

**THE CHANGING FACE OF CORPORATE GOVERNANCE
REGULATION IN THE UNITED STATES: THE
EVOLVING ROLES OF THE FEDERAL AND STATE
GOVERNMENTS**

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Since the 1930s, the United States federal government and the individual states have shared the responsibility for regulating the governance of public corporations.¹ In general, the states have regulated the substance of corporate governance, while the federal government has focused on regulating the communications of public corporations with investors and securities markets. This Article explores three topics related to this shared responsibility for corporate governance regulation: first, it discusses, in greater detail, the basic division of authority to regulate corporate governance between the United States federal government, on the one hand, and the individual states, on the other; second, it explores how this division of authority has evolved since the 1930s; and third, it offers some thoughts on the future of this shared regulatory responsibility, concluding that there is little to fear, and much to gain, from retaining the current system of shared regulatory responsibility.

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1. Corporate “governance” regulation refers to those laws and regulations that control the internal governance of the corporation. These laws and regulations control how power and authority is allocated and exercised within the corporation, and cover such matters as: the powers of various stakeholders in the corporation to make or participate in corporate decision-making; how, as a practical matter, the groups to whom authority is allocated exercise that power; and the constraints that ensure that the power and authority granted to particular groups is not misused. *See generally* LARRY E. RIBSTEIN & PETER V. LETSOU, BUSINESS ASSOCIATIONS § 5.01 (4th ed. 2003).

I. THE BASIC DIVISION OF REGULATORY AUTHORITY UNDER CURRENT U.S. LAW

A. *The Role of the States*

The use of corporations in the United States greatly expanded during the nineteenth century with the states' adoption of general incorporation laws.² Because corporations were creatures of state law, the states, not the federal government, regulated their internal affairs. Although states continue to play the primary role in regulating corporate governance today, this role is no longer exclusive. The summary of state corporate governance regulation that follows explores four basic features of state corporate law: first, the ability of businesses to choose where, within the United States, they would like to incorporate; second, the basic allocation under state law of authority between managers and shareholders; third, the devices that state law provides to constrain corporate managers from misusing their authority; and fourth, the on-going debate over the effectiveness of these devices.

1. *Choice of State of Incorporation*

In the United States almost all corporations are created by the individual U.S. states, not by the federal government.³ As a result, organizers of corporations in the United States can obtain corporate charters from any of the fifty states or the District of Columbia. Under a conflicts-of-law principle known as the "internal affairs" doctrine,⁴ the law of the state in which the organizers choose to incorporate will control the internal affairs of the corporation—the relationship among the various corporate constituencies, especially

2. The earliest general incorporation laws were adopted in North Carolina, Massachusetts, New York, and Connecticut in 1795, 1799, 1811, and 1832 respectively. See HARRY G. HENN & JOHN R. ALEXANDER, *LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* 25 (3d ed. 1983). New Jersey adopted the first modern general incorporation law in 1875; Delaware entered the competition with an 1899 law based closely on New Jersey's. RIBSTEIN & LETSOU, *supra* note 1, at 11. Prior to the adoption of these "general" incorporation laws, corporations could only be formed by special acts of state legislatures.

3. See HENN & ALEXANDER, *supra* note 2, at 25. In certain limited circumstances, particularly in the financial services sector, corporate charters are available from the federal government. For example, businesses organized to engage in the business of banking can obtain a charter from the Comptroller of the Currency under the National Bank Act of 1864. Act of June 3, 1864, ch. 106, 13 Stat. 99 (codified as amended at 12 U.S.C. §§ 1–604 (2006)).

4. See RIBSTEIN & LETSOU, *supra* note 1, § 1.04.

the shareholders, the corporation's directors, and its officers. And this internal affairs rule applies *regardless of the location within the United States of the firm's business or physical assets*.⁵ Therefore, for example, a business with all its assets in California, and none in Delaware, could still choose Delaware as its jurisdiction of incorporation with the result that Delaware law, not California law, would set the rules for the internal governance of the firm.

Indeed, for larger public corporations, Delaware is far and away the single most popular jurisdiction in the United States for corporations, with approximately half of the nation's largest 500 firms being organized under Delaware law.⁶ There are several reasons for Delaware's popularity: First, the substance of Delaware's corporate law appeals to corporate managers⁷ by, among other things, giving managers extensive control over the corporation's affairs,⁸ providing powerful protections against shareholder lawsuits,⁹ and providing expansive protections to those managers who are unlucky enough to be sued, including indemnification,¹⁰ expense advancement,¹¹ insurance,¹² and limitations on personal liability for money damages.¹³ Second, Delaware offers its noted Court of Chancery,¹⁴ which is staffed by expert judges who resolve large numbers of corporate cases quickly and consistently, making Delaware an extremely efficient and predictable jurisdiction in which to litigate corporate cases. And third, Delaware's state constitution includes

5. There are some exceptions to this principle, but application of these exceptions is extremely rare. For an example of an unusual case declining to apply the internal affairs rule, see *Havlicek v. Coast-to-Coast Analytical Servs., Inc.*, 46 Cal. Rptr. 2d 696 (Cal. Ct. App. 1995).

6. See LEWIS S. BLACK, JR., WHY CORPORATIONS CHOOSE DELAWARE 1 (2007), available at http://corp.delaware.gov/whycorporations_web.pdf (publication printed and distributed by the Delaware Department of State, Division of Corporations).

7. *Id.*

8. See, e.g., DEL. CODE ANN. tit. 8, § 141 (2009) (providing that, subject to limited exceptions, "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors").

9. See *infra* notes 54–67 and accompanying text (discussing Delaware's version of the demand requirement and the business judgment rule).

10. DEL. CODE ANN. tit. 8, § 145 (2009).

11. *Id.*

12. *Id.*

13. DEL. CODE ANN. tit. 8, § 102(b)(7) (authorizing provisions in certificates of incorporation limiting the liability of directors for money damages for certain breaches of fiduciary duty).

14. See BLACK, *supra* note 6, at 1.

special provisions that promote the stability of Delaware's corporate law by requiring a special super-majority in both houses of the legislature in order to amend Delaware's General Corporation Law.¹⁵ But these three explanations, by themselves, do not seem sufficient to explain Delaware's dominance in securing corporate charters because other states could easily replicate these features and, at least in theory, obtain a portion of Delaware's lucrative incorporation business. Yet while some states have tried this strategy, Delaware remains preeminent.¹⁶ This suggests that other factors must at least contribute to the explanation for Delaware's dominance, that is, there must be something unique to Delaware that is not susceptible to easy copying. This special feature may be Delaware's small size and population, which make it particularly dependent on the revenue it earns from its incorporation business.¹⁷ This unique dependence on corporate fees and franchise taxes to fund the state's operations may mean that Delaware can be uniquely trusted not to alter its corporate laws in ways that public corporations dislike, because any detrimental change to Delaware's corporate law could lead corporations to leave the jurisdiction, thereby depriving the state of a vital source of revenue.¹⁸ Indeed, another U.S. state—New Jersey, which was the first U.S. state to adopt a modern general incorporation law in the latter portion of the nineteenth century¹⁹ and the early leader in U.S. incorporations—saw its advantage disappear when, in the early twentieth century, a tough New Jersey antitrust law led corporations to flee the jurisdiction and never return.²⁰ Delaware's unique dependence on revenue from incorporations may explain why other states that have attempted to

15. See DEL. CONST., art. IX, § 1 (providing that “[n]o general incorporation law, nor any special act of incorporation, shall be enacted without the concurrence of two-thirds of all the members elected to each House of the General Assembly”).

16. Nevada, the most prominent example of a state that has sought to compete with Delaware, has enjoyed some limited success. See Marel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 716 (2002) (noting that Nevada is one of the few states to attract a substantial number of companies headquartered in other states). Indeed, Nevada is sometimes referred to as “the Delaware of the West.” See, e.g., Keith Paul Bishop, *The Delaware of the West: Does Nevada Offer Better Treatment for Directors?*, INSIGHTS, Mar. 1993, at 20.

17. See BLACK, *supra* note 6, at 1–2.

18. For a complete discussion of this theory, see Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985).

19. See sources cited *supra* note 2.

20. See RIBSTEIN & LETSOU, *supra* note 1, at 11. See generally CHRISTOPHER GRANDY, *NEW JERSEY AND THE FISCAL ORIGINS OF MODERN AMERICAN CORPORATION LAW* (1993).

entice corporations to organize within their jurisdictions have, for the most part, failed to make inroads into Delaware's dominant position.

2. Allocation of Authority Between Management and Shareholder; Rules Favoring Management over Shareholders

One of the primary functions of corporate governance regulation is the allocation of decision-making authority among the various corporate constituencies, particularly management, on the one hand, and shareholders, on the other. Although state law governance rules can generally be altered in the corporate charter or bylaws,²¹ state corporate law generally provides a default allocation of power that plainly favors management over the shareholders. These state laws typically provide that the corporation will be managed "by or under the direction of a board of directors"²² and that the day-to-day operations of the corporation will be carried on by officers appointed by the directors,²³ and employees selected by the officers. Shareholder powers, on the other hand, are generally limited to certain discrete matters, such as: (1) electing the directors at the corporation's annual meeting;²⁴ (2) adopting or amending corporate bylaws;²⁵ and (3) voting to approve fundamental corporate changes, like mergers,²⁶ sales of all or substantially all the corporation's assets,²⁷ and dissolutions.²⁸ In general, state laws provide shareholders with no role in ordinary corporate business decisions and state courts look skeptically on efforts to expand shareholder authority, unless the terms of those contracts are included in the corporation's organizational documents.²⁹

21. See sources cited *infra* note 30.

22. See, e.g., DEL. CODE ANN. tit. 8, § 141 (2009).

23. See, e.g., *id.* § 142.

24. See, e.g., *id.* § 211. In general, all the members of the board of directors will stand for election each year, but the corporation's certificate of incorporation or bylaws may provide for a classified board of directors. See, e.g., *Id.* § 141(d). If the board is classified (or staggered), only a portion of the board (generally 1/3 of the members) will be elected at each annual meeting.

25. See, e.g., *id.* § 109.

26. See, e.g., *id.* § 251.

27. See, e.g., *id.* § 271.

28. See, e.g., *id.* § 275.

29. Cf. *Zion v. Kurtz*, 405 N.E.2d 681 (N.Y. 1980) (upholding contract expanding power of shareholder to participate in corporate business decisions, even though provision expanding shareholder power was not included in certificate of incorporation, but only because the defendant had the power and duty to amend the certificate of incorporation and no third party rights were affected) (Delaware law).

As noted above, the state law governance rules for corporations generally function as default rules that can be altered in the company's charter or in its bylaws.³⁰ These alterations can cover almost all aspects of corporate governance, and can include provisions increasing or decreasing the powers of the shareholders to participate in corporate governance. For instance, the number of shares that must be represented at a shareholders meeting for business to be conducted, or the number of shares that must be voted in favor of a resolution for the resolution to pass, can typically be altered through properly approved amendments to the corporation's charter or its bylaws.³¹ In practice, limitations on shareholder powers are far more common than expansions. For example, many public corporations in the United States take steps to limit the ability of shareholders to control the timing of corporate action by restricting the power of shareholders to call meetings and by eliminating the power of shareholders to act by written consent without a meeting. Further, even in the case of shareholder meetings convened by the directors, public corporations frequently require shareholders to give advance notice of any business they plan to bring before the meeting,

30. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (2009) (providing for management of the corporation by or under the direction of a board of directors, "*except as may be otherwise provided . . . in its certificate of incorporation*" (emphasis added)); *id.* § 228(a) (providing that any action that can be taken by shareholders at a meeting can also be taken by written consent without a meeting, "*[u]nless otherwise provided in the certificate of incorporation*" (emphasis added)). However, some provisions of corporation law are mandatory and may not be altered, at least without unanimous consent of the shareholders. A prominent example is the shareholders' right to an annual meeting under DEL. CODE ANN. tit. 8, § 211. See, e.g., *Hoschett v. TSI Int'l Software, Ltd.*, 683 A.2d 43 (Del. Ch. 1996) (mandatory requirement of annual meeting of shareholders could not be satisfied by shareholder action by written consent under § 228 unless the shareholder consent was unanimous).

31. See, e.g., DEL. CODE ANN. tit. 8, § 216 (2009):

Subject to this chapter in respect of the vote that shall be required for a specified action, *the certificate of incorporation or bylaws* of any corporation authorized to issue stock may specify the number of shares and/or the amount of other securities having voting power the holders of which shall be present or represented by proxy at any meeting in order to constitute a quorum for, and the votes that shall be necessary for, the transaction of any business, but in no event shall a quorum consist of less than one-third of the shares entitled to vote at the meeting, except that, where a separate vote by a class or series or classes or series is required, a quorum shall consist of no less than one-third of the shares of such class or series or classes or series.

(Emphasis added).

thereby ensuring that management will be well prepared to respond to any resolutions shareholders may make.³²

But while alterations designed to limit shareholder powers are more common, there are also examples of changes designed to expand shareholder powers. Most notable in this regard are recent provisions giving shareholders in public corporations greater powers to reject management-proposed candidates to the board of directors by requiring board nominees to receive a majority, rather than a mere plurality, of the votes cast.³³ In addition, public corporations are often required by stock exchange rules to provide shareholders with powers permitted, but not required, by state corporation law, such as the right to vote on transactions that may result in excessive issuances of new shares, thereby diluting the stake of existing shareholders.³⁴ These modifications, however, seldom, if ever, change the basic state law allocation of authority in the corporation, which gives management the near exclusive authority to manage the business with little or no formal input, or even approval, from shareholders.

3. Constraints on Managerial Authority

Because of this vast allocation of authority to management, much of state corporate law, particularly judge-made common law, concerns itself with devices designed to prevent corporate directors and officers from misusing their powers. There are a number of such devices built into each state's corporation law.³⁵ The discussion below highlights three of the most basic.

