowing causes of action where risk cannot be hedged away and by getting rid of causes of action that do not serve the interests of diversified investors.[6]

I began this by talking about the fact that there were various kinds of investors, various kinds of shareholders in companies these days. Because of stock options and other forms of equity compensation, management has become an important class of stockholders. Managers are a very different kind of investor in that, generally speaking, they cannot diversify away company-specific risk. At least for the period of time that stock options cannot be exercised, managers are very dependent on how well their particular company performs. So stock options cannot really induce managers to think the same way that diversified stockholders think. To be sure, managers are stock-holders, but they are not diversified stockholders. They still care most about how *their* company does.

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[3]DEL. CODE ANN. tit. 8, § 102(b)(7) (1991 & Supp. 1998).

[4]488 A.2d 858 (Del. 1985).

[5]Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

[6]For a fuller exposition of these themes, see Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429, 472 (1998).

In other words, stock options make managers think like owners, not necessarily like shareholders. Thus, there is a bit of a conflict, perhaps even a major conflict, that has arisen between the public shareholder who tends to be diversified and the management shareholder who tends to be relatively undiversified.

The question then becomes is there a duty to one group of these shareholders or another? Is the duty to the shareholders one that is to be interpreted as one towards diversified investors or is it something else? I think the answer falls somewhere in the middle.

On the one hand, companies have very little choice but to cater to the interests of their diversified shareholders. The takeover market still works. Companies still leverage themselves if they think that is what shareholders would prefer. They still engage in spinoffs even though they are not forced into bust-up takeovers.

But on the other hand, we do not have, except in the context of an end-period transaction like a *Revlon* case, a general duty to maximize shareholder wealth as one might argue for on the basis of the notion that the shareholders own the company.

I think in the end, diversified shareholders are probably pretty happy to live with this half-a-loaf arrangement. That is, they are not concerned about the fact that there is no general duty to maximize shareholder wealth in part because they stand to gain more from deconglomeration, increasing leverage, and, most of all, from the fact that individual managers do, in fact, focus on the performance of their individual companies. In other words, even a diversified shareholder would probably prefer that managers act as if their company was the only one that mattered.

The fact that we have ended up with a class of managers who are significant stockholders can also be traced back to the takeover wars of the 1980s. Focus on stock price has induced most companies to pay much of their compensation to high-level managers in the form of stock options. But the whole system of stock options has backfired to a certain extent because it has created a class of shareholders who are vitally concerned in the health of the company in which they are involved and, perhaps, not nearly as beholden to the interests of diversified shareholders as one might have expected.

But as I said, I think that diversified shareholders probably are pretty happy to live with this arrangement. As far as they are concerned, they like it that managers stick to their last, as one might say, and focus on the health of the company.

How is this likely to play out in the future? What about this conflict between inside managers who are relatively undiversified and outside shareholders like institutional shareholders, who may have a stronger interest

in maximizing earnings or maximizing the share price no matter what the risk?

One area in which controversies are likely to arise in the future, I would think, has to do with the use of various derivative instruments to manage the risk that is taken at the corporation level. Again, diversified shareholders care very little about risk at the individual company level. They care about portfolio performance. But managers, on the other hand, care a lot about risk at the company level.

The question that is likely to arise is, to what extent should managers be able to use corporate assets to manage the level of risk that the corporation has taken? We have some outlying cases from jurisdictions such as Indiana where there appears actually to be a duty to use derivative instruments to manage risk.[7] That does not seem to me to be a result that is terribly consistent with the interests of diversified shareholders, but it may be something that managers are going to find to be relatively attractive because they want to see their company perform well as opposed to some sort of theoretical portfolio performing well.

Another question that is closely related is, to what extent are the courts likely to take the interests of particular kinds of shareholders into consideration in deciding whether decisions of the managers are consistent with those interests. We have at least one case, authored by Chancellor Allen, in the *Marriott* litigation that suggests that the position of individual shareholders is largely irrelevant to what the outcome of a particular case ought to be.[8] On the other hand, it seems to me that the losses that companies might suffer from having invested in derivative instruments may well be an issue over which there is some fighting to be done in the future.

One other trend that I see evolving has grown out of recent litigation having to do with preferred stockholders.[9] Preferred stockholders, after all, are stockholders. The question that arises is to whom does management owe its duty given more than one class of stockholders? Most of the answers have tended to come from a contractual approach to the case rather than a fiduciary duty approach. To what extent is a contractual approach going to intercede in the conflicts that we may see between groups of common shareholders, that is, diversified common shareholders like institutions, versus undiversified common shareholders like managers?

I think some similar interpretation problems are likely to arise with respect to tracking stock where individual parts of companies have been, in

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[7]Brane v. Roth, 590 N.E.2d 587 (Ind. Ct. App. 1992).

[8]Korenvaes Invs. v. Marriott Corp., No. 12,922, 1993 Del. Ch. LEXIS 105 (Del. Ch. July 1, 1993).

[9]*Id.*

a sense, informally spun off as standalone investments so that shareholders can select what part of the company they want to be investing in.[10]

Another related issue that is likely to arise as a result of conflicts between classes of shareholders is exactly what do we mean by a conflict of interest? To the extent that we recognize management shareholders as shareholders too, do we need a better approach to deciding things like whether option repricing, for example, is something that is a conflict of interest or something that should be protected by a traditional approach under the business judgment rule?

Those are just some of the issues that I think are likely to arise in the next few years as a result of a continued process of playing out this distinction between diversified and undiversified shareholders.