32. For an example of a provision limiting the power of shareholders to convene special meetings and requiring advance notice of certain actions, see PETER V. LETSOU, CASES AND MATERIALS ON CORPORATE MERGERS AND ACQUISITIONS § 5.2 (2006).

33. For a review of shareholder proposals for majority, rather than plurality, voting on directors, see Dennis K. Berman, *Boardroom Defenestration: As Proxy Season Heats Up, Companies Consider Rules To Boot Unwanted Directors*, WALL ST. J., March 16, 2006, at B1. The article reported that, as of 2006, "[o]ver 120 companies [had] some form of majority voting in place, . . . with 73 of them adding the changes over the past 14 months . . ." Companies adopting these proposals included Pfizer, Intel, and Motorola.

34. See, e.g., NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 312.03(c) (2009), available at <http://nysemanual.nyse.com/lcm/>.

35. For a general discussion of the various devices that constrain managers to act consistently with the best interests of the shareholders, see RIBSTEIN & LETSOU, *supra* note 1, at § 7.02[A][1].

a. Right to Vote

The right of shareholders to meet at least once every year to elect and remove directors is undoubtedly the most important shareholder right.³⁶ Because of its importance, courts generally treat the shareholder's right to elect directors as fundamental and non-waivable.³⁷ Come what may, shareholders of United States corporations, particularly in Delaware, get at least one opportunity per year to meet and exercise their right to replace old directors with new ones. And if the directors fail to convene such an annual meeting within the statutory period, the courts will summarily order the meeting to be held upon the request of any shareholder.³⁸ As a result, directors who fail to act in the best interests of the shareholders face the risk of removal at the corporation's annual meeting, perhaps at the urging of a dissident shareholder or group of shareholders who wage a proxy contest to oust the incumbent board or some of its members.

b. Derivative Suits

A second important constraint on managerial power is the shareholder's derivative suit.³⁹ Using the device of the derivative suit, a shareholder is permitted to stand in the shoes of the corporation and assert the corporation's right (for the corporation's benefit)

36. In Delaware, this right is provided pursuant to DEL. CODE ANN. tit. 8, § 211 (2009).

37. See, e.g., *Hoschett v. TSI Int'l Software, Ltd.*, 683 A.2d 43 (Del. Ch. 1996).

38. See DEL. CODE ANN. tit. 8, § 211(c) (2009). In part, it states:

If there be a failure to hold the annual meeting . . . for a period of 30 days after the date designated for the annual meeting, or if no date has been designated, for a period of 13 months after the latest to occur of the organization of the corporation, its last annual meeting or the last action by written consent to elect directors in lieu of an annual meeting, the Court of Chancery may summarily order a meeting to be held upon the application of any stockholder or director.

In *Clabault v. Caribbean Select, Inc.*, 805 A.2d 913 (Del. Ch. 2002), *aff'd*, 846 A.2d 237 (Del. 2003), the court stated that "the case law interpreting Section 211(c) strongly favors the convening of an annual meeting for the purpose of electing directors when the factual predicate defined by the statute is shown; indeed, 'a stockholder's right to have a meeting convened to elect directors is 'virtually absolute.'" For a case ordering an annual meeting under DEL. CODE ANN. tit. 8, § 211(c), see *Saxon Industries, Inc. v. NKFW Partners*, 498 A.2d 1298 (Del. 1985) (mere fact that a proxy contest might scare away a buyer for a company that was reorganizing in bankruptcy was not enough to rebut the strong presumption in favor of the shareholders' right to an annual meeting under § 211).

39. See John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 261 (1981) (noting that derivative suits have been "a recognized form of litigation in American courts since 1855," and citing the U.S. Supreme Court's decision in *Dodge v. Woolsey*, 59 U.S. (18 How.) 331 (1856), as marking the derivative suit's acceptance).

against directors and/or officers who have allegedly injured the corporation by breaching their legal duties to act as fiduciaries for the shareholders. State statutes are generally explicit as to the existence of shareholders' right to sue derivatively to seek redress, on the corporation's behalf, for injuries to the corporation, including injuries inflicted by management itself.⁴⁰ But the statutes say very little about the circumstances under which management will be held liable, leaving that important question to the courts.⁴¹ Therefore, at least in theory, corporate managers are constrained by the fear that their actions, if not consistent with the best interests of the shareholders, could result in personal liability.

c. Right to Sell

The third significant constraint on the directors' exercise of authority is the ability of shareholders to sell their shares.⁴² This right functions as a constraint on managerial conduct because the right can be employed by shareholders to sell control of the corporation to third parties (hostile bidders), who may offer a premium price for the shares because they can use the shares and votes so acquired to remove and replace poorly performing directors, along with the corporate officers those directors have appointed. Therefore, managers concerned with maintaining their positions in the firm (and the related perquisites) have an incentive to try to keep hostile bidders at bay by managing the firm in the interests of the shareholders,

40. See, e.g., DEL. CT. C.P.R. 23.1. Modeled on Rule 23.1 of the Federal Rules of Civil Procedure, Delaware Rule 23.1 sets forth various procedural requirements related to the prosecution and termination of derivative litigation. FED. R. CIV. P. 23.1 serves as a model for provisions in several states. See generally RIBSTEIN & LETSOU, *supra* note 1, § 10.03.

41. For example, in Delaware most questions of liability are resolved under the business judgment rule, a doctrine created by the courts and not mentioned expressly in any provision of the Delaware corporate statutes. For a general discussion of the business judgment rule, see Peter V. Letsou, *Implications of Shareholder Diversification on Corporate Law: The Case of the Business Judgment Rule*, 77 CHI.-KENT L. REV. 179 (2001). The Model Business Corporation Act also leaves questions of management liability largely to the courts, although unlike Delaware, the Act includes a statutory version of the business judgment rule based on general standards, such as "good faith," "material interest," "reasonabl[e] belie[f]" and proximate cause, to be applied by the courts on a case-by-case basis. See MODEL BUS. CORP. ACT § 8.31 (2007) [hereinafter MBCA].

42. The right of shareholders to freely transfer their shares is implicit in traditional corporation statutes. In general, corporation statutes do not expressly grant shareholders the right to sell their shares, but that right is implied from explicit provisions that identify the circumstances under which the sale of shares can be restricted. See, e.g., DEL. CODE ANN. tit. 8, § 202 (2009); MBCA § 6.27.

thereby eliminating (or at least reducing) the potential profits from an acquisition of control. The power to sell shares is also an important constraint on managerial action because excessive sales of shares will drive stock prices down, thereby decreasing any managerial compensation that is tied, directly or indirectly, to stock price.⁴³

4. The Debate over the Effectiveness of Constraints

Much of the debate over the effectiveness of state corporate governance rules in the United States turns on an analysis of how effective these (and other) devices are in constraining the exercise by managers of their powers to control the corporation. Some critics of state corporate governance rules point to the apparent laxity of modern corporation statutes, which they say prevent devices such as shareholder voting from functioning as effective checks on managers.⁴⁴ But others defend state corporate governance rules, contending that these limitations are appropriate and necessary to keep the costs of these devices from exceeding the benefits.⁴⁵ The following provides a sample of the debate with respect to the three basic constraints on director action discussed immediately above.

a. State Law Voting Rights

State law shareholder voting rights are limited in their usefulness as constraints on managerial conduct for a variety of reasons. First and foremost, in the case of a public corporation with thousands upon thousands of geographically dispersed shareholders, it is extremely expensive for shareholders to communicate with one another, thereby making it difficult for dissatisfied shareholders to communicate their dissatisfaction to others.⁴⁶ Second, even if shareholders can overcome these costs of communication, shareholders—particularly those with a limited financial stake in the firm—face credibility issues that make it difficult for them to convince other shareholders to vote with them,

43. For a discussion of the link between executive compensation and managerial incentives, see RIBSTEIN & LETSOV, *supra* note 1, § 7.02.

44. See, e.g., William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

45. See, e.g., Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

46. See, e.g., John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 849 (1999) (noting that the costs of communication and coordination for shareholders rise in proportion to the number of shareholders).

rather than with management; in general, shareholders—like most people—prefer the devil they know to the one they do not.⁴⁷ Third, most ordinary shareholders will be largely apathetic about shareholder voting, since the financial consequences of any vote for any individual shareholder will generally be small.⁴⁸ As a result, the typical shareholder will ignore communications from his fellow shareholders and adopt the simple strategy of either voting as management recommends or not at all, except in the most extreme instances. Finally, as discussed above,⁴⁹ many corporate charters include limitations that make it difficult for shareholders to convene meetings, or to otherwise act without management consent, and provide management with advance notice of potential shareholder action, leaving management with ample time to plan and react. Consequently, shareholder voting may, in fact, function as a check on managerial misconduct, but only in the most extreme instances.

There are, of course, responses to this critique of shareholder voting. One common response focuses on the fact that, in many firms, particularly larger ones, institutional investors—like insurance companies, pension funds, mutual funds, and hedge funds—own a large percentage of the stock (often greater than 50%). This means that attracting an influential block of shares to a dissident shareholder's position may not be as difficult as it first appears, for at least two reasons: first, institutional shareholders own larger blocks of stock and therefore do not face the same credibility problems that affect shareholders with lesser stakes; and second, institutional shareholders have greater resources to devote to shareholder communications and, in any case, may need to communicate only with a relatively small number of other institutional investors to secure the support of a majority (or at least a substantial portion) of the firm's shares.⁵⁰ Disney Corporation provides a particularly

47. See, e.g., William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1388 (2007) (discussing evidence that an activist shareholder's credibility in a proxy contest increases with the percentage of voting shares held by, or allied with, the initiating activist).

48. For a concise statement of the rational apathy problem, see Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1745 (2006).

49. See *supra* note 32 and accompanying text.

50. The potential for institutional activism to act as a check on managerial misconduct received considerable attention in the 1990s. See, e.g., MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990). Some, however, took a more skeptical view of institutional activism, questioning whether increased levels of

noteworthy example of successful shareholder activism. In 2004, dissident Disney shareholders, led by former Disney directors Roy Disney and Stanley Gold, were able to convince shareholders owning 43% of the corporation's stock to withhold support for the re-election of Michael Eisner as Chairman of the Disney board, leading to Eisner's immediate replacement as board Chairman by former U.S. Senator George Mitchell and, in 2005, to Eisner's resignation as Disney CEO.⁵¹ However, it certainly remains true that outright victories by dissident shareholders and even indirect victories, as in Disney, are extremely rare.

b. Shareholder's Derivative Suit

The shareholder's derivative suit is limited in its capacity to constrain managerial decision-making by both statutory and judicial doctrines. These doctrines make it difficult not only for shareholders to prevail in derivative suits, but also to commence such cases in the first place, particularly when the alleged misconduct does not involve conflicts of interest. The shareholder's derivative suit effectively permits a single shareholder to take control of the corporation's right to litigate, even when the particular shareholder's interest in the corporation is small, perhaps as little as a single share.⁵² Accordingly, state corporation laws include a variety of constraints to prevent shareholders and their attorneys from using the derivative suit in cases where the costs to the corporation may exceed the benefits. These constraints include doctrines that limit the shareholder's ability to commence and continue a derivative suit (known as standing

institutional ownership would necessarily result in improved corporate governance. *See, e.g.*, STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 514–15 (2003); Roberta Romano, *Less is More: Making Shareholder Activism a Valuable Mechanism of Corporate Governance*, 18 *YALE J. ON REG.* 174 (2001); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 *COLUM. L. REV.* 795 (1993); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 *GEO. L.J.* 445 (1991).

51. *See* Laura M. Holson, *Defied in Vote, Disney Leader Loses One Post*, *N.Y. TIMES*, March 4, 2004, at A1; Eric Dash, *Eisner Takes a Bow Without the Curtain Call*, *N.Y. TIMES*, March 14, 2005, at A19.

52. *See, e.g.*, DEL. CT. C.P.R. 23.1 (providing that a derivative complaint must allege that "the plaintiff was a shareholder," without specifying any minimum ownership requirement); *see also* HENN & ALEXANDER, *supra* note 2, at 1054 (noting that "[t]he size of the plaintiff's holding is usually immaterial" in determining whether a plaintiff can commence and continue a derivative suit).

requirements),⁵³ as well as substantive legal doctrines that provide special defenses to corporate managers who are charged with misconduct. Key among these requirements and defenses are the demand requirement and the business judgment rule.

The demand requirement is a rule that requires that the shareholder first present the proposed litigation to the corporation's board of directors to provide the corporation's management with an opportunity to address the alleged misconduct, perhaps by commencing its own lawsuit.⁵⁴ But making demand on the board generally means that the shareholder-plaintiff will be barred from commencing the litigation, because boards of directors, when asked, almost invariably determine that the shareholder-proposed litigation is contrary to the best interests of the corporation,⁵⁵ a judgment courts will typically accept as a basis for blocking the litigation should the shareholder nonetheless elect to proceed with the derivative suit after the demand has been rejected.⁵⁶ Therefore, in order to get a derivative case to court, the shareholder commencing the suit must generally convince the court that demand should be excused.⁵⁷ In most jurisdictions, courts may excuse a demand if the court determines that demand is "futile"; however, establishing futility is no easy task.⁵⁸ For example, for demand to be excused as futile in Delaware, the plaintiff must plead "particularized facts" creating a "reasonable doubt . . . that (1) the directors are disinterested and independent [or] (2) the challenged decision was otherwise the

53. For a general discussion of standing requirements related to derivative litigation, see HENN & ALEXANDER, *supra* note 2, §§ 361–67. See also JAMES D. COX & THOMAS LEE HAZEN, *CORPORATIONS* §§ 15.04–11 (2d ed. 2003); RIBSTEIN & LETSO, *supra* note 1, §§ 10.03–05.

54. See HENN & ALEXANDER, *supra* note 2, § 365; see also COX & HAZEN, *supra* note 53, § 15.05; RIBSTEIN & LETSO, *supra* note 1, § 10.05.

55. Cf. COX & HAZEN, *supra* note 53, at 431 & n.15 (noting that "instances are rare when the board of directors approves of the action *and* does not authorize the corporation's counsel to take over the suit" (emphasis in original)).

56. See COX & HAZEN, *supra* note 53, at 429 (noting that "[c]ourts have often said that the question of whether to sue is within the directors' discretion, and that if they act in good faith, their refusal is binding," citing, among other cases, *Burks v. Lasker*, 441 U.S. 471 (1979)); see also *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 n.10 (Del. 1981) (stating that "when stockholders, after making demand and having their suit rejected, attack the board's decision as improper, the board's decision falls under the 'business judgment' rule and will be respected if the requirements of the rule are met").

57. See COX & HAZEN, *supra* note 53, at 431 ("[M]ost derivative suits arise where the plaintiff has successfully pleaded facts that excuse any demand on the board of directors.").

58. See generally HENN & ALEXANDER, *supra* note 2, § 365; COX & HAZEN, *supra* note 53, § 15.05; RIBSTEIN & LETSO, *supra* note 1, § 10.05.

product of a valid business judgment.”⁵⁹ Where the challenged conduct involves self-dealing or a similar conflict of interest, establishing demand futility will not pose insurmountable obstacles; the plaintiff need only show that the conflict of interest tainted at least half of the directors, either because at least half of the directors were similarly conflicted or because the conflicted directors dominated or controlled enough of the other directors to leave the board without a disinterested majority.⁶⁰ But in the absence of such a tainted board, establishing demand futility is all but impossible, both because the “particularized facts” required by the Delaware demand-excuse standard are very difficult to come by, and because the business judgment rule (discussed immediately below) defines the range of valid non-reviewable business judgments by disinterested directors extremely broadly to include all but the most egregious decisions.⁶¹ Accordingly, cases excusing demand on this latter basis are extremely rare.

Even if a plaintiff in a derivative suit is able to overcome the demand requirement (along with the other shareholder standing requirements that apply to derivative actions),⁶² the plaintiff still faces a difficult burden at trial. In Delaware, and throughout the United States, directors and officers sued by the shareholders in a derivative suit can avail themselves of a defense known as the business judgment rule. This defense essentially bars judicial second-guessing

59. *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984). The two-pronged *Aronson* test only applies when the board that made the challenged business decision is also the board on which demand will be made. When a majority of the directors has been replaced following the challenged decision, or where the subject matter of the derivative suit is not a business decision of the board, the Delaware courts restrict themselves to examining whether “the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations.” *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993). Accordingly, the court “must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.” *Id.*

60. *See Grimes v. Donald*, 673 A.2d 1207, 1217 (Del. 1996) (explaining that the first prong of the *Aronson* test could be satisfied by showing either that “(1) a majority of the board has a material financial or familial interest” or “(2) a majority of the board is incapable of acting independently for some other reason such as domination or control”). Subsequent decisions, including *Beam v. Martha Stewart*, 845 A.2d 1040 (Del. 2004), make clear that the first prong of *Aronson* will be satisfied if *at least half* of the board is not independent. However, the latter case also demonstrates the difficulty of challenging director independence based on personal or social relationships, as opposed to economic or family ties.

61. *See infra* notes 62–67 and accompanying text.

62. *See sources cited supra* note 53.

of managerial business decisions, except in extraordinary cases.⁶³ To overcome the protections of the business judgment rule (and thereby enable courts to assess the fairness of the challenged transaction or decision), plaintiffs must generally establish (1) that the challenged decision-maker (typically the board of directors or a committee of the board) lacked a disinterested majority,⁶⁴ (2) that the board was grossly negligent in informing itself before making its decision,⁶⁵ or (3) that *no* reasonable person could have concluded that the challenged transaction or decision was consistent with the best interests of the corporation and the shareholders.⁶⁶ As a result of these substantial protections of the business judgment rule, even in the relatively few cases involving disinterested business decisions (i.e., cases where a board has a disinterested majority) where demand has been excused, few shareholders are able to carry their burden at trial of showing a lack of business judgment protection for the challenged transaction or decision by a preponderance of the evidence.⁶⁷

63. See generally HENN & ALEXANDER, *supra* note 2, § 242; COX & HAZEN, *supra* note 53, § 10.01; RIBSTEIN & LETSOU, *supra* note 1, § 9.03.

64. For leading decisions on establishing the presence or absence of a disinterested majority of directors, see *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993); *Cinerama v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995); and *Beam v. Martha Stewart*, 845 A.2d 1040 (Del. 2004). Cf. MBCA § 8.60.

65. The leading case on the board's duty to inform itself before acting is *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). Although *Van Gorkom* held that Trans Union's directors had breached their duty to make an informed decision before approving the sale of the corporation to a third party, subsequent cases have made clear that the duty to be informed may not be as demanding as *Van Gorkom* initially suggested. See, e.g., *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 767 (Del. Ch. 2005) (distinguishing the relatively strict duty in *Van Gorkom* on the basis that the transaction in *Van Gorkom* was "orders of magnitude more important" than the typical business decision), *aff'd*, 906 A.2d 27 (Del. 2006).

66. See *Brehm v. Eisner*, 746 A.2d 244, 265 (Del. 2000) (complaint failed to show business judgment rule did not apply because, among other things, it "[did] not allege with particularity facts tending to show that no reasonable business person would have made the decision that the [board] made under [the] circumstances"); see also *Gagliardi v. TriFoods International, Inc.*, 683 A.2d 1049, 1051–52 (Del. Ch. 1996) ("There is a theoretical exception to this general statement that holds that some decisions may be so 'egregious' that liability for losses they cause may follow even in the absence of proof of conflicts of interest or improper motivation. The exception, however, has resulted in no awards of money judgments against corporate officers or directors in this jurisdiction . . .").

67. Indeed, even if either of these showings could be made, liability for monetary damages might still be avoided if the corporation's certificate of incorporation included a provision eliminating or limiting personal liability of directors for monetary damages under DEL. CODE ANN. tit. 8, § 102(b)(7) (2009). See *Lyondell Chemical Corp. v. Ryan*, 970 A.2d 235 (Del. 2009) (directors who may not have adequately informed themselves before selling company protected by § 102(b)(7) charter provision absent a showing that directors acted in

Again, an example from the Disney Corporation illustrates the point. In 1996, Disney dismissed its president, Michael Ovitz, after only thirteen months on the job. Disney paid Michael Ovitz a severance package alleged to be worth approximately \$140 million for those thirteen months of service. Yet even with this extraordinary amount of severance pay, shareholders who commenced a derivative suit on the corporation's behalf had a very difficult time even obtaining a trial on their claim that Disney's directors had breached their duty to the corporation by, among other things, approving Ovitz's employment contract and agreeing to a non-fault termination. When the Delaware Chancery Court first heard the case in 1998 (well before the Enron/WorldCom debacle), it concluded that the complaint failed to create a reasonable doubt as to whether Disney's decision to approve Ovitz's employment contract was protected by the business judgment rule, because, among other things, the court could not conclude that no reasonable person would have agreed to a contract with such a high level of severance pay.⁶⁸ While the plaintiffs ultimately obtained a trial on the merits of their claim after the Delaware Supreme Court gave the plaintiffs a chance to replead their case with additional facts⁶⁹ and (following the Enron/WorldCom debacle) the Chancery Court agreed that the particularized facts alleged were sufficient to excuse demand,⁷⁰ in the end the trial judge ruled against the plaintiffs on all counts, finding, among other things, that the decisions to approve Ovitz's employment contract and to terminate him without cause were protected by the business judgment rule.⁷¹ In affirming the Chancery Court's decision, the Delaware Supreme Court concluded that the extraordinary amounts required to be paid to Ovitz under his employment contract did not constitute waste and that the processes followed by Disney's compensation committee and board in approving that contract, while far from perfect, were not legally defective.⁷² Accordingly, like shareholder

bad faith; to establish bad faith, plaintiffs must show that directors were aware of their duty and intentionally violated it).

68. *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342 (Del.Ch. 1998), *aff'd in part, rev'd in part*, *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

69. *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

70. *In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. 2003).

71. *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

72. *In re The Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 55–62, 73–75 (Del. 2006).

voting, the derivative suit may function as a check on managerial misconduct, but only in the most extreme cases.

Of course, some argue that the derivative suit, and potential managerial liability, must be limited to prevent shareholders (particularly those with limited financial stakes in the firm) and their attorneys from using the derivative suit in cases where the costs to the corporation might exceed the benefits.⁷³ The costs to the corporation of derivative litigation include such things as the distraction of management while the litigation is pending, as well as the costs and expenses of both the plaintiffs (if they obtain a substantial benefit for the corporation as a result of the derivative suit)⁷⁴ and of the defendants (if the defendants prevail or there is a settlement without an adjudication of liability),⁷⁵ while the benefits include the amounts paid to the corporation as a result of the action and/or the value of any non-monetary relief. The risk of “bad” derivative suits (i.e., those where the costs to the corporation exceed the benefits) arises largely because of the potential for so-called strike suits where an attorney may bring an action, with little factual basis and little chance of success (and therefore little value to the corporation), in the hope of extracting a settlement from the defendant directors and officers. Despite the fact that such cases impose net costs on the corporation, defendants may be willing to pay a modest amount to settle such claims (thus justifying a fee award for the plaintiff’s counsel) rather than be bothered with the litigation,⁷⁶ particularly when all or part of the amount to be paid in settlement (if anything) will be covered by insurance and the defendants’ attorneys’ fees in negotiating the settlement will be paid by the corporation. In addition, if it were too easy to sue corporate managers whenever a decision turned out badly,

73. See, e.g., BAINBRIDGE, *supra* note 50, § 8.3; see also RIBSTEIN & LETSOU, *supra* note 1, § 10.01[C].

74. See HENN & ALEXANDER, *supra* note 2, § 377 (discussing rules related to the corporation’s payment of the plaintiff-shareholder’s litigation expenses).

75. *Id.* §§ 379–80 (discussing the indemnification by the corporation of the litigation expenses incurred by directors and officers).

76. Thompson and Thomas trace the focus on the potential for strike suits to a 1944 study by Franklin Wood, see FRANKLIN S. WOOD, SURVEY AND REPORT REGARDING STOCKHOLDERS’ DERIVATIVE SUITS (1944), which reported that derivative suits in the 1930s and early 1940s were largely frivolous. Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1758 (2004). Thompson and Thomas attribute the emergence of restrictions on derivative suits, including the requirement for a bond to be posted by the plaintiff and, more recently, the demand requirement, to this concern with strike litigation. *Id.*

perhaps due to bad luck rather than bad judgment, managers might be dissuaded from taking the kinds of business risks that diversified shareholders in business corporations often prefer them to take.⁷⁷

c. Market for Corporate Control

Finally, the ability of shareholders to sell their shares to hostile bidders who might displace poorly performing managers is impaired by the powers of directors to unilaterally erect obstacles—including so called “poison pills”—which make takeovers by bidders who have not received prior approval from incumbent management difficult or, in the case of state-of-the-art poison pills, practically impossible.⁷⁸ Courts that have scrutinized these antitakeover measures, particularly in Delaware, have consistently upheld them.⁷⁹ And, in many instances, state legislatures have amended their corporate statutes to make clear that directors are, in fact, authorized to act unilaterally (without explicit shareholder approval) to adopt devices that make hostile takeovers more difficult.⁸⁰

Again, there are responses from those who would defend state corporate law and the vitality of the market for corporate control. First, these antitakeover measures may not be as insurmountable as they at first appear. In fact, while the directors of public corporations have had clear authority to implement poison pill takeover defenses for more than two decades, hostile takeover bids still occur even if

77. See Peter V. Letsou, *Implications of Shareholder Diversification on Corporate Law: The Case of the Business Judgment Rule*, 77 CHI.-KENT L. REV. 179 (2001).

78. For a general discussion of the history and evolution of poison pills, see Peter V. Letsou, *Are Dead Hand (and No Hand) Poison Pills Really Dead?*, 68 U. CIN. L. REV. 1101, 1104–22 (2000).

79. See, e.g., *Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985) (upholding one of the earliest poison pills and opening the door to widespread adoption of the device). Only the most extreme forms of poison pills have been rejected. See, e.g., *Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998) (no-hand poison pill); *Carmody v. Toll Brothers, Inc.*, 723 A.2d 1180 (Del. Ch. 1998) (dead hand poison pill). Ordinary poison pills can be redeemed (i.e., cancelled) by a bidder who captures control of a corporation’s board of directors, while no-hand and dead-hand poison pills cannot.

80. See, e.g., 15 PA. CONS. STAT. ANN. § 2513 (expressly permitting the adoption of both flip-over and flip-in poison pills, which generally take the form of “shareholders rights plans,” i.e., contracts giving shareholders the right to purchase new securities upon the occurrence of certain triggering events, such as a hostile bidder’s acquisition of a specified percentage of a firm’s shares). In *AMP, Inc. v. Allied Signal, Inc.*, 1998 WL 778348, No. Civ. A. 98-4058, Civ. A. 98-4109, Civ. A. 98-4405 (E.D. Pa. 1998), the court used 15 PA. CONS. STAT. ANN. § 2513 as a basis for upholding a no-hand poison pill similar to the one rejected by the Delaware Supreme Court in *Quickturn Design Systems*, 721 A.2d 1281.

somewhat less frequently than in the past.⁸¹ In many of those successful takeovers, incumbent managers voluntarily dismantle the defenses when market and shareholder pressures to yield to the bid become too great.⁸² Second, it may be necessary to limit the threat of hostile takeovers by making them a bit more difficult because managers and other employees who fear they might be easily removed from office as a result of a takeover bid might be dissuaded from making the types of firm-specific investments in their own skills that benefit corporations in the long-term.⁸³

B. The Role of the Federal Government

In the late nineteenth century and the early part of the twentieth century, as the corporate form was becoming increasingly popular in the United States, the role of the states in regulating the internal governance of corporations was exclusive, even for larger firms with a greater impact on the national economy. During this early era of corporate law, the federal role was largely limited to controlling the outward conduct of corporations through such devices as antitrust and trade regulation, labor laws, and corporate reorganization and taxing statutes.⁸⁴ However, this state of affairs began to change as part of the government's response to the 1929 Stock Market Crash and the Great Depression, in particular with the adoption of the Securities Act of 1933,⁸⁵ the Securities Exchange Act of 1934,⁸⁶ and the creation, under the latter statute, of the United States Securities and Exchange Commission. This section of the Article briefly describes each of

81. A recent high-profile example is Microsoft's \$44 billion (unsuccessful) hostile bid for Yahoo. See Miguel Helft & Andrew Ross Sorkin, *Eyes on Google, Microsoft Bids \$44 Billion for Yahoo*, N.Y. TIMES, Feb. 2, 2008, at A1.