Let me say that when I was in law school, I formed an image of Chancellor Marvel who was sort of a comic book character to me. He was somebody in a cape and a mask who could sweep down and fix things whenever they needed fixing, at least as long as they happened in Delaware and had something to do with corporation law. The spirit of Chancellor Marvel is still out there. Delaware corporation law is a system that has proved to be quite resilient. Even if decisions like *Van Gorkom* and *Revlon* and their progeny are mystifying initially, somehow the courts have intuited issues and answers about how to distinguish between legitimate interests of managers in managing their company and diversified shareholders in maximizing the return they get. It is very much a case-by-case approach and I think Chancellor Marvel would approve.

MR. BALOTTI: Thank you, Rich. I think what we're going to do is rather than have any discussion on some of Rich's topics, we're going to turn to Jack Coffee and get both of our presentations on the table before we have any discussion. Jack?

PROFESSOR COFFEE[11] :

THE MODERN MARKET FOR CORPORATE CHARTERS: COMPETITION, COLLUSION, AND THE FUTURE

I. INTRODUCTION

We are gathered here to celebrate the 100th Anniversary of the Delaware General Corporation Law of 1899. This is both appropriate and

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[10]*See, e.g.*, Solomon v. Armstrong, 746 A.2d 277 (Del. 2000), *aff'g*; 747 A.2d 1098 (Del. Ch. 1999); *In re* General Motors Class H Shareholders Litig., 734 A.2d 611 (Del. Ch. 1999).

[11]Professor John C. Coffee, Jr., is the Adolf A. Berle Professor of Law at Columbia University School of Law. Copyright, John C. Coffee, Jr.

ironic. It is appropriate because Delaware has long been the dominant supplier of corporate law to large public corporations in the United States. It is ironic because in 1899 Delaware was a copycat—indeed, unkinder persons than I might even call it a plagiarist, — largely adopting concepts and a corporate philosophy of laissez-faire that New Jersey had earlier put into practice.[12] A year later, in 1900, Delaware took the even more extraordinary step of adopting by judicial decision all the corporate legal precedents of New Jersey.[13] Delaware's motive was obvious: New Jersey had reaped significant economic gains from its approach, attracting the Standard Oil Trust to incorporate in New Jersey. As in all markets, success breeds imitators. Ever alert, Delaware nimbly followed New Jersey's lead, and when Governor Woodrow Wilson later took New Jersey out of what he viewed as an ungentlemanly competition, Delaware had a major head start on the rest of the field. Thus, the anniversary we are really marking is the beginning of the competition in corporate chartering in the United States.

Depending on one's point of view, this was either an auspicious event, well deserving celebration, or a dubious one—but one that still needs to be recalled (if with alarm). As most of you undoubtedly know, the topic of corporate charter competition has been much analyzed by academics—indeed, to the point that in my judgment this topic now constitutes the most overwritten theme in the academic literature about corporate law. Did the competition produce a race to the top or the bottom? Or somewhere in between? Each year academics add to the vast pile of articles on this theme. Almost no one, however, takes the point of view that I am about to express: Because we have an overlapping system of state and federal regulation of public corporations, with no self-defining line between corporate law and securities law, Delaware's hegemony in the market for corporate charters represents neither the victory for regulatory arbitrage and efficiency that "conservative" scholars have proclaimed nor the defeat for public policy that "liberal" scholars have bemoaned. Like much else in life, its significance is more nuanced and contingent.

Although my position may be novel, I do not mean to suggest that new ideas have not been proposed by others. To the contrary, a new and provocative theme has been raised just this year: The market for corporate charters, it is argued, is imperfectly competitive, and therefore will not yield an optimal product.[14] Delaware dominates this market in part by allegedly

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[12]For accessible short histories, see Christopher Grandy, *New Jersey Corporate Chartermongering, 1875-1929*, 49 J. ECON. HIST. 677 (1989); Joel Seligman, *A Brief History of Delaware's General Corporation Law of 1899*, 1 DEL. J. CORP. L. 249 (1976).

[13]*See* Wilmington City Ry. v. People's Ry., 47 A. 245, 251-54 (Del. Ch. 1900).

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

producing a corporate law that is inherently indeterminate and ambiguous, thereby making its law's application depend upon fact sensitive judicial interpretations, which other states cannot replicate. Others have earlier raised this indeterminancy characterization (including Delaware's esteemed former Chancellor[15]), but never before as a competitive strategy by which Delaware achieved a *de facto* monopoly in corporate chartering. I do not intend to attempt to resolve this indeterminancy debate today; the phrase is inherently subjective, and the truth may lie in the eye of the beholder.[16] But I do want to reconsider the regulatory competition hypothesis, on which this critique relies. The "regulatory competition" model has been part of the standard "law and economics" toolbox for over forty years.[17] Essentially, this theory postulates that regulatory rivalry represents a form of perfect competition in the market for laws, which hence will yield the optimal product (namely, the laws most appealing to the consumers of these laws[18]). Precisely because this theory is well known, academics may have accepted too quickly and uncritically the premise that this model can be applied to the market for corporate charters. As I will suggest, there remains a mystery at the heart of this debate.

Rich (or overrich) as the theoretical literature on charter competition has been, the empirical literature is much thinner. Last year, Professor William Carney of Emory University Law School made an important contribution to it by finding that on the statutory level American corporate law has become "relatively uniform across most states."[19] Professor Carney's meticulous comparison looked at the traditional statutory differences among state corporate laws and found that most of them had been resolved. All that separates most individual states, he concluded, "is the pace of innovation," but not the direction.[20] In theory, this convergence could be viewed as

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[15]*See* William T. Allen, *Ambiguity in Corporation Law*, 22 DEL. J. CORP. L. 894 (1997); *see also* Douglas Branson, *Indeterminancy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 42 VAND. L. REV. 85 (1990) (discussing the intricacies of Delaware shareholder decisions).