82. A recent example is PeopleSoft's ultimate surrender to Oracle. Oracle launched its hostile bid for PeopleSoft on June 9, 2003, with an offer of \$16 per share. PeopleSoft defended vigorously, declining to redeem its poison pill and instituting a customer protection plan designed to frustrate Oracle's plans to discontinue the sale of certain PeopleSoft products after a successful takeover. Despite the vigorous resistance, PeopleSoft finally surrendered in January 2005, after Oracle had increased its original bid of \$16.00 per share to \$26.50 per share. For more detailed information on Oracle's bid for PeopleSoft, see LETSOU, *supra* note 32, § 3.2.

83. See David D. Haddock, Jonathan R. Macey, & Fred S. McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701 (1987).

84. See HENN & ALEXANDER, *supra* note 2, at 27.

85. Act of May 27, 1933, ch. 38, 48 Stat. 74, (codified as amended at 15 U.S.C. §§ 77a-77z-3 (2000))[hereinafter Securities Act of 1933].

86. Act of June 6, 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78nn (2000)) [hereinafter Securities Exchange Act of 1934].

these statutes, as well as the limited role as a corporate governance regulator originally created for the SEC.

1. The Securities Act of 1933

One of the first statutory responses to the 1929 Stock Market Crash, the Securities Act of 1933 (the 1933 Act) had both a limited focus and a limited impact on corporate governance. Without going into detail, the Securities Act of 1933 was designed primarily to prevent the recurrence of the speculative frenzy in stock purchases that had marked the 1920s.⁸⁷ The idea underlying the Securities Act of 1933 was not to change the state law rules that governed the management of corporations, but instead to ensure that the investors who purchased securities did so only after receiving full information about the company's management, its business, its properties, and its finances, that is, only after learning the "truth" about the securities.⁸⁸ Consequently, instead of tinkering with the internal governance of corporations, or limiting the types of securities that could be offered or sold to the public, the 1933 Act focused its attention single-mindedly on disclosure. Under the 1933 Act, corporations would be permitted to continue to issue securities to the public whenever they wished, and on terms of their own choosing, but only if they provided full and fair disclosure to prospective investors before the investment decision was made. Toward that end, the 1933 Act (as originally adopted)⁸⁹ did three things: first, it required issuers of securities to prepare and file with federal securities regulators (originally the Federal Trade Commission, but later the SEC) a detailed registration statement with extensive disclosures about the company, its business, its management, its properties and its financial affairs;⁹⁰ second, it mandated that the prospectus prepared as part of that registration statement be distributed to all investors who received written offers of sale or to whom securities were sold;⁹¹ and third, it limited the use of

87. See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 1.2[3](6th ed. 2009).

88. The 1933 Act is sometimes referred to as the "Truth in Securities" Act. See Milton H. Cohen, *"Truth in Securities" Revisited*, 79 Harv. L. Rev. 1340 (1960).

89. The original text of the 1933 Act can be found in H.R. REP. NO. 152 (1933) (Conf. Rep.) [hereinafter 1933 ACT CONFERENCE REPORT].

90. See Securities Act of 1933, § 5(a)(1), reprinted in 1933 ACT CONFERENCE REPORT, *supra* note 89, at 5.

91. See Securities Act of 1933, § 5(b), reprinted in 1933 ACT CONFERENCE REPORT, *supra* note 89, at 5.

non-statutory sales materials until the statutory prospectus had been provided.⁹² In addition, to ensure the accuracy of the registration statement and statutory prospectus, the law subjected all those connected with the offering—the company itself, its directors and principal officers, and the underwriters, securities dealers, and accountants associated with the offering—to legal liability if information in the registration statement and prospectus proved to be materially inaccurate or incomplete.⁹³ The purpose of this regime was to ensure that all investors who were offered securities made their investment decision based on sober, complete information prepared in compliance with the federal securities laws, rather than on the basis of unsupported (and possibly unsupportable) hype of unaccountable corporate promoters.

The statute and related rules are, of course, far more complicated than this, but the key point for present purposes is that the Securities Act of 1933 did not give the federal authorities any substantial power to set standards of corporate governance; that power remained, as it always had been, with the states. Therefore, the federal government's response to the 1929 Stock Market Crash and the Great Depression, at least in the Securities Act of 1933, was not to directly change the way corporations were governed, but to ensure that all relevant facts about the corporation, including information necessary to assess the quality of its management, were made available to potential investors. This is not to say, however, that the 1933 Act had no impact on corporate governance. It almost certainly did, but that impact was indirect. Because of the disclosure obligations imposed on management under the Act, management undoubtedly had an incentive to avoid management arrangements that might appear questionable to shareholders if disclosed.⁹⁴ Also, because the 1933 Act required

92. See Securities Act of 1933, §§ 2(10)(a) & 5(b), *reprinted in* 1933 ACT CONFERENCE REPORT, *supra* note 89, at 2–3, 5. The statute's operation has been significantly modified since its adoption in 1933, both by statutory amendments and by SEC rules. See *infra* notes 96–97 and accompanying text.

93. See Securities Act of 1933, § 11, *reprinted in* 1933 ACT CONFERENCE REPORT, *supra* note 89, at 9–11.

94. Along these lines, it is worth noting that several of the disclosures for registration statements suggested in the 1933 Act relate to information that is more likely to be embarrassing than economically significant, thus giving issuers an incentive to structure their affairs to avoid or minimize these disclosures. See, for example, the following items from Schedule A to the Securities Act of 1933 (*reprinted in* 1933 ACT CONFERENCE REPORT, *supra* note 89, at 16–17 (emphasis added)): “(14) the remuneration, paid or estimated to be paid, by the issuer or its predecessor, directly or indirectly, during the past year and ensuing year to (a) the directors or persons performing similar functions, and (b) its officers and other persons,

underwriters and accountants to, in effect, certify the information in the registration statement through the liability provisions in section 11,⁹⁵ dishonest or less competent managers faced higher hurdles in hiring the professionals necessary to assist in a public offering than they had in the past.

The regulatory scheme established by the Securities Act of 1933 has undergone considerable change since it was first adopted. Some of these changes have resulted from statutory amendments,⁹⁶ but the most dramatic changes have been effected through SEC rulemaking.⁹⁷ However, much of the original statutory scheme for public offerings established in 1933 remains in place today, particularly for companies that are conducting their first public offerings and for companies that have been public for a relatively short time or have relatively few shares in public hands.⁹⁸

naming them wherever such remuneration exceeded \$25,000 during any such year”; “(20) any amount paid within two years preceding the filing of the registration statement or intended to be paid to any promotor and the consideration for any such payment”; “(21) the names and addresses of the vendors and the purchase price of any property, or good will, acquired or to be acquired, *not in the ordinary course of business*, which is to be defrayed in whole or in part from the proceeds of the security to be offered”; and “(22) full particulars of the nature and extent of the interest, if any, of every director, principal executive officer, and of every stockholder holding more than 10 per centum of any class of stock or more than 10 per centum in the aggregate of the stock of the issuer, in any property acquired, *not in the ordinary course of business of the issuer*, within two years preceding the filing of the registration statement or proposed to be acquired at such date.”

95. Securities Act of 1933, § 11, *reprinted in 1933 ACT CONFERENCE REPORT*, *supra* note 89, at 9–11.

96. For example, in 1954, Congress significantly altered the operation of the 1933 Act by adding subsection (c) to 15 U.S.C. § 77e, which includes a bar on oral offers prior to the filing of a registration statement, and by making related changes to 15 U.S.C. § 77j(b) and 15 U.S.C. § 77e(b)(1) to permit the use of preliminary prospectuses after a registration statement has been filed but before it becomes effective. 1954 Amendments to the Securities Act of 1933, Pub. L. No. 83-577, 68 Stat. 683 (1954). Prior to the 1954 amendments, the statute did not permit any offers or sales before the registration statement became effective.

97. In 1996, the SEC received broad authority to “conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title.” Pub. L. No. 104-290, § 105, 110 Stat. 3424 (1996) (codified at 15 U.S.C. § 77z-3 (2000)). Acting pursuant to that authority, the SEC adopted expansive rule changes in 2005 designed to greatly streamline the registration and prospectus delivery process, particularly for issuers who file periodic reports under the 1934 Act. *See* Securities Offering Reform, SEC Release No. 33-8591, 70 Fed. Reg. 44,722 (Aug. 3, 2005).

98. These latter types of issuers were not as dramatically impacted by the 2005 reforms mentioned in the immediately preceding footnote.

2. *The Securities Exchange Act of 1934*

The first major response of the federal government to the 1929 Stock Market Crash, the Securities Act of 1933 did not stand alone for long. Indeed, its adoption was followed, one year later, by far more extensive regulation of securities transactions under the Securities Exchange Act of 1934 (the 1934 Act).⁹⁹ Unlike the Securities Act of 1933, which dealt almost exclusively with initial distributions of securities to the public, the Securities Exchange Act of 1934 focused on secondary trading in public securities markets. But while the focus of the two statutes was different, the two statutes had similar goals and took similar, though not identical, steps toward achieving those goals. To ensure that investors in public markets could have confidence in the markets themselves, and in the prices generated by those markets, the 1934 Act—like the 1933 Act—relied, at least in part, on disclosure. Companies whose securities were listed for trading on a national securities exchange would have to register those securities with the SEC and comply with certain SEC rules.¹⁰⁰ Central among these rules was the requirement that all public companies file “[s]uch annual reports, certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports, as the Commission may prescribe.”¹⁰¹ The annual report, known now as a 10-K,¹⁰² includes the same type of detailed information about a company, its business, its management, and its finances as is included in a registration statement for a public offering prepared under the 1933 Act; quarterly reports, known now as 10-Qs,¹⁰³ update this annual information, though these quarterly reports are far less extensive than the required annual reports and need not be certified by independent accountants. To ensure the accuracy of these reports, the statute permitted lawsuits against “any person,” including the company’s outside accountant, “who shall make or cause to be made any statement in any . . . report . . . filed pursuant to this title . . . , which statement was at the time and

99. Securities Exchange Act of 1934, *supra* note 86. The original text of the 1934 Act can be found in H.R. REP. NO. 1838 (1934) (Conf. Rep.) [hereinafter 1934 ACT CONFERENCE REPORT].

100. See Securities Exchange Act of 1934, § 12(a), *reprinted in* 1934 ACT CONFERENCE REPORT, *supra* note 99, at 13.

101. See Securities Exchange Act of 1934, § 13(a), *reprinted in* 1934 ACT CONFERENCE REPORT, *supra* note 99, at 15.

102. 17 C.F.R. § 249.310 (2009).

103. 17 C.F.R. § 249.308a (2009).

in the light of the circumstances under which it was made false or misleading with respect to any material fact.”¹⁰⁴

Unlike the 1933 Act, however, the 1934 Act did not rely exclusively on disclosure regulation to solve the problems that plagued U.S. corporations and U.S. securities markets in the 1930s. Instead, the statute went beyond the periodic disclosure requirements briefly described above and included, among other things, requirements that national securities exchanges register with the SEC and abide by SEC rules.¹⁰⁵ The statute also expressly limited certain practices thought to have been important causes of the 1929 Stock Market Crash, including lending for the purposes of purchasing securities,¹⁰⁶ borrowing by securities brokers and dealers,¹⁰⁷ and manipulative practices,¹⁰⁸ such as wash sales. Most importantly for purposes of this Article, however, the 1934 Act also took steps, in particular the authorization of federal proxy rules,¹⁰⁹ to respond to academic critics of corporate governance—most prominently Columbia and Harvard Professors Adolph Berle and Gardiner Means, whose 1932 book, *The Modern Corporation and Private Property*,¹¹⁰ had revolutionized thinking about corporate America.

Berle and Means argued that at least part of the problem with American corporations in the 1930s could be traced to their control by corporate managers who were not themselves constrained to act as owners would act. Managers of modern corporations could not be expected to act as owners themselves would act because the managers lacked a significant ownership interest in the firm, while the actual owners—the shareholders—could not be expected to actively monitor

104. See Securities Exchange Act of 1934, § 18(a), reprinted in 1934 ACT CONFERENCE REPORT, *supra* note 99, at 18.

105. See Securities Exchange Act of 1934, § 6, reprinted in 1934 ACT CONFERENCE REPORT, *supra* note 99, at 5–6. In addition, under Securities Exchange Act of 1934, § 15, reprinted in 1934 ACT CONFERENCE REPORT, *supra* note 99, at 16, the SEC was empowered to regulate over-the-counter securities markets if it determined such regulation was “necessary or appropriate in the public interest.”

106. See Securities Exchange Act of 1934, § 7, reprinted in 1934 ACT CONFERENCE REPORT, *supra* note 99, at 7–8.

107. See Securities Exchange Act of 1934, § 8, reprinted in 1934 ACT CONFERENCE REPORT, *supra* note 99, at 8–9.

108. See Securities Exchange Act of 1934, § 9, reprinted in 1934 ACT CONFERENCE REPORT, *supra* note 99, at 9–10.

109. See Securities Exchange Act of 1934, § 14(a), reprinted in 1934 ACT CONFERENCE REPORT, *supra* note 99, at 15.

110. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

the firm's managers because of the small size of their individual ownership stakes, their geographic dispersal, and their limited access to information about the corporation and the performance of management. As a result, Berle and Means concluded that the American corporation of the 1930s was marked by a separation of *ownership* by shareholders from *control* by managers that could result in corporations being run in the private interests of the firm's managers, rather than in the interest of the owners. In Berle and Means's view, owner-run firms could be trusted to act in the public interest because, at least in the ideal world, the owners would be guided by Adam Smith's invisible hand to use the vast resources held in the corporate form to society's advantage. But management-controlled firms operated with no such constraint, leading to the danger that managers with control over vast corporate assets would use them, not in society's interests, but in the managers' own personal interests. In effect, Berle and Means saw the rise of the modern public corporation, and the related separation of ownership and control, as disrupting the basic market forces that in earlier eras guided the use of private property in the public interest.

Influenced by the work of Berle and Means, the drafters of the Securities Exchange Act of 1934 took the first steps at the federal level to change the ways in which public corporations were governed, and in the process introduced the two-tiered state-federal system of corporate governance regulation that the United States still has today. These first federal steps into corporate governance regulation were limited largely to a single subsection in the 1934 Act, designed primarily to improve shareholder voting: section 14(a) of the statute, which made it "unlawful for any person, . . . in contravention of such rules as [the SEC] may prescribe . . . , to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security registered [under the 1934 Act]."¹¹¹ With this single subsection, Congress granted the SEC authority to control the methods and processes by which public corporations communicated with their shareholders. This power over the proxy solicitation process by no means authorized the SEC to displace the states as the primary setters of corporate governance standards, but it did give the SEC a foot in the door.

111. See Securities Exchange Act of 1934, § 14(a), reprinted in 1934 ACT CONFERENCE REPORT, *supra* note 99, at 15 (emphasis added).

The SEC made quick use of its new power, adopting its first proxy rules in 1935.¹¹² These initial proxy rules, like many subsequent modifications over the last seventy-five years, attempted to address the Berle and Means critique by increasing the likelihood that shareholders would vote their shares in an intelligent and informed fashion, rather than simply granting management general discretionary authority to vote shares as management saw fit on whatever issues might come before a shareholders' meeting. The 1935 rules took just a small step towards this goal, requiring only that shareholders be given basic information identifying the various matters that management intended to present or consider at the meeting and specifying the actions management intended to take with respect to those matters.¹¹³ Subsequent revisions of the proxy rules, beginning with the 1938 amendments,¹¹⁴ strengthened the federal proxy rules in a variety of ways that are still with us today: these amendments required: (1) that shareholders be provided with greater information about the matters to be voted on at the meeting and about the identity of the person seeking the authority to act as a proxy, including any private interest of that person in the subject matter of the vote;¹¹⁵ and (2) that shareholders be given the ability to direct, in the proxy, exactly how their shares should be voted.¹¹⁶ The idea

112. SEC Release No. 34-378, 1935 WL 29270 (Sept. 24, 1935).

113. The informational requirements for proxy statements were set forth in Rule LA3(a) of the 1935 version of the SEC's proxy rules. *See id.*

114. *See Amended Proxy Rules*, SEC Release No. 34-1823, 3 Fed. Reg. 1991 (Aug. 11, 1938).

115. *See id.* at *1 ("The keystone of the new rules is the requirement that a 'proxy statement' must be sent to each person whose proxy is being solicited. These 'proxy statements,' which must meet certain standards of legibility, must set forth (a) the identity of persons soliciting the proxy, (b) the nature of the matters to be voted on under the proxy, (c) power of the security holder to revoke his proxy and the rights of dissenting stockholders, and (d) the expenses of the solicitation including all compensation paid to solicitors. In addition, certain financial data are sometimes required to be included."). Not only did the 1938 amendments introduce the formal concept of the "proxy statement," these amendments also marked the first appearance of the SEC's Schedule 14A, which sets forth detailed disclosure requirements for the particular matters to be considered at the shareholders' meeting. Specifically, Rule X-14A-1 required a proxy statement with the "information specified in such of the items of Schedule 14A, as may be applicable in the particular case." *Id.* at *3. Schedule 14A is still with us today, albeit with much more detail than in 1938, *see* 17 C.F.R. § 240.14a-101 (2009), as is the modern analogue to Rule X-14A-1, *see* 17 C.F.R. § 240.14a-3 (2009).

116. *See Amended Proxy Rules*, SEC Release No. 34-1823, 3 Fed. Reg. 1991 (Aug. 11, 1938), at *1 ("Another feature of the new rules is that the security holder who is being solicited must be given the opportunity to direct how his vote shall be cast on each of the items

underlying this scheme was to make corporate managers more responsive to the interests of the firm's owners, that is, the shareholders, to address the separation of ownership from control that Berle and Means had identified. Accordingly, even though the 1934 Act did not confer on the SEC the power to directly alter state law governance rules, the SEC was nonetheless able to use its power to prescribe proxy rules that at least nudge the balance of corporate power in the shareholders' direction.

As with the 1933 Act, this basic regulatory scheme established by the 1934 Act largely remains in place today, albeit with some significant modifications, including a vast expansion in 1964 in the number of firms covered by the SEC's rules.¹¹⁷ As a result of these changes, there are now approximately 15,000 U.S. corporations that are subject to the dual structure of governance regulation described above, with state law—particularly that of Delaware—providing the basic rules of corporate governance, and federal law largely controlling corporate disclosure and the proxy solicitation process.

Like the Securities Act of 1933, the periodic reporting and proxy rules under the Securities Exchange Act of 1934 primarily focus on regulating the disclosures required of public corporations. But, as in the case of public offering regulation under the 1933 Act,¹¹⁸ these disclosure regulations can (and do) have the indirect effect of regulating corporate governance practices. As already discussed,¹¹⁹ the SEC's proxy rules under section 14(a) of the 1934 Act, while technically regulating only the content of proxy statements and proxies, have the effect of shifting the balance of corporate power at least slightly in the direction of the corporation's shareholders. In addition, the SEC's power over periodic reporting can (and is)

under consideration.”). The formal requirement was included in Rule X-14A-2. *See id.* at *3. The modern analogue of Rule X-14A-2 is Rule 14a-4. 17 C.F.R. § 240.14a-4 (2009).

117. Initially, the 1934 Act's securities registration requirements, and the related periodic disclosure and proxy rules triggered by registration, applied only to those corporations whose shares were listed for trading on a national securities exchange, such as the New York Stock Exchange. *See* Securities Exchange Act of 1934, § 12(a), *reprinted in* 1934 ACT CONFERENCE REPORT, *supra* note 99, at 13. But in 1964 Congress extended the registration and compliance requirements under the 1934 Act to all corporations with at least 500 shareholders of record and assets in excess of \$1 million. *See* Securities Acts Amendments of 1964, Pub. L. No. 88-467, § 3(c), 78 Stat. 565, 566–67 (1964) (codified as amended at 15 U.S.C. § 78l(g) (2006)). Through rulemaking, the SEC has increased the dollar value of an issuer's assets triggering a registration obligation under section 12(g) to \$10 million. *See* 17 C.F.R. § 240.12g-1 (2009).

118. *See supra* notes 94–95 and accompanying text.

119. *See supra* notes 112–116 and accompanying text.

frequently used by the SEC to adopt “shaming” regulations. These are regulations where the SEC requires disclosure of certain categories of information, not so much because that information is useful to help value securities, but to induce public corporations to change their practices in order to avoid making disclosures that might be embarrassing or cast the company or its management in a negative light. This shaming purpose is plain from the text of the original statute, which permitted the SEC to require disclosure, not only with respect to matters of clear economic significance to shareholders, including “the organization, financial structure and nature of the business,” but also with respect to such matters as “[the] remuneration [of directors and officers] and their interests in the securities of, and their material contracts with, the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer” and the “remuneration to others than directors and officers exceeding \$20,000 per annum.”¹²⁰ As will be explored in more detail in the next subsection, the SEC has frequently used its power over disclosure to accomplish indirectly that which Congress denied it the power to do directly—regulating (or at least strongly influencing) corporate governance practices controlled in the first instance by the states.

II. THE EVOLUTION OF THE FEDERAL-STATE DIVISION OF AUTHORITY OVER PUBLIC CORPORATIONS

Although the SEC still focuses primarily on regulating disclosure, while the states focus on the substance of corporate governance practices, the relative powers of the federal government and the states have shifted over the last seventy-five years, particularly in response to corporate crises and scandals. From time-to-time over the last several decades, commentators have criticized the dominant role that the small state of Delaware has played in setting corporate governance standards for the majority of U.S. public corporations¹²¹ and called on the SEC, the federal courts, and the U.S. Congress to do more. As described below, each of these bodies has, at times, taken steps in response to these calls for an increased federal role in corporate governance regulation, but for the most part these

120. Securities Exchange Act of 1934 §§ 12(b)(1)(D) & (E), *reprinted in* 1934 ACT CONFERENCE REPORT, *supra* note 99, at 13.

121. The most serious attacks on Delaware’s dominance came during the 1970s in response to the arguments outlined in Part II.A below.

steps have been modest. More ambitious proposals—those that would cause a fundamental shift of corporate governance regulation from the states to the federal government—have been uniformly rejected. The subsections below address three topics related to the evolving roles of the state and federal governments in regulating corporate governance. These subsections discuss, first, the classic critique of state regulation of corporate governance standards; second, some of the steps that have been taken at the federal level to more greatly control the substance of corporate law; and third, some of the more dramatic steps that have been proposed—but not taken—at various times over the last century.

A. *The Classic Critique*

The classic critique of permitting the states, particularly Delaware, to act as the primary setters of corporate governance standards is that of Professor William Cary in his well known 1974 article from the Yale Law Journal, *Federalism and Corporate Law: Reflections upon Delaware*.¹²² A former Chairman of the SEC, Professor Cary argued that competition among the states for corporate charters had led to a “race for the bottom” in corporate law.¹²³ In effect, Professor Cary contended that states competed with one another to set lower and lower corporate governance standards so that corporate managers would be enticed to incorporate within their jurisdictions. Delaware won this competition by adopting the most lax governance standards of all. To support his position, Professor Cary cited examples of Delaware statutory provisions and judicial decisions he viewed as unjustifiably favorable to management.¹²⁴ These included statutory provisions, such as those permitting corporations to substitute written consents for actual shareholder meetings, as well as judicial decisions setting low standards for the directors’ duty of care. Cary contrasted these Delaware statutes and court decisions with federal cases brought under the federal securities laws, including some brought during his tenure as SEC Chairman, where the federal courts had demonstrated a much greater willingness than the Delaware courts to set rigorous standards with respect to such matters as deceptive proxy statements and duties of

122. William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974).

123. *Id.* at 666.

124. *Id.* at 669–88.

disclosure,¹²⁵ not because the federal courts were necessarily better than state courts, but because federal courts did not need to compete for business as the states did. Professor Cary used his critique as a basis to call for uniform federal standards of corporate responsibility that would apply to all public corporations, regardless of their state of incorporation.¹²⁶

Not surprisingly, Professor Cary's views have been challenged and hotly debated, particularly from the law and economics perspective. For instance, in the leading response to Professor Cary, Judge Winter argued that the same types of market forces that generally lead corporate managers to act consistently with shareholder interests, e.g., fear of ouster as a result of proxy contests or hostile takeovers and managerial concern with stock price, also discipline corporate management's selection of the state of incorporation.¹²⁷ For example, incorporation under a state law that offers terms that are unfavorable to shareholders, for instance by permitting managerial theft, will depress the stock price of firms incorporated in the state, triggering pressure by the market for corporate control for managers to change the state of incorporation. Thus, Winter argued that competition among the states for corporate charters would lead to a race to the top (in Judge Winter's words, a "tend[ency] towards optimality"),¹²⁸ not a "race for the bottom." In Judge Winter's view, states that want to attract managers to organize corporations within their borders will compete by offering corporate laws that are *favorable* (not *contrary*) to shareholder interests. In addition, others have argued that state chartering offers the additional benefit of a diversity of laws that permits shareholders and managers to choose the set of rules best suited for their particular circumstances.¹²⁹ Putting the relative merits of Professor Cary's and Judge Winter's arguments to the side, Professor Cary's views have certainly won at least some adherents among legislators and regulators, particularly in Congress and at the SEC, if not in the states.

125. *Id.* at 692–96.

126. *Id.* at 701.

127. Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

128. *Id.* at 254.

129. See, e.g., Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 921–923 (1982).

B. SEC/Congressional Forays into Corporate Governance

Responding to critiques like those of Professor Cary, the SEC and Congress have taken steps over the years at the federal level that encourage or mandate changes in corporate governance practices of public corporations. But these steps, while certainly significant, tend to be more modest reforms, rather than wholesale displacements of state corporate law. The SEC's actions, of course, must be modest because of statutory limitations on the SEC's authority; in general, the SEC is authorized to set disclosure standards for public corporations and to adopt proxy rules, but not to prescribe corporate governance standards more generally.¹³⁰ Congress, of course, can do as it pleases, but like the SEC, it too has taken more modest steps in the corporate governance arena, even in response to dramatic crises like the accounting scandals of the first years of this decade and the more recent financial crisis.¹³¹ Several examples of the increased federal role in corporate governance since 1933 follow.

a. Disclosure Regarding the Honesty and Integrity of Management

The original text of both the 1933 Act and the 1934 Act authorized the SEC to require the disclosure of information with respect to officers and directors.¹³² The SEC has long used this power to require detailed disclosures regarding the integrity of management in both registration statements filed under the 1933 and 1934 Acts and in periodic reports and proxy statements prepared under the latter statute.¹³³ The required disclosures cover such matters as self-dealing

130. See *supra* Part I.B.

131. For a discussion of current corporate governance reform proposals pending in the U.S. House of Representatives and the U.S. Senate, see *infra* note 202.