[16]Incisive and iconoclastic as the author (Mr. Ehud Kamar) of this new critique may be, it should be noted that he is also an Israeli graduate student now finishing a graduate degree at my law school. This is relevant to the extent that his initial legal training was in the civil law. From a civil law perspective, the common law decision-making process with its fact specific decisions may seem inherently indeterminate. Much depends, as always, on the position of the observer.

[17]For the seminal article, see Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

[18]Obviously, this theory still leaves the question of whom the consumers of these laws are: shareholders or managers. This has been the issue around which most of the subsequent debate has revolved.

[19]William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 717 (1998).

[20]*Id.*

evidence of Delaware's dominance and market power. But, Professor Carney did not find that other states were mimicking Delaware; indeed, Delaware sometimes followed the legislative initiatives of other jurisdictions. In general, states no longer seem to compete according to the classic Brandeisian model of individual states serving as "laboratories of democracy"—with other states emulating successful experiments. Rather, innovation comes from external sources: namely, interest groups. Both management groups and bar associations (most notably, the ABA Corporate Laws Committee) sponsor legislative changes, which revisions tend to be adopted in successive waves that flow across the country. This raises a question (to which I will return): are we witnessing the phenomenon of regulatory arbitrage, or more traditional rent-seeking behavior by powerful interest groups, or something else?

In any event, if American corporate law has become relatively uniform, it might be argued that we are now at (in a popular phrase) the "end of history." Much as the Cold War has been resolved, so arguably have the traditional issues of corporate law. Today, based on Professor Carney's evidence, one might well conclude that corporate law has evolved to a stable structure that is enabling and contractarian, in which legal norms have become default rules, rather than mandatory strictures.

Although such a case might well be made by countless "law and economics" scholars (and predictably will be), I am not here today to make it. Nor am I about to tell you that history has been resolved. Rather, I see major confrontations on the horizon. But the horizon I have in mind is not the traditional domestic one. As with all other areas of business practice, corporate law has to recognize the need to think globally. Globalization is increasingly bringing very different systems of corporate governance into active competition. Indeed, because systems of corporate governance tend to be embedded in deeper, more fundamental systems of social and political organization, the conflict is not simply a competition between rival products offered by different states to corporate entrepreneurs (as Professor Roberta Romano modeled the state competition over corporate chartering). Rather, given this tendency on the international level for corporate governance to be embedded in a deeper political system, the approaching conflict is more like a geological collision of giant tectonic plates, each with its own vast momentum and with their contact implying considerable friction. Although one tectonic plate may ride up over the other, the other does not disappear. Instead, it becomes submerged and may surface elsewhere (sometimes in a volcanic form).

A. *The Mystery Stated*

Although charter competition has long been a fact of life within the United States, it is surprisingly absent when one looks abroad. Both Canada and Australia have, for example, federal systems in which business firms incorporate under a provincial corporate law. In principle, this supplies the preconditions for charter competition, as firms can choose between the corporate laws of different provinces. But in neither Canada nor Australia has actual charter competition been observed.[21] Rather, although local commentators have sometimes suggested that such a development would be desirable, they have agreed that it has not arisen.

In Europe, where the potential for charter competition would seem approximately as great as in the United States, the actual experience has been for the European Union to resist competition and seek harmonization of disparate corporate laws. As a German law professor with broad American experience recently phrased it, the founders of the European Community "assumed that an economically integrated single European market calls for a single European company law."[22] As a result, directives from the European Union have required member states to revise their corporate laws to conform to a common standard. This process of harmonization has been at times controversial, and some topics, such as takeover regulation and worker representation in corporate governance, have so for eluded agreement. But if complete convergence of European member state corporate laws has not yet resulted (and clearly it has not), more progress has been made on this score than toward the adoption of a proposed European Company Statute, which statute would create a truly transnational corporation with no home in any individual state. This proposed statute, which was first drafted in 1970 and reproposed in 1975 and 1989, is the European equivalent of federal chartering. According to most European commentators, although such a statute is much desired by many companies, it has "virtually no chance of adoption soon."[23] In short, while harmonization of corporate laws can be controversial, it appears to be less so than overriding the laws of member states with a federal statute.

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[21]*See* Ronald J. Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 MCGILL L.J. 130 (1991) (calling for, but noting absence of, charter competition in Canada). In Australia, since 1981, the Australian states have (pursuant to intergovernmental agreements) cooperated with the federal government to enable a federal corporation statute to apply as the governing corporate law statute of each state. Communication to author from Geoffrey Stapledon, Senior Lecturer in Law at the University of Melbourne.

[22]*See* Werner Ebke, *Company Law and the European Union: Centralized Versus Decentralized Lawmaking*, 31 INT'L LAW. 961 (1997).

[23]*Id.* at 975.

Why has harmonization been an acceptable reform, while federalization has not been? One purpose of harmonization has clearly been to reduce the possibility of regulatory arbitrage: namely, firms using the threat of reincorporation to coerce individual states into reducing the substantive obligations imposed by their corporate laws. In effect, harmonization is a policy of regulatory collusion by which member states in the European Union resist the "divide and conquer" tactic of individual firms seeking to play one jurisdiction off against another.