132. Securities Exchange Act of 1934, § 12(b)(1)(D), reprinted in 1934 ACT CONFERENCE REPORT, *supra* note 99, at 13 (authorizing the SEC to require disclosures “in respect of . . . the directors [and] officers”); Securities Act of 1933, sched. A, reprinted in 1933 ACT CONFERENCE REPORT, *supra* note 89, at 16–17 (authorizing the SEC to require disclosure of “the names and addresses of the directors or persons performing similar functions, and the chief executive, financial and accounting officers”). In addition to the express authority provided in Schedule A, Section 10(b)(3) of the Securities Act of 1933 authorizes the SEC to require “such other information as the Commission may by rules or regulations require as being necessary or appropriate in the public interest or for the protection of investors.” See 1933 ACT CONFERENCE REPORT, *supra* note 89, at 9.

133. The details of disclosures required in various SEC forms are set forth in the SEC's Regulation S-K, which is codified at 17 C.F.R. §§ 229.10–229.802 (2009) [hereinafter Regulation S-K].

transactions,¹³⁴ indebtedness of management to the corporation,¹³⁵ the remuneration of directors and the five most highly compensated officers (now in far greater detail than ever before),¹³⁶ and the involvement of management in certain legal proceedings—including bankruptcy proceedings, criminal matters, and certain securities laws violations—to the extent “material to an evaluation of the ability or integrity [of the director or officer].”¹³⁷ Beyond these specific disclosure items required by the SEC’s disclosure forms and Regulation S-K, the SEC has long maintained that the disclosure of illegal or unethical conduct of management may be required in order to prevent the information provided about management from becoming materially misleading.¹³⁸ These disclosure rules and policies provide good examples of the SEC’s use of “shaming” regulations to encourage changes in corporate governance practices. Among other things, these rules plainly encourage public companies to avoid conflict of interest transactions, limit the amount and form of executive compensation, and reject potential officers and directors whose backgrounds include troublesome legal matters.

b. The Shareholder Proposal Rule

Very early on in its history, the SEC adopted a rule, which has come to be known as the “Shareholder Proposal Rule.”¹³⁹ Adopted in 1942,¹⁴⁰ this rule now enables a qualifying shareholder to have a

134. Regulation S-K, Item 404, 17 C.F.R. §§ 229.404.

135. *Id.*

136. Regulation S-K, Item 402, 17 C.F.R. §§ 229.402. The SEC substantially revised its executive compensation disclosure rules in 2006, requiring, among other things, a new Compensation Discussion and Analysis, which sets forth and analyzes the material factors underlying the company’s compensation policies and decisions. *See* Executive Compensation and Related Person Disclosure, SEC Release No. 34-54302A, 71 Fed Reg. 53158 (Sept. 8, 2006).

137. Regulation S-K, Item 401, 17 C.F.R. §§ 229.401.

138. *See, e.g.*, Franchard Corp., 42 S.E.C. 163 (1964) (failure to disclose off-book loans to CEO); SEC v. Joseph Schlitz Brewing Co., 452 F. Supp. 824 (E.D. Wis. 1978) (nondisclosure of commercial kickback payments). *But see* Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981) (rejecting allegations based on Lockheed’s payment and concealment of millions of dollars of bribes and other questionable payments from 1961 to 1974 because “[a]bsent credible allegations of self-dealing[,] . . . director misconduct of the type traditionally regulated by state corporate law need not be disclosed in proxy solicitations for director elections”).

139. The current version of the Shareholder Proposal Rule can be found at 17 C.F.R. § 240.14a-8 (2009).

140. *See* Solicitation of Proxies Under the Act, SEC Release No. 34-3347, 7 Fed. Reg. 10655 (Dec. 22, 1942) (Rule X-14A-7).

proposal for shareholder action included in the proxy materials prepared by the corporation in connection with the corporation's annual meeting.¹⁴¹ The qualifying shareholder also is permitted to include a supporting statement for the proposal, and the corporation's proxy card must provide a space where shareholders can indicate whether their shares should be voted for or against the shareholder's proposal.¹⁴² Absent something like the shareholder proposal rule, it would be practically impossible for an ordinary shareholder to present a resolution to his fellow shareholders because of the cost and expense of preparing and circulating his own proxy materials to thousands and thousands of shareholders scattered across the nation and now the world. Although the shareholder proposal rule substantively alters the balance of power between management and shareholders, the SEC originally justified the rule on disclosure—not corporate governance—grounds, contending “that the corporate practice of circulating proxy materials which failed to make reference to the fact that a shareholder intended to present a proposal at the annual meeting rendered the solicitation inherently misleading.”¹⁴³ Consequently, with the shareholder proposal rule as well as with other rules discussed in this section, the SEC used a disclosure-oriented rule to effectively alter the substantive balance of power within the corporation.¹⁴⁴

c. Insider Trading Restrictions

A third example of SEC efforts to influence the governance of public corporations relates to insider trading restrictions. Prior to 1961, state law determined the question of whether corporate insiders could trade in the United States while in possession of non-public material information about the company or its prospects. The states did not uniformly bar insider trading, with the majority taking the view that insider trading would only constitute a violation when

141. See 17 C.F.R. § 240.14a-8(a) (2009).

142. See 17 C.F.R. §§ 240.14a-8(a) & (d) (2009).

143. See *Medical Committee for Human Rights v. SEC*, 432 F.2d 659, 677 (D.C. Cir. 1970), *vacated*, 404 U.S. 403 (1972).

144. But while the rule certainly strengthens shareholder activists, its impact is limited. First, there are many limitations included in the rule itself on when and how the rule could be used. See, e.g., 17 C.F.R. §§ 240.14a-8(b), (c), (d), (e) & (i) (2009) (minimum ownership requirements; limits on number and length of proposals; timeliness requirements; impermissible subjects for shareholder proposals). Second, shareholder activists still face more practical barriers, including the tendency of ordinary shareholders to side with management. See *supra* notes 46–49 and accompanying text.

“special facts” were present,¹⁴⁵ such as when the corporate insider traded in a face-to-face transaction with the shareholder, rather than over an anonymous securities exchange.¹⁴⁶ In 1961, however, the SEC used its power to police fraudulent disclosures in securities markets to bar trading by corporate insiders based on non-public information.¹⁴⁷ The SEC reasoned that those who had a “relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone committed” a fraud on the other party to a securities transaction when they traded on that information without first disclosing it.¹⁴⁸ Because the SEC construed insider trading as a failure of disclosure, the SEC was able to use its unquestioned power to police fraud to bar a practice that the SEC felt might undermine the proper management of a corporation and the efficiency of securities markets.

d. Foreign Corrupt Practices Act

The next example of a federal effort to influence corporate governance practices took the form of an act of Congress, the Foreign Corrupt Practices Act, adopted in 1977.¹⁴⁹ The principal substantive restrictions of the Foreign Corrupt Practices Act, added as section 30A of the Securities Exchange Act of 1934,¹⁵⁰ have little, if anything, to do with corporate governance. These provisions prohibit public companies from engaging in specified corrupt practices, including offering, paying, promising to pay, or authorizing the payment of any money to any foreign official in order to assist the public company in obtaining or retaining business. The restrictions on foreign bribery and other corrupt practices covered by the statute, however, were accompanied by amendments to section 13(b) of the 1934 Act¹⁵¹ that, unlike the substantive restrictions in Section 30A, regulated the internal governance practices of public corporations.

145. *See* *Strong v. Repide*, 213 U.S. 419, 431 (1909).

146. *Compare* *Strong v. Repide*, 213 U.S. 431 (1909) (finding liability in a face-to-face transaction), *with* *Goodwin v. Agassiz*, 186 N.E. 659 (Mass. 1933) (rejecting liability in exchange transaction).

147. *See* *Cady, Roberts & Co.*, 40 S.E.C. 907, 1961 WL 60638 (1961).

148. *Id.* at *4.

149. Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified as amended at 15 U.S.C. §§ 78m(b), 78dd-1, 78dd-2 (2006)).

150. 15 U.S.C. § 78dd-1.

151. 15 U.S.C. § 78m(b).

Designed to prevent the types of conduct prohibited by section 30A, the amendments to section 13(b) require public companies to “make and keep books, records and accounts, in reasonable detail, which accurately and fairly reflect” corporate expenditures, and also to “devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances” that corporate expenditures are consistent with management’s authorization, properly recorded, and verified “at reasonable intervals.”¹⁵²

e. Going Private Regulation

Another example of an SEC effort to influence corporate governance relates to so-called “going private transactions.”¹⁵³ With relatively low stock prices in the mid-1970s, it became popular for the management of public corporations in the United States to take those corporations private—for the company itself, or its affiliates, to purchase stock from the public shareholders in a transaction or series of transactions that would generally result in the complete or near complete elimination of public ownership, with the result that the corporation’s shares would be delisted from trading on securities exchanges and the company’s obligation to file periodic reports and provide other information to the SEC under the federal securities laws would be terminated.¹⁵⁴ The SEC became concerned about these transactions, not only because those few public shareholders who might remain after a going private transaction would no longer have access to a liquid securities market or information filed under the federal securities laws, but also because “going private” transactions were often marked by a lack of arms-length bargaining with public shareholders (i.e., in many cases a shareholder vote on the “going private” transaction would not be required or the vote would be a mere formality because affiliates of the issuer already held the requisite percentage for approval) that presented management with a conflict of interest that could call into question the fairness of the terms offered to the public shareholders.¹⁵⁵ Although commentators called on the SEC to require that going private transactions satisfy a

152. *Id.*

153. The current version of the SEC’s going private regulations can be found at 17 C.F.R. § 240.13e-3 (2009).

154. For a discussion of the business background to the adoption of the SEC’s going private rules, see *Going Private*, SEC Release No. 34-14185, 42 Fed. Reg. 60,090, at *3–*4 (Nov. 23, 1977).

155. *Id.* at *13.

federal fairness standard, the SEC ultimately declined to directly regulate the substance of going private transactions, and instead limited itself to its more traditional disclosure-focused role.¹⁵⁶ Therefore, in 1979 the SEC adopted its going-private rule requiring special disclosures in going private transactions.¹⁵⁷ The core of the SEC's new rule was a requirement that management state whether or not it believed the transaction to be fair under state law, and provide supporting reasons for that assessment.¹⁵⁸ Therefore, as with some of the SEC's other forays into corporate governance regulation, the SEC did not directly alter the state law rules governing going private transactions, but once again sought—through its disclosure rules—to shift the balance in favor of the shareholders, this time by helping shareholders gather the information necessary to challenge going private transactions under state law.¹⁵⁹

f. Audit Committee Reports

The next example of an SEC attempt to influence corporate governance is more recent—from the late 1990s. Even before the Enron and WorldCom crises of 2001 and 2002, the SEC had made efforts to encourage public companies to increase the effectiveness of the audit committees of their boards of directors to help ensure the accuracy and completeness of the company's audited financial statements. Through new rules adopted in 1999,¹⁶⁰ the SEC attempted to increase the likelihood that audit committees did their jobs and did them well. These rules worked through the SEC's

156. See *Going Private Transactions by Public Companies or Their Affiliates*, SEC Release No. 34-16,075, 44 Fed. Reg. 46736 (August 8, 1979).

157. *Id.*

158. The current version of this requirements is found at 17 C.F.R. § 240.13e-3(d) (2009), which requires the issuer (or affiliate) engaging in a Rule 13e-3 transaction to file with the SEC a Schedule 13E-3 under 17 C.F.R. § 240.13e-100 (2009). Item 8 of Schedule 13E-3, by cross-reference to Item 1014(a) of Regulation M-A, 17 C.F.R. § 229.1014(a), requires a statement of whether the issuer or affiliate “believes that the Rule 13e-3 transaction is fair or unfair to the unaffiliated security holders.”

159. Just two months before the SEC proposed Rule 13e-3 in November of 1977, the Delaware Supreme Court held in *Singer v. Magnavox*, 380 A.2d 969 (Del. 1977), that freeze-out mergers (a common form of going private transaction) would be subject to a new “fairness” test, thus abandoning the much-criticized hands-off approach previously applied to freeze-out transactions. Rule 13e-3 would provide unaffiliated shareholders with information that could prove useful in challenges under *Singer*. The *Singer* fairness test was substantially modified in *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

160. See *Audit Committee Disclosure*, SEC Release No. 34-42266, 64 Fed. Reg. 73,389 (Dec. 30, 1999).

traditional “shaming” approach, rather than through direct regulation of the conduct of audit committees. Accordingly, the 1999 rules required that each annual proxy statement include a report from the audit committee, which in effect required the audit committee to state *whether* (not *that*) it had done its job in connection with that year’s audit.¹⁶¹ The rules also required that the proxy statement disclose whether the board of directors had adopted a written charter for its audit committee, and whether the audit committee members were “independent” of the corporation.¹⁶² Again, these rules were written in classic SEC style. So as not to directly tread on ground reserved for the states, the SEC wrote rules that did not actually *require* that corporations or audit committees do anything, that is, change any of their behavior. Instead, the rules simply required that corporations *disclose* certain details about how their audit committees had performed their duties, with the hope that corporations and their audit committees would be shamed into doing the “right thing” as the SEC defined it.

g. Sarbanes-Oxley

The final example of federal intervention in the governance of public companies is probably the most famous and the most significant, the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley).¹⁶³ Sarbanes-Oxley was the principal piece of U.S. federal legislation that resulted from the combined effects of the Enron and WorldCom accounting scandals of 2001 and 2002. Among other things, Sarbanes-Oxley created the Public Company Accounting Oversight Board to regulate public accounting firms that audit public companies,¹⁶⁴ it adopted new standards of auditor independence,¹⁶⁵ and it mandated the implementation of new rules designed to

161. Specifically, these rules required the audit report to state (a) whether the audit committee reviewed and discussed the audited financial statements with management; (b) whether the audit committee had discussed certain important matters, such as the selection of significant accounting policies, with the independent auditors; and (c) whether the auditor committee had received disclosures from the auditors regarding the auditor’s independence. *Id.* at *2.