Yet, the potential for regulatory arbitrage is far less in Europe than in the U.S. because of another constraint that is unknown in the United States: in some European countries, a corporation cannot merge with a foreign firm—at least if the consequence would be to cause the domestic firm to be merged into the foreign firm. This factor greatly constrained the Daimler/Chrysler merger last year. Even if a German firm could flee Germany, German corporation law mandates that its most distinctive contribution to corporate governance—namely, its co-determination provisions under which roughly half the corporate board must be composed of employee representatives—will apply to any large firm operating in Germany. Indeed, the problem is even more basic: within Europe, the "internal affairs rule," which requires each American state to deter to the substantive law of a company's jurisdiction of incorporation, does not necessarily apply. Rather, each member state looks to its own conflict of laws rule. Historically, many member states have required a foreign corporation that has its principal place of business or seat within the jurisdiction to comply with that jurisdiction's laws.[24] Under such legal rules, charter competition is infeasible.

Where the "seat rule" does not apply, the first signs of charter competition have now broken out. Gucci is an obviously Italian company in all respects, except for the fact that is incorporated in the Netherlands.[25] Coincidentally, the Netherlands just happen to have the most protective

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[24] *Id.* at 966-69. This "seat rule" is applied by Belgium, France, Luxembourg, and Portugal. This rule has been upheld by the European Court of Justice as consistent with EC law. *See* Regina v. H.M. Treasury & Comm'rs of Inland Revenue, *ex parte* Daily Mail & Gen. Trust Plc, 1988 E.C.R. 5483, 3 C.M.L.R. 713 (1988). However, the "seat" rule may have been recently reversed by the European Court of Justice in the *Centros Ltd.* case. Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, 2 C.M.L.R. 551 (1999). The future development of European law is, however, beyond the scope of the article.

[25] Technically, Gucci did not reincorporate. Rather, the firm (now Gucci Group, N.V.) was acquired from the founding family by investors, who later did an IPO on the Amsterdam Stock Exchange in 1995. For a description of Gucci's defensive tactics (which have in any event been frozen by an Amsterdam court), see *Gucci Says Amsterdam Court Freeze on PPR Alliance Has Not Prejudged Any Issue*, AFX NEWS, Apr. 27, 1999, available in LEXIS, News Library News Group File.

antitakeover legislation in Europe. When a hostile bidder (LVGH Moet Hennessy Louis Vuitton) acquired a substantial interest in Gucci and then made a tender offer for the remaining Gucci shares late last year, Gucci's board responded by diluting the hostile bidder from 34% to 19.6%. It did so by first creating and issuing shares to an ESOP and then selling 42% of its stock to a white knight (Pinault-Printemps Redoute or PPR). These tactics sound reminiscent of the 1980's era in the history of the U.S. takeover wars when "PacMan" bids and other scorched earth tactics were the norm. Although the outcome of this contest remains in doubt (as an Amsterdam court has stayed Gucci), this resort to a "friendly" jurisdiction of incorporation would not have been possible if Gucci had its principal "seat" in France. Hence, re-incorporation is a strategy that only works sometimes.

Still, these developments underscore the fundamental question: why is corporate charter competition such an accepted and apparently established fact of life in the United States and yet so invisible elsewhere? Similarly, why has federalization of corporate laws been rejected in the United States, and yet apparently succeeded on the *de facto* level in other federal republics, such as Canada and Australia? Finally, in the increasingly federalized world of the European Union, why has a consensus been reached on harmonization, which is essentially the opposite strategy to charter competition because it requires all member states to converge?

B. *Some Tentative Answers*

Answers to this paradox are not obvious. A neo-classical efficiency theorist might respond: "This is why U.S. public corporations do so well, and European firms do so poorly; this is the 'genius of American corporate law.'"[26] The problem with this simplistic answer is that over any sustained recent period, it is not clear that U.S. firms have outperformed their European rivals, either in operating efficiency, profits, or return on capital.

Another, more politically nuanced answer might be that because European countries (and possibly other nations as well) place more of their cherished social and political policies and norms into their corporate laws (including both co-determination, restraints on worker layoffs, and mandatory workers councils), they are less willing to tolerate regulatory arbitrage. In other words, because European corporate laws seek to protect stakeholders as well as shareholders, they cannot be entrusted to stockholder amendment or evasion through reincorporation. This answer clearly has

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[26]Obviously, this comment is a reference to Professor Roberta Romano's well-known thesis. *See* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993). I do not mean to suggest, however, that she would make this particular claim about the European context.

some potential merit, but it begs a prior question: how did things get this way? Once, U.S. corporate laws were also extremely regulatory, and at least until the mid-nineteenth century, U.S. corporations were regarded as quasi-public entities. But U.S. corporate history evolved in a different direction that found charter competition acceptable, while Europe (in the main) has not. Why?

History–or path dependency–may supply a partial answer. The vast majority of U.S. states never existed independently of the United States and are long acclimated to federal supremacy. Even those that did have a prior existence learned the costly lesson of the Civil War that federal supremacy cannot be directly challenged. Thus, although American states may disfavor federal chartering of corporations, they do not fear the "internal affairs" rule, although it does intrude on their sovereignty over business organization operating within their borders. Perhaps more importantly, there are no well-recognized and politically sensitive ethnic, religious, or racial lines of division in the United States that follow state boundaries. Deference to the state of incorporation (and hence as a practical matter to Delaware) does not as a practical matter mean deference to any distinctive racial, religious, ethnic, or political group.

In marked contrast, the European Community has only a thirty year history, not the 225 odd years of the United States. European states can thus still question the federal supremacy of the EC with respect to matters that they consider socially or politically sensitive. Equally if not more important, state boundaries do mark ethnic and historic divisions. The French have still bitter memories of the Germans, and thus the idea that a firm with its principal seat in France could be governed by German law seems even more insufferable than the idea of a federal corporate law (although that too has been resisted). In short, nationalism is a barrier to the acceptability of the "internal affairs rule" in Europe, but not in the United States.

Does this imply that at some possibly distant point in the future the "internal affairs" rule and charter competition might become acceptable to the European Community after federal supremacy becomes more established and the nationalistic ardor of its member states cools? I doubt it–at least for the foreseeable future. Path dependency is a powerful force, and the EC has been embarked on a policy of harmonization for nearly thirty years now. Precisely to the extent that they have not harmonized their corporate law on some controversial issues (such as co-determination), they are not likely to permit local firms to escape those politically sensitive policies by re-incorporating under a foreign jurisdiction's more permissive laws. Remember also that Canada and Australia have never encouraged charter competition (although they presumably do accept the internal affairs rule).

C. *Charter Competition Reconsidered*

The absence of active charter competition abroad raises a subversive possibility about our own experience in the United States: Have we truly had the kind of Darwinian style charter competition that "law and economic" theorists assume? To be sure, re-incorporations occur, and Delaware has powerful economic incentives to make its corporate laws as attractive to as many corporations as possible. But the possibility remains that we have only experienced a "constrained competition," which has not permitted true regulatory arbitrage to develop. Why? The beginnings of charter competition can be dated more or less to the liberalized corporation laws of New Jersey and later Delaware, which developments coincide with (or just predate) the appearance in the United States of the public corporation with broadly dispersed share ownership. But for dispersed ownership to arise, companies had to list on the New York Stock Exchange and satisfy its listing requirements; many of these listing requirements directly regulated corporate governance matters. To be sure, listing was voluntary, but it was the only route to dispersed public ownership. Hence, the NYSE established governance standards for public companies and states did not possess the sole authority even at the outset of this century.

Now turn the clock forward to the New Deal and the passage of the federal securities laws. Although federal chartering was not adopted, the broad authority of the SEC over many aspects of corporate governance was established, and it steadily grew over the following decades—up until at least the Reagan era in 1980. The relative balance between state law and federal standards in the regulation of corporate governance can be debated endlessly, but my modest claim here is that the existence of federal standards and SEC oversight severely constrained charter competition in the U.S.

To illustrate, think of the most controversial topics in corporate governance over the last thirty years. My list would include: insider trading, hostile takeovers, "going private" transactions, and the 1970's experience with questionable payments and foreign bribes. What was the relative state and federal roles in each of these episodes? Clearly, insider trading has come to be regulated almost exclusively at the federal level. Tender offers are, however, regulated at both levels, with the Williams Act supplying both procedural and substantive rules, but state law determining the propriety of most takeover defensive tactics. Similarly, going private transactions are also jointly regulated. While state law generates the substantive norms,[27] SEC Rule 13e-3 may even more significantly affect the thinking and

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[27]Obviously, there is a long line of important Delaware cases, with *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), being the most notable. Their importance is conceded.

behavior of transaction planners. As to corporate bribes and similar payments, Delaware law establishes some important substantive obligations (witness: *Caremark*[28]), but the Foreign Corrupt Practices Act contains criminal provisions and disclosure rules that probably have even more teeth and deterrent impact. One can fairly debate the relative balance, but federal law clearly plays a significant role.

In consequence, federal law has constrained charter competition in the United States. More or less to the extent that regulatory competition might have eroded the substantive legal standards and obligations on corporations at the state level, the SEC has compensated (or possibly overcompensated) for this shortfall in the case of the public corporation. In response, I expect the predictable reply that the SEC's reach has been cut back by the Supreme Court.[29] Indeed, it has, but not to the point that the SEC does not still play a significant role in corporate governance. As a result, my basic premise remains valid: the classic regulatory competition model has only limited relevance to the context of federal systems. Regulatory arbitrage does not work if variations in legal standards at the state level are offset at the federal level. This may explain in turn why charter competition has never begun in Canada and Australia, and it adds a further reason why it is unlikely to begin in Europe.

D. *Implications*

If the regulatory competition model does not describe the current corporate charter marketplace, what generalization then works better? Here, it is useful to return to Professor Carney's findings, which essentially were that state corporation codes had converged in the United States. More importantly, he found that this process of convergence has been driven by model standards and codes (most notably, the ABA Model Business Corporation Act). Such a process seems the functional equivalent of the European experience with harmonization. Harmonization can be seen as the logical alternative to regulatory competition: an attempt by the member states

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[28] *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

[29] The predictable, but superficial, response of the dyed-in-the-wool proponents of charter competition will be that well-known Supreme Court decisions—most notably, *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), and *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985)—have barred the SEC from intruding into matters of state corporate governance. That may have been the intent of these decisions, but it is not their real effect. Take, for example, SEC Rule 13e-3, which requires the issuer's board in a "going private" transaction to explain why its members consider the transaction to be fair to the minority shareholders. Even if the SEC cannot require fairness, its ability to require the key actors to justify the fairness of the transaction procedures produces a close substitute.

to mediate differences and thereby avoid the "destructive" impact of regulatory competition.

In economic terms, however, harmonization can also be regarded as a form of collusion. Member states are agreeing not to compete and are insisting that all comply with common agreed upon terms. This sounds like price-fixing. My point is not that such conduct is unlawful (it is not[30]), but that those attempting to model behavior in the market for corporate charters have it precisely backwards. Collusion, not competition, may be the dominant behavior.