162. *Id.*

163. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C. (2006)) [hereinafter Sarbanes-Oxley].

164. See Sarbanes-Oxley, Title I, 116 Stat. at 750 (codified at 15 U.S.C. § 7211 (2006)).

165. See Sarbanes-Oxley, Title II, 116 Stat. at 771 (codified at 15 U.S.C. § 78j-1 (2006)).

minimize conflicts of interest for securities analysts.¹⁶⁶ This subsection, however, focuses on a different aspect of Sarbanes-Oxley: those provisions that relate to the obligations of public companies under the Securities Exchange Act of 1934, especially those that go beyond the federal government's traditional "shaming" approach to corporate governance regulation.

1. Audit Committees

As the Enron and WorldCom fiascos were chiefly accounting failures, it probably should not be surprising that Sarbanes-Oxley provided the SEC with enhanced authority to govern the substance of the operations of audit committees of public companies. Specifically, Section 301 of Sarbanes-Oxley mandated that the SEC require securities exchanges to adopt listing standards that *required* public companies to have strengthened audit committees.¹⁶⁷ Under the statute, exchange listing standards must mandate: 1) that the audit committee—not the firm's management—be directly responsible for the appointment, compensation, and oversight of the work of the independent accountant employed by the company; 2) that, in general, each member of the audit committee be independent of the corporation (which means that audit committee members may not accept "any consulting, advisory, or other compensatory fee from the issuer" (other than customary directors' and committee members' fees)); and 3) that audit committees have the authority to engage independent counsel and other advisers.¹⁶⁸

2. Enhanced CEO/CFO Responsibilities

The statute also imposes enhanced responsibilities on CEOs and CFOs of public companies. In particular, Section 302 of the statute required the SEC to adopt rules relating to CEO and CFO certification of the company's annual and quarterly financial reports.¹⁶⁹ The statute sets forth six items that must be certified, including 1) the fact that the signing officer has reviewed the report, 2) the absence of any material misstatements or omissions, 3) the fair presentation of

166. See Sarbanes-Oxley, Title V, 116 Stat. at 791–794 (codified at 15 U.S.C. § 78o-6 (2006)).

167. 116 Stat. at 775–77 (codified at 15 U.S.C. § 78j-1(m) (2006)).

168. *Id.* The implementing rule for these requirements can be found at 17 C.F.R. § 240.10A-3 (2009).

169. 116 Stat. at 777–78 (codified at 15 U.S.C. § 7241 (2006)).

financial information, 4) the responsibility of the signing officer for establishing and maintaining internal disclosure controls and the evaluation of those controls, 5) the disclosure by the signing officers to the issuer's auditors and its audit committee of significant deficiencies in the issuer's internal controls, as well as any fraud involving management or significant employees, and 6) the disclosure in the report of significant changes in internal controls or other factors that could significantly affect these controls in the future, including any corrective action to address significant deficiencies or weaknesses.¹⁷⁰ In addition, section 906 of Sarbanes-Oxley requires the CEO and CFO to certify, with respect to each periodic report containing financial statements, that the report "fully complies with the requirements of [the Exchange Act] and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer," with penalties for false certifications of up to \$5 million or twenty years imprisonment, or both.¹⁷¹ Although sections 302 and 906 are stated in terms of disclosure obligations, these sections are properly categorized as substantive corporate governance regulations because of the responsibilities these sections impose upon the certifying officers (e.g., verifying the accuracy of SEC filings and financial statements, establishing and maintaining internal controls, and communicating with the issuer's audit committee and auditors).

3. Officer/Director Misconduct in Connection with Audit

Section 303 of Sarbanes-Oxley makes it unlawful for any officer or director to fraudulently influence, coerce, or mislead the company's independent auditors.¹⁷² The SEC's implementing rule¹⁷³ provides examples of improper conduct, including: 1) making a false or misleading statement to an accountant, or omitting a fact necessary to make a statement not misleading; and 2) coercing, manipulating, misleading, or fraudulently inducing an auditor a) to issue or reissue a financial report that is not warranted under the circumstances, b) not to perform auditing procedures required by auditing or professional standards, c) not to withdraw an issued report, or d) not to

170. *Id.* The implementing rules for these certification requirements can be found at 17 C.F.R. §§ 240.13a-14 & 240.15d-14 (2009).

171. 116 Stat. at 806 (codified at 18 U.S.C. § 1350 (2006)).

172. 116 Stat. at 778 (codified at 15 U.S.C. § 7242 (2006)).

173. 17 C.F.R. § 240.13b2-2 (2009).

communicate matters to the issuer's audit committee, if any of the foregoing actions would render the issuer's financial statements materially misleading.¹⁷⁴

4. Prohibition of Personal Loans

Section 402 of Sarbanes-Oxley makes it unlawful for any issuer to provide or arrange for any extension of credit to or for any director or executive officer, except for certain loans provided in the ordinary course of an issuer's consumer credit business.¹⁷⁵ This provision is notable not so much for its practical importance as for its direct conflict with state corporation law. For example, the Delaware General Corporation Law expressly provides that "[a]ny corporation may lend money to, or guarantee any obligation of, or otherwise assist any officer or other employee of the corporation or of its subsidiary, . . . whenever, in the judgment of the directors, such loan, guaranty or assistance may reasonably be expected to benefit the corporation."¹⁷⁶ Section 402 plainly preempts this provision of Delaware law, at least for public companies required to file periodic reports under sections 12 or 15(d) of the Securities Exchange Act of 1934.

5. Internal Controls Reports

Finally, under section 404 of Sarbanes-Oxley, the SEC is required to adopt rules requiring an issuer's annual report to include an "internal control report."¹⁷⁷ Section 404 further mandates that the required report shall "state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting," "contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures," and be accompanied by report of the firm's auditor that attests to management's assessment.¹⁷⁸ The SEC has implemented this mandate through new Item 308 of Regulation S-K,¹⁷⁹ which requires disclosure of the content specifically listed in Section 404, a description of the framework used by management to evaluate the firm's internal

174. *Id.*

175. 116 Stat. at 787–88 (codified at 15 U.S.C. § 78m(k) (2006)).

176. DEL. CODE ANN. tit. 8, § 143 (2009).

177. 116 Stat. at 789 (codified at 15 U.S.C. § 7262 (2006)).

178. *Id.*

179. 17 C.F.R. § 229.308 (2009).

controls, and a discussion of material changes in the issuer's internal controls that occurred during the most recent fiscal quarter.¹⁸⁰ Like the CEO and CFO certifications discussed above,¹⁸¹ the requirement of an internal control report represents much more than a mere disclosure obligation; it effectively alters the issuer's internal operations by requiring management to take responsibility for establishing and maintaining adequate internal controls, a matter traditionally left to state law.¹⁸²

Each of the above-described provisions from Sarbanes-Oxley plainly goes beyond the federal government's traditional shaming approach to corporate governance regulation and, to at least a limited extent, infringes on the traditional powers of the states to control corporate governance. The first requires an active, independent audit committee for listed public companies as a matter of federal law; the second imposes new audit-related oversight responsibilities on CEOs and CFOs; the third makes the improper influence of a public company audit a violation of federal law; the fourth bars extensions of credit to directors and executive officers, a practice specifically authorized by many state corporation laws; and the fifth establishes new federal duties with respect to internal controls distinct from those imposed under state law. Therefore, at least in relation to practices thought to be at the heart of the accounting scandals of 2000 and 2001, federal standards have encroached on traditional state turf and, in the case of loan restrictions and perhaps internal controls responsibilities, have displaced conflicting—and possibly more permissive—state laws.

That said, many other provisions of Sarbanes-Oxley still fit within the federal government's traditional "shaming" approach to corporate governance regulation. For example, in addition to the provisions discussed above, Sarbanes-Oxley mandates new disclosures with respect to codes of ethics for senior financial officers and the financial expertise (or lack thereof) of members of audit committees. Specifically, section 406(a) of Sarbanes-Oxley directs the SEC to issue rules requiring issuers to disclose whether or not the issuer has adopted of code of ethics for senior financial officers, and

180. *Id.*

181. *See supra* notes 169–171 and accompanying text.

182. *See, e.g., In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

if not, the reason therefore.¹⁸³ Section 406(b) requires the SEC to mandate the immediate disclosure of any change in or waiver of the code.¹⁸⁴ Along the same lines, section 407 of Sarbanes-Oxley directs the SEC to adopt rules requiring issuers to disclose “whether or not, and if not, the reasons therefor,” the audit committee of the issuer is comprised of at least one member who is a financial expert.¹⁸⁵ Both of these provisions are classic “shaming” regulations that do not, in any way, require issuers to alter their practices, but instead encourage compliance by embarrassing those who fail to follow the implicitly suggested course.¹⁸⁶

Thus, even in response to what was then the largest public company financial scandal in many years, the U.S. Congress did not completely abandon its traditional approach; it certainly took a greater hand in regulating the corporate governance practices of public companies than it had in the past, but it avoided encroaching too far onto traditional state turf. Congress adopted a mix of substantive rules that addressed areas of particular federal sensitivity (such as the adequacy of disclosure and accounting oversight), but limited itself to shaming regulation in other areas and, even more significantly, left large areas of traditional state corporate governance regulation untouched, including fiduciary duties of managers, rules for

183. 116 Stat. at 789 (codified at 15 U.S.C. § 7264(a) (2006)).

184. 116 Stat. at 789 (codified at 15 U.S.C. § 7264(b) (2006)).

185. 116 Stat. at 790 (codified at 15 U.S.C. § 7265 (2006)).

186. Building on the corporate governance disclosures required by Sarbanes-Oxley and by pre-existing regulation, the SEC added a new Item 407, titled “Corporate Governance,” to Regulation S-K in 2006. *See* 17 C.F.R. § 229.407 (2009). This Item requires disclosure of whether each director and director nominee is independent; a description of any relationships not otherwise disclosed that were considered when determining whether each director and director nominee is independent; and disclosure of any audit, nominating, and compensation committee members who are not independent. These enhanced director independence disclosure requirements followed the adoption by the New York Stock Exchange and Nasdaq (in 2003 and 2004), at the not-so-subtle urging of the SEC, of independence standards for boards of directors and compensation and nominating committees to supplement the independence standards for audit committees established by Sarbanes-Oxley. Item 407 also consolidates corporate governance related disclosure requirements previously set forth in a number of places in the proxy rules and in Regulation S-K, including some of the corporate governance disclosures discussed in the text. 17 C.F.R. § 229.10 (2009). These include disclosures regarding board meetings and specific disclosures about nominating and audit committees, including whether or not the committees have charters. Item 407 also requires similar disclosures regarding compensation committees and a narrative description of committee procedures for determining executive and director compensation. Like the corporate governance disclosures discussed in the text, the corporate governance disclosures required by Item 407 of Regulation S-K plainly fall within the category of “shaming” regulations.

shareholders' derivative suits, and rules related to officer and director insurance and indemnification. This shows the durability—even in times of crisis—of the basic state-federal division of regulatory authority over corporate governance, with the federal government still limiting itself largely, though not exclusively, to disclosure regulation, and the states, including Delaware, continuing to control much of the substance of corporate law.

C. Broader Proposals to Federalize Corporate Governance Regulation

The relatively limited encroachments of the federal authorities on the states' control of corporate governance standards described above should be contrasted with the fate over the last century of proposals that would have gone much farther in displacing state law. As discussed below, such proposals have been consistently rejected.

1. Federal Chartering or Licensing of Corporations

On several occasions over the last century, politicians and academics have called for a more extensive federal role in regulating the conduct, rather than merely the disclosures, of U.S. corporations. There were calls for federal chartering or licensing of corporations as part of the progressive movement in the first years of the twentieth century, with at least 13 bills on federal chartering or licensing introduced in the United States Congress between 1905 and 1909.¹⁸⁷ Calls for increased federal regulation of corporations, including federal chartering and licensing proposals, were renewed in several bills introduced in the U.S. Congress during the Great Depression era of the 1930s.¹⁸⁸ And more recently, proposals for a greater federal role in regulating at least larger corporations once again took center stage during the 1970s as Congress and the public began to focus on the corporate social responsibility—or the lack thereof—of large U.S. corporations, like General Motors.¹⁸⁹ Despite the populist appeal of

187. Note, *Federal Chartering of Corporations: Constitutional Challenges*, 61 GEO. L.J. 123, 126 (1972).

188. *Id.* at 127–28.

189. See HENN & ALEXANDER, *supra* note 2, at 32–34. During this era, more liberal shareholder advocates called once again for federal chartering that would completely displace state law, see RALPH NADER, *CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS* (1976), while others, such as Professor William Cary, took a more measured approach by calling for uniform federal minimum

all of these proposals, in each instance the U.S. Congress failed to act, leaving the states in general, and Delaware in particular, free to set corporate governance standards in the United States.¹⁹⁰

2. Federal Fiduciary Duties under 10b-5

Having failed to get federal chartering or licensing from the U.S. Congress, shareholder advocates have, at times, turned to the federal courts to provide at least a partial antidote to the limitations of state law. During the 1970s, shareholders who sought a greater federal role in standard setting tried to convince the federal courts to use SEC Rule 10b-5¹⁹¹ for that purpose. Adopted by the SEC in 1942, Rule 10b-5 prohibits, as a matter of federal law, fraudulent devices and schemes as well as acts and practices which operate as a fraud or deceit in connection with the purchase or sale of any security.¹⁹² Essentially, Rule 10b-5 federalizes the law of fraud in securities transactions.

Proponents of using 10b-5 as a vehicle for setting federal standards of corporate conduct argued that certain corporate practices constituted frauds under Rule 10b-5, at least when the challenged conduct occurred in connection with the corporation's purchase or sale of securities.¹⁹³ Had this argument succeeded, the SEC would have obtained the authority to regulate at least a subset of corporate conduct, including, among other things, corporate conduct related to mergers and other similar corporate transactions, which involved the corporation's purchase or sale of securities. But, like the previous

standards that would supplement, but not displace state chartering, *see* Cary, *supra* note 122, at 701.