This interpretation is subject to an obvious rejoinder: cartels are notoriously unstable, and a fifty member cartel consisting of all U.S. states would be larger by far than the typical antitrust conspiracy. But this implies only that the cartel will occasionally have defectors (and Pennsylvania may be the best example of a defector in the U.S. market, given its unique antitakeover provisions[31]). Conversely, powerful interest groups may have strong incentives to maintain the cartel. The most logical candidate for an interest group favoring harmonization is the organized Bar, which may have a strong interest in the uniformity of corporate laws. Uniformity implies predictability and simplifies their task of explaining and predicting judicial decisions for their clients. Clearly, it has been the Bar (and most notably, the ABA Corporate Laws Committee) that has been the most steadfast proponent of uniformity in corporate laws and harmonization. Local bar associations may also fear that in an environment of regulatory competition, they will lose corporate clients, as firms reincorporate elsewhere. Either because (1) they do not have confidence that their legislature will compete effectively in any such competition or (2) they fear that the clients they lose may cost them more than any clients they gain, they may prefer the status quo and favor harmonization over competition. If so, it would not be the first time that the joys of the quiet life have won out over the potential gains from competition.

In short, if most statutory changes in corporate law today emanate from a central source (such as the ABA Corporate Laws Committee), such a process is inconsistent with the regulatory competition model. To be sure, this pattern may raise troubling questions to the extent that powerful interest groups are thought to have influence over that central body (as they may have). But this is the standard problem of rent seeking, and it is a virtually

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[30]The market for corporate charters is almost certainly not a "relevant market" for purposes of the Sherman Antitrust Act. *See* United Mine Workers of Am. v. Pennington, 381 U.S. 705 (1965); Eastern R.R. Presidents Conference v. Noerr Motor Freight, Inc., 365 U.S. 130 (1961).

[31]Nonetheless, there have been few migrations to Pennsylvania, probably because of the expected resistance of institutional shareholders. Such resistance also reduces the prospect of certain forms of regulatory arbitrage.

universal problem. Whether we examine the U.S. context or the European, actual real world applications of the regulatory competition model seem to be conspicuously lacking.

E. *The Future*

If the market for corporate charters may be less competitive than academics have assumed, this does not mean that competition cannot break out at other levels. While we have tended to assume that the large scale corporate enterprise has dispersed ownership (as Professors Berle and Means taught us long ago), recent comparative research has found the Berle/Means form of dispersed ownership to characterize virtually only the U.S. and the U.K. Elsewhere (including Canada), concentrated ownership is very much the norm. For example 85% of German Corporations have 25% or greater of shareholders who presumably hold *de facto* control.[32] Another recent study finds that 64% of large German firms and 59% of large French firms have a majority owner.[33] To summarize a great deal of recent data quickly, the corporate universe breaks down globally into two very different systems: (1) systems of dispersed ownership (which predominate only in the U.S. and the U.K.), and (2) systems of concentrated ownership (which feature either a controlling group or an interlocking network of shareholders who together control a broad collection of firms). Suffice it to say that very different systems of corporate governance and legal rules characterize these two systems.

While many factors help to explain the origins of these different systems, one explanation increasingly seems the most important: dispersed share ownership can only arise and persist under highly developed legal systems that give strong legal protections to minority shareholders. Absent such protections, most investors will be reluctant to make equity investments, except to the extent that they can participate in a powerful blockholder group (because concentrated ownership is ultimately a substitute for legal protections against expropriation). Uniquely, the common law

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[32]*See* Julian Franks & Colin Mayer, *Ownership, Control and Performance of German Corporations* (unpublished manuscript presented at the Columbia Law School Sloan Project Conference, Apr. 1997, on file with the author), *discussed in* John Coffee, *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 642 n.2 (1999).

[33]*See* Paul Windolf, *The Governance Structure of Large French Corporations: A Comparative Perspective*, CORPORATE GOVERNANCE TODAY 695, 714 (1998) (The Sloan Project Conference at Columbia Law School).

traditions of the U.S. and the U.K. have provided such protections, while civil law systems appear to do far less well.[34]

In a global economic environment, these rival systems of dispersed and concentrated ownership are in obvious competition. More importantly, there is persuasive evidence that the U.S./U.K. model is winning. The most obvious evidence is the growing migration of European firms to U.S. securities exchanges. These firms are in effect "opting in" to the U.S. system (and its substantially more rigorous disclosure and accounting standards) in order to obtain dispersed shareholders and broadly publicly traded stock. Further evidence lies in the determined effort being made across Europe to develop deeper, more liquid stock exchanges. Finally, several European nations (most notably, Italy) have recently rewritten their corporations codes in a conscious attempt to adopt U.S. standards and confer greater protections on minority shareholders.

Underlying this movement is not some newfound concern with fairness, but a consensus among European finance ministers that active stock markets are an engine of economic growth and are necessary to finance high technology investment (and to permit the development of venture capital companies). To match the United State's economic growth, they have decided they must replicate some of its institutions.

What does this have to do with my earlier focus on charter competition? Two observations about this process dovetail with my earlier focus:

(1) The market for stock listings is becoming the active charter market of the future, because the differences between the governance standards applicable to firms listing on the New York Stock versus firms listing on a European exchange are substantial. Yet, although the rules and disclosure standards are more demanding in the U.S., the migration is in this direction. In short, the migration is not to the bottom, but the top, in this area. Firms appear to be willing in growing numbers to bond themselves to higher standards in order to attract investors. Once again, regulatory arbitrage is not working as the theory predicts.