190. This is not to say that these calls for federal chartering or minimum federal standards had no effect. At least during the 1970s, if not in earlier periods, the calls for federal chartering or licensing caused Delaware to take steps to mute those calls, in some cases tightening up state law standards that policymakers and shareholder advocates had criticized. See, for example, the discussion *supra* at note 159 of the Delaware Supreme Court's decision in *Singer v. Magnavox*, 380 A.2d 969 (Del. 1977), which arguably had the effect of preventing the adoption of a substantive federal fairness standard for private transactions. This tactic appears to be repeating itself in the post-Enron period. See, for example, DEL. CODE ANN. tit. 8, § 112, added in 2009, which permits a Delaware corporation to adopt a bylaw that specifies the circumstances under which shareholders would have access to the corporate proxy to nominate candidates for election to the board of directors. This provision seems designed to derail the SEC's shareholder access proposal, discussed *infra* at Part III.C.

191. 17 C.F.R. § 240.10b-5 (2009).

192. *Id.*

193. See, e.g., *Green v. Santa Fe Industries*, 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977).

efforts in Congress, this effort also failed when, in 1977, the U.S. Supreme Court held that the SEC's authority in connection with Rule 10b-5 extended only to outlawing conduct that involved some form of deception or manipulation.¹⁹⁴ Accordingly, conduct that corporate managers engaged in openly, even if plainly contrary to shareholder interests—such as causing the corporation to engage in a securities transaction with its own shareholders on unfair terms or without a valid business purpose—could not constitute a 10b-5 violation. The Supreme Court thereby made absolutely clear its belief that existing legislation did not give the SEC authority to set federal fiduciary duty standards that would undermine the traditional role of the states in corporate law.

3. *Business Roundtable v. SEC*

The SEC made a final effort to adopt substantive rules directly setting standards of corporate conduct in 1988. This time the SEC used its authority under a different section of the 1934 Act, section 19(c),¹⁹⁵ that permits the SEC to amend the rules of a securities exchange, like the New York Stock Exchange, “in furtherance of the purposes of this title.”¹⁹⁶ Acting under this grant of authority, the SEC adopted Rule 19c-4—its so-called one share-one vote rule, which prohibited the exchanges from listing a company's stock if the company took any action that nullified, restricted, or disparately reduced the voting power of existing stockholders.¹⁹⁷ Essentially, this rule was designed to prohibit an antitakeover device that had become popular in the 1980s—dual class common stock recapitalizations—which resulted in management's receipt of high voting stock while public shareholders received low voting stock. This technique was often used to put voting control of the corporation in the hands of management (and other friendly shareholders), even though management owned only a small fraction of the firm's equity.

The SEC contended that its rule was authorized under 19(c) because it furthered the purposes of the 1934 Act, in particular the statutory concern with fair shareholder voting reflected in the 1934

194. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977).

195. 15 U.S.C. § 78s (2006).

196. *Id.*

197. Voting Rights Listing Standards, SEC Release No. 34-25891, 53 Fed. Reg. 26,376 (July 12, 1988).

Act's proxy provisions.¹⁹⁸ However, the federal court ultimately rejected the SEC's argument and invalidated the rule, holding that the SEC's powers under the 1934 Act extended only to regulating the proxy *process*, not to regulating the *substantive* voting rights of shareholders.¹⁹⁹ Therefore, the SEC's attempt to extend its own powers to the substance of corporate law suffered the same fate as prior Congressional and judicial efforts to set federal standards of conduct for publicly traded corporations, leaving in place the traditional division of state and federal authority, with Delaware as the *de facto* national standard setter.

It is worth noting, however, that while the SEC may have lost the battle with Rule 19c-4, it ultimately won the war when it convinced the New York Stock Exchange, the Nasdaq, and the American Stock Exchange to "voluntarily" adopt rules very similar to the one the SEC had proposed.²⁰⁰ This is a technique that the SEC has used effectively in more recent times to encourage the principal exchanges to adopt independence requirements for boards of directors and for nominating and compensation committees that supplement the independence standards for audit committees established by Sarbanes-Oxley.²⁰¹

198. See *Business Roundtable v. SEC*, 905 F.2d 406, 410 (D.C. Cir. 1990).

199. *Id.* at 410–13.

200. See Floyd Norris, *New Amex Rule on Super Classes*, N.Y. TIMES, April 12, 1991, at D8 (noting that NYSE and Nasdaq voluntarily adopted rules similar to 19c-4, but that AMEX initially declined to do so); see also Stephen Bainbridge, *Crash Landing for SEC Proposal: The Securities and Exchange Commission Has Many Powers, but the Authority to Dictate Corporate Governance Is Not Among Them*, THE RECORDER, June 20, 1991, at 4 (noting the SEC's considerable influence over the stock exchanges and its use of that power to encourage the exchanges to adopt rules tracking Rule 19c-4). After the American Stock Exchange initially declined to adopt a version of Rule 19c-4, SEC Chairman Arthur Levitt urged the exchanges and Nasdaq to formulate a uniform policy on dual class voting structures. The uniform policy ultimately adopted in 1994 was based upon, but more flexible than, Rule 19c-4. See SEC Release No. 34-34518, 59 Fed. Reg. 42,614 (August 18, 1994) (notice of proposed rule changes); SEC Release No. 34-35121, 55 Fed. Reg. 66,570 (Dec. 27, 1994) (approving final rules).

201. See New York Stock Exchange, Inc., SEC Release No. 34-48745, 68 Fed. Reg. 64,154 (November 12, 2003) (approving, among other things, proposed rule changes for the NYSE and Nasdaq related to the independence of boards of directors and committees of the board and noting that such proposals were formulated after "the [SEC]'s Chairman . . . requested that the NYSE and NASD, as well as the other exchanges, review their listing standards, with an emphasis . . . on all corporate governance standards, and not just those provisions relating to audit committees [required by Sarbanes-Oxley]").

III. THE FUTURE OF THE CURRENT REGULATORY STRUCTURE

The state-federal division of authority has survived largely intact for more than 75 years. However, the United States is now faced with a financial crisis of almost unprecedented proportions, along with new pressures and proposals for the increased federalization of corporate governance regulation.²⁰² Will the dual roles of the federal government and the states with respect to corporate governance regulation persist, or will the weight of the current financial crisis finally result in the federal government displacing Delaware as the primary regulator of corporate governance, at least for publicly held firms? The final section of this Article contends that history, politics, and recent experience suggest that the current regulatory structure will persist, despite the current crisis.

A. History

As noted earlier, there have been many, many proposals over the last century for the federal government to take a greater role in regulating corporate governance, including proposals during the progressive era of the early twentieth century, the Great Depression of the 1930s, and the debate over corporate social responsibility during the 1970s.²⁰³ In each of these eras, proposals to federalize corporate law or impose minimum federal standards of conduct failed in the United States Congress. Only in the Foreign Corrupt Practices Act²⁰⁴ and Sarbanes-Oxley, adopted in the aftermath of the Enron-

202. On December 11, 2009, the U.S. House of Representatives passed The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009). This bill is designed principally to provide comprehensive reform of the regulation of financial institutions, but the legislation also includes (as a very small part of its 1279 pages) a number of corporate governance measures, including provisions: (1) giving public company shareholders the right to cast annual advisory votes on pay packages for the company's executives (Section 2002); (2) requiring each member of a public company's compensation committee to be independent (Section 2003); and (3) authorizing the SEC to issue rules regarding the inclusion in a public company's proxy solicitation materials of nominees submitted by shareholders to serve on the company's board of directors (Section 7222). The related 1136-page Senate bill, the Restoring American Financial Stability Act of 2009, introduced on November 10, 2009, contains similar provisions to the House bill (see Sections 951-959), but goes further in terms of corporate governance regulation by addressing majority voting standards in director elections, staggered boards of directors, and disclosures on the separation of the positions of chief executive officer and chairman (Sections 971-974). Neither bill, however, proposes anything even remotely resembling a fundamental reallocation of state and federal power with respect to corporate governance regulation.

203. See *supra* notes 187-190 and accompanying text.

204. See *supra* notes 149-152 and accompanying text.

WorldCom debacle, did the U.S. Congress go somewhat beyond the traditional federal role, encroaching to a limited degree on state powers; even then, the steps taken were modest ones at best. As a result, even against the backdrop of the present financial crisis, history suggests that a federal takeover of corporate governance standards is highly unlikely.

B. Politics

Political considerations also support this conclusion. There are a whole host of entrenched interests that benefit from the current regulatory regime that leaves the states largely in control of corporate governance standards. First and foremost, the small State of Delaware derives much of the revenue needed to finance the operations of the state from franchise taxes and other fees paid by businesses that are incorporated in the state. It is doubtful that Delaware will relinquish its control over this revenue stream without a spirited fight.²⁰⁵ Indeed, in the past Delaware has taken steps to reduce the pressure for federalization of corporate law by responding to crises in corporate governance with changes to its law designed to relieve the pressure for federalization; that process appears to be under way now, with Delaware recently adopting amendments to its corporate law to facilitate the ability of shareholders to nominate directors in order to counter SEC proposals to expand shareholder access to the corporate proxy.²⁰⁶

In addition to the state itself, there are a number of private interest groups with considerable investments in state control of corporate governance, which could be expected to strongly resist any substantial change in the current state-federal regulatory structure. These include, first and foremost, the many public corporations that have chosen Delaware as their state of incorporation because of the many advantages of Delaware incorporation, including a reliable legislature, an expert judiciary, and a highly stable corporate law. Others who benefit from the current structure include many of the country's leading law firms, which have made substantial investments in lawyers and law offices within the state, and the entire corporate servicing industry that has grown up within the Delaware to offer

205. See *supra* notes 17–18 and accompanying text.

206. See discussion *supra* note 190.

services to corporations that choose Delaware as their jurisdiction of incorporation without having any physical presence in the state.²⁰⁷

C. Experience: The SEC's Shareholder Access Proposal

Finally, we have the SEC's recent experience with its now six-year-old proposal to expand the ability of shareholders to access the corporation's annual proxy statement to nominate candidates to the corporation's board of directors. In October 2003, the SEC, acting in response to the corporate scandals of 2001 and 2002, proposed new rules that would have required companies to include in their proxy materials shareholder nominees for election to positions on the corporation's board of directors.²⁰⁸ The proposed proxy access rules were relatively modest, and would only have become operative upon the occurrence of certain triggering events indicative of shareholder discontent.²⁰⁹ Further, only shareholders who owned at least 5% of the corporation's stock would be permitted to nominate directors, and in no event would the corporation have to include more than three shareholder nominees in its proxy statement.

This proposal languished for almost six years without being adopted by the SEC. Only after the onset of the current financial crisis and the election of a new administration in Washington did the SEC renew its efforts to provide shareholders with access to the corporate proxy to nominate directors by offering a new proposal in June of 2009.²¹⁰ The new proposal is broader than the 2003 proposal in the sense that there is no longer any triggering event that must occur before shareholders are permitted to include nominees in the company's proxy materials, and the ownership thresholds for shareholder eligibility have been reduced. However, the rule also

207. It is also at least worth noting that the current United States Vice President, Joe Biden, was a long-time U.S. Senator from the State of Delaware. It seems unlikely that he would support any federal changes that could have the effect of undermining the stature or economy of his home state.

208. See Security Holder Director Nominations, SEC Release No. 34-48626, 68 Fed. Reg. 60,784 (October 23, 2003).

209. The shareholder access rule would have become operative only after the occurrence of one of two triggering events: if (1) at least one of the company's nominees for the board of directors had received "withhold" votes from more than 35% of the votes cast at an annual meeting of shareholders; or (2) a shareholder proposal providing that the company become subject to the shareholder nomination procedure had received more than 50% of the votes cast at a meeting.

210. See Facilitating Shareholder Director Nominations, SEC Release No. 34-60089, 74 Fed. Reg. 29,024 (June 10, 2009).

makes clear that corporations can, in effect, opt out of the shareholder nomination process by eliminating the power of shareholders to nominate directors in the corporation's charter or bylaws, and that shareholder nominees cannot comprise more than 25% of the board of directors. In the current atmosphere, with a new President, a new SEC Chair, and a new democratic majority on the SEC, one might have expected this revised proposal to be approved with ease. But approval still has not been obtained.

Business groups in the United States, as well as many leading corporations, have joined in opposing the SEC's proposal, arguing, among other things, that the proposed rule would exceed the SEC's statutory authority by encroaching on the substantive governance area traditionally left to the states. At least in part due to this opposition, the SEC cancelled a meeting to consider the rule that had been scheduled for November 9, 2009, and delayed final consideration of the proposal until 2010.²¹¹

The bitter and continued opposition to this one SEC proposal suggests that the likelihood for more dramatic expansions of federal authority over corporate governance remains small.

IV. CONCLUSION

Should we lament the failure of the federal government to play a greater role in corporate governance regulation in the United States? In my view, we should not. One of the benefits of the U.S. federal system is the regulatory experimentation, innovation, and diversity generated when the individual states compete with one another to develop the best regulatory scheme. It is certainly possible that regulatory competition could, in some instances, lead to a "race for the bottom," as Professor Cary argued, rather than a "race to the top." But at least in the area of corporate governance regulation, there appear to be adequate checks to prevent the states from getting too far out of line. Among other things, the federal government can take direct control of certain matters as occurred with Sarbanes-Oxley. In addition, the SEC has ample power to strongly influence corporate governance practices, including through its ability to adopt "shaming" regulations and its considerable influence over securities exchange listing standards. Because of these checks, and because of

211. See Katayuni I. Jaffari & Justin B. Ettelson, *The SEC Takes Another Pass at Shareholder Access*, LEGAL INTELLIGENCER, Oct. 27, 2009, at 5.

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Delaware's strong interest in avoiding the complete federalization of corporate law, there is little to fear, and much to gain, from leaving corporate governance standards where they have long resided: in the states.