(2) Harmonization of corporate laws in Europe seems to be seeking not simply to compromise disparities, but to upgrade standards. Neither the models of competition nor collusion fully capture this behavior. Thus, another possibility must be faced which "law and economic" scholars

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[34]For a summary of the data and evidence supporting this position, see Coffee, *supra* note 32, at 641-45, and Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999).

(particularly those of the "public choice" persuasion) tend to resist: legislative efforts can be public regarding, and need not only be motivated by private interests. The effort to harmonize corporate laws across Europe has imported numerous U.S. law concepts that were previously unknown to Europe (for example, across Europe an equivalent of the Williams Act has been enacted and insider trading has been banned).

II. CONCLUSION

The market for corporate charters has now been with us for a century. But what is occurring within it today remains very debatable. The neoclassical model assumes a regulatory competition. But closer inspection finds few current indications that the players are competing actively. Collusion supplies an alternative hypothesis, as does the claim that Delaware has such a dominant position that only imperfect competition can occur. But the prospects for regulatory arbitrage are chiefly limited by our overlapping and dual systems of state and federal regulation. The line between corporate governance and securities regulation is not self-defining. If the SEC has been rebuffed on some occasions, it has won on enough other occasions to be able to restrict the impact of competition among the states. Finally, the competition versus collusion dichotomy misses the prospect of truly public-regarding legislation that seeks to improve the corporate governance system. Across Europe today, we are witnessing that rare phenomenon, which is being implemented through harmonization. My message then is modest: reality is complex; theory somewhat easier, but the devil is in the details. One cannot adequately explain Delaware law or its impact using the over-simple model of regulatory arbitrage.

MR. BALOTTI: Thank you very much to both of our speakers. They presented some very thoughtful remarks, at least Rich 100% of yours and Jack about 99% of your remarks were thoughtful. The others were scurrilous and you'll hear from my lawyer.

I think that as Yogi Berra might have said predictions are very difficult, especially ones about the future. And our panelists have given us some good thoughts about the future. And rather than go into the prepared remarks by Ed and David, I think what we ought to do is devote the time that we have left for this panel to some discussion with our panelists.

And I'd like to start off, Rich, by posing for you the following: Your hypothesis seems to be that a diversified shareholder would prefer that directors not own too much stock. Otherwise, they might be risk adverse. And leave aside what too much is for the moment.

At the same time, there is another body of scholarly thought which says, and this is mainly Charles Elson, that stock ownership by directors is

of critical importance because it improves decision making and enhances their ability to fulfill the duty of care.

Do those two thoughts collide or is there some number of shares or dollar figure which is optimum?

MR. BOOTH: Yes.

MR. BALOTTI: Thank you.

MR. BOOTH: I don't think there's any question that those things collide. And I think, practically speaking, with the specter of cases like *Smith v. Van Gorkom*,[35] which really, of course, cannot be completely done away with even with 102(b)(7), directors know they have a duty. I mean, now we've got *Caremark*.[36]

I don't know how much difference shareholding actually makes. I guess my bottom line is that ultimately it is going to be very difficult for somebody who is managing a company to think in terms of how that company fits into a portfolio. What diversified shareholders want managers to do, and I think what they tend to do, is to think about the health of that individual company.

One example that I like to give is one that comes from the movie "It's A Wonderful Life," where old man Potter who's on the board of directors says that the town's too small to have two banks and, therefore, he proposes that the Bailey Building & Loan vote to dissolve itself because it would be better overall for the economy if there's only one bank in that town. That would be the approach that a director taking the point of view of a diversified shareholder might prefer. But it's utterly unbelievable except for a collusive situation where old man Potter also happens to own the other bank.

So I just don't think it's practical. I don't think it makes a lot of difference how much directors own in the way of shares. It may make them more enthusiastic if they do own shares and that's just fine. But I don't think it creates any additional conflict in point of view that's particularly worrisome. If anything, it allows us to better see the conflict that is naturally there.

MR. WELCH: Frank, isn't the answer to that question going to vary widely really depending upon the individual personality of the directors or managers involved? If you have somebody who's inherently risk adverse, if they got a lot of stock, maybe they'll be too conservative. If, on the other hand, you have someone with a lot of stock who's entrepreneurial in spirit, you know, they're going to make a lot of moves and make a lot of money for

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[35] 488 A.2d 858 (Del. 1985).

[36] *In re* Caremark Int'l Inc. Derivative Litig.,.698 A.2d 959 (Del. Ch. 1996).

people who are their shareholders. It sort of strikes me that that's two of those chicken and egg —

MR. BALOTTI: Let's put that in the context of Michael Price's discussion of this morning. The managers of Pennzoil assumed they had their own personal wealth tied up in Pennzoil. Should they not have been risk adverse as to the future of the company and accepted the $84 offer as it was presented to them? Before your client left, Ed, fled the fight.

MR. WELCH: I guess with respect to UPR, it struck me that that was a substantial offer and would have been appealing to a lot of managers. Michael Price also made a number of good points. And I suppose a compelling case can be made where you have a stock that's now being sold in the teens, where that opportunity existed to sell for 84 bucks a share, that transaction should have been looked at very carefully.

I will say this to put in context some of the comments that were made this morning, particularly with respect to Delaware law and the Delaware courts. I'm mindful of the fact that the Court of Chancery did, at least in my judgment, move quickly. I don't know that any criticism whatsoever should be directed to the Court because I have a clear recollection that when we did ask for an expedited trial, that the Chancellor was most responsive and gave it to us. And, indeed, we were in the process of preparing for that trial when the decision was made not to go forward.

MR. BALOTTI: I'm throwing it out more to test Rich's hypothesis that if stock ownership breeds anti-risk behavior, how can you explain that decision, Rich, of the managers?

MR. WELCH: My view would be that the answer to that question is going to vary depending upon the nature, the personality of the individuals involved. And not only that, in some cases, depending on the industry that they're in. The oil industry, let's face it, is an entrepreneurial business. It always has been. Wild catting was the start of it.

MR. BALOTTI: Yeah. And our firm represented Pennzoil.

PROFESSOR COFFEE: Well, let me throw in two other factors. There's more than simply diversification. First of all, there's something called the private benefits and control. Managers do receive private benefits and control.

MR. BALOTTI: Certainly not our clients.

PROFESSOR COFFEE: They're very responsible. The managers would resist an offer that every other shareholder in the firm would find to be attractive.

As to stock ownership with regard to directors, I think you have a tradeoff here between diversification, which can produce risk neutrality, and apathy. If you own no stock at all, it's hard to see why you're going to spend much time monitoring the corporation's affairs. You've got to get over that apathy hurdle which is what I think is the position of most institutional

investors today. They want a board that receives stock options as compensation rather than cash because, otherwise, they doubt there'll be a motive to engage in serious monitoring.

MR. BALOTTI: So some ownership but not too much?

PROFESSOR COFFEE: I'll let Rich address that.

MR. BOOTH: Well, it sounds to me like there wasn't enough in the *Pennzoil* case at the time the initial offer was rejected. I'm going out on a limb because I have no idea what kind of stock option plan they had or what sort of incentives were in place, but I was one of the early proponents of golden parachutes which people thought were just an awful takeover defense. In fact, they are a way for managers to neutralize the reluctance to have the company sold out from under them.

PROFESSOR COFFEE: Well, this is the cozy answer. You are bribing managers to do what the shareholders want by giving them a golden parachute.

MR. BOOTH: Or stock options now, which work even better.

MR. BALOTTI: Well —

MR. BOOTH: Is that an answer?

MR. BALOTTI: That's a kind of answer, yeah.

Jack, for you, let me ask you the following: To my mind, I've never quite understood the thought of competition between states for the chartering business if you look at it as states trying to protect their own citizens rather than enhance their revenues. Because the internal affairs rule as you mentioned, to my — I think of it as the law of the place of incorporation governs the internal affairs rather than the law of the principal place of business governs the internal affairs.

It's so easy for a state to change the choice of law rule. After all, some states have place of the making for a contract, choice of law rule. Others have a most significant contacts for torts. Some have the last act. Some have the most significant contacts. Why can't a state just say that a corporation that has its principal place of business in our state will be subject to our corporation law? That is, the choice of law that our state will apply.

PROFESSOR COFFEE: Well, as you know, both California and New York have something called pseudoforeign incorporation statutes. They aren't as simple as simply the place of business. They require that there be certain other contacts, both place of business, majority of the shares, other tests.

The constitutional validity of both of those statutes is certainly unresolved. There is a recent Second Circuit decision, the *Stadler*[37] decision,

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[37]Stadler v. Rolscreen Co., No. 95-7416, 99 F.3d 400 (Table), 1995 U.S. App. LEXIS 39910 (2d Cir. Dec. 7, 1995).

that managed to somewhat duck the issue and uphold in force the New York pseudo-incorporation statute. But they found there wasn't a conflict between Delaware law and New York law and the question of whether you had to provide a list of your no votes.

I think that there is a very good chance that in the right set of facts that the application of the pseudoforeign corporation statute could be struck down as violating or burdening interstate commerce. I'm not saying they should do that. I think the modern Supreme Court wants to constitutionalize less rather than more. And constitutionalizing a conflicts of law rule is fairly sweeping.

But once you move away from the place of incorporation, there is a good deal of uncertainty because five different states could pass statutes saying this corporation belongs to us and I think that would be unacceptable. And in that kind of area, it wouldn't surprise me for the Supreme Court to say that was too much of a burden on interstate commerce.

MR. BALOTTI: Well, I don't think that would happen. We have a lot of experience under the federal law of what is the principal place of business, at least for diversity.

PROFESSOR COFFEE: Once you go beyond that, you can go to three other things. You can say the majority of the shareholders or if you have this, this and that. And then I could imagine multiple states claiming that they're all obliged to the same corporation.

MR. WELCH: It's interesting, Frank. I think in the *McDermott*[38] case, *McDermott v. Lewis*, that Justice Moore made the comment that the internal affairs doctrine does, in fact, have a compelling constitutional basis not only in the commerce clause as Jack mentioned, but also in the due process clause and the full faith and credit clause. So, we do have the Delaware Supreme Court's view from at least that perspective. And it does make a lot of sense when you consider the potential for differing decisions and rulings on the same set of facts, if you present a question to different courts across the country, which does happen, particularly in M&A cases.

MR. BALOTTI: Same as in a contract case where different states' laws might apply to a contract case and yet no one has the temerity that I know of to say that a contract choice of law provision is driven by the U.S. Constitution.

PROFESSOR COFFEE: It's not a burden.

MR. BALOTTI: Maybe, maybe not. Depends on whether you win or lose whether it's a burden.

Well, other questions? Thoughts from David?

MR. McBRIDE: Nope.

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[38]McDermott Inc. v. Lewis, 531 A.2d 206 (Del. 1987).

MR. BALOTTI: Ed? Well, I want to thank our panelists for being with us today and if there are no questions from the audience, I think we're now scheduled for a break. Thank you very much.