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ADVANCED CORPORATION LAW

A PRACTICAL APPROACH TO CORPORATE GOVERNANCE

STEPHEN M. BAINBRIDGE
William D. Warren Distinguished Professor of Law
UCLA School of Law

Commented [AR1]: Author: please update titles or affiliations, if desired.

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PREFACE

This text is designed for use in an advanced course in corporate law and governance. It assumes that students have taken a basic course in Corporations or Business Associations.

Corporate governance has been much in the news in recent years and lawyers are devoting increasing amount of attention to it. The passage of major federal legislation in 2002 (the Sarbanes-Oxley Act a.k.a. SOX) and 2010 (the Dodd-Frank Act) were particularly important developments, generating much new law and, as a result, much new legal work. Curiously, however, the law school casebook market has largely ignored these trends.

Corporate governance is regulated by many of the same laws covered in the basic Business Associations course, but increasingly is also regulated by laws—such as SOX and Dodd-Frank—that get short shrift in the typical Business Associations casebook and course. In contrast, those laws are the core focus of this text.

Unlike the more basic topics that dominate Business Associations, which are a product of state corporate law with a minor federal overlay, corporate governance is regulated by a much more complex body of law that emanates from multiple regulators. Many of the rules of corporate governance come from traditional state corporate and federal securities law sources, but many more come from sources such as stock exchange listing standards or rules issued by the Public Company Accounting Oversight Board and similar quasi-governmental bodies. All of these are grist for the mill in this text.

Importantly, however, lawyers practicing in the corporate governance space must be knowledgeable not only about the law but also best practice. As Sir Adrian Cadbury observed in connection with the United Kingdom's adoption of the so-called Cadbury Code, it is tempting for managers to obey the letter of law while ignoring the deeper purposes behind it. Sound corporate governance structures thus must be informed as much by best practices as well as formal legal rules.

Likewise, this text assumes that mastering the relevant law requires situating it in an understanding of the contemporary business environment. The legal issues governing executive compensation makes little sense, for example, if one does not understand the political and economic debate over CEO pay. Similarly, to cite just one more example, mastering the high-profile issues respecting shareholder rights will be much easier if the students are familiarized with the changing demographics of shareholders and the rise of activist hedge funds.

Notice that I refer to this book as a text rather than a casebook. Although the text includes many canonical cases presented in the traditional format, the case method is not the only—or even always the best—way of teaching students to draft workable contracts and disclosure documents, conduct due diligence, or counsel clients on issues that require business savvy as well as knowing the law. Accordingly, the book also relies on textual explication, sample documents, and problems to build student transactional skills.

This approach is driven by my belief that, because lawyers plan at least as often as they litigate, advanced business law course texts need to adopt a transaction planner's perspective. Most law school casebooks—even in the corporate law area, where the authors ought to know better—have an inherent bias towards litigation perspectives due to their emphasis on cases. I avoid that by using additional sources, such as law review articles and regulatory materials, and by including numerous problems—typically at the start of a block of material—requiring students to think about how the materials will affect real world transactions and planning.

The text assumes familiarity with some basic law and economics tools—such as transaction costs and agency costs—that are commonly used in many business law classes. Indeed, the central theme of this text is the agency costs resulting from the separation of ownership and control in public corporations. The appendix offers a brief overview of these tools for the benefit of those students who have not encountered them previously.

EDITORIAL NOTE

Editorial footnotes run consecutively, starting over at 1 at the beginning of each chapter, except that footnotes in excerpted materials retain their numbering from the original source, with no renumbering to take account of omitted footnotes. Editorial footnotes in excerpted materials are indicated using an asterisk and have the footnote text in brackets.

Citations and footnotes in cases and other excerpts are generally omitted without indication thereof, except where they provide the source of quoted language or otherwise seemed noteworthy.

A number of abbreviations are used throughout the text, as follows:

- DGCL: Delaware General Corporation Law
- Dodd-Frank: Dodd-Frank Act of 2010
- MBCA: Model Business Corporation Act
- Rule: A rule promulgated by the SEC under either the Securities Act or the Securities Exchange Act
- SEC: Securities and Exchange Commission
- Securities Act: Securities Act of 1933
- Securities Exchange Act: Securities Exchange Act of 1934
- SOX: Sarbanes-Oxley Act of 2002

The text makes active use of text boxes to highlight certain materials:

- Case in Point. These boxes offer a concise summary of cases that illustrate the point being made in the text.
- For More Information. These boxes point students to additional resources to consult for more information on a subject.
- FYI. A self-explanatory category that shares useful or simply interesting information relevant to material in the text.
- Practice Pointer. These boxes provide commentary especially relevant to junior associates' legal practice.
- Think About It. These boxes pose questions that prompt students to pause to think about various issues presented by the material or raise critical reading questions designed to focus student attention on the key issues.
- What's That? These boxes explain the meaning of special legal terms that appear in the main text.

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PART I

INTRODUCTION

CHAPTER 1

REGULATING CORPORATE GOVERNANCE IN A FEDERAL SYSTEM

One of the most widely cited definitions of corporate governance was set out in 1992 by the UK's Cadbury Commission report: "Corporate governance is the system by which companies are directed and controlled."[1] The Cadbury definition is certainly correct, but it turns the virtue of succinctness into a vice. It is simply too concise to tell us very much.

A more detailed definition offered by former Delaware Chief Justice Norman Veasey states that corporate governance encompasses "the structure, relationships, norms, control mechanisms, and objectives of the corporate enterprise."[2] Yet, while more detailed than the Cadbury definition, the Chief Justice's statement sweeps far too broadly for the concept to be useful.

Properly understood, corporate governance consists of the legal rules, private contracts, and best practices that create, maintain, and respond to the separation of ownership and control that is the defining characteristic of the U.S. public corporation.

In the U.S.A.'s federal system, the legal rules creating and constraining corporate governance traditionally came from the states. To be sure, the federal securities laws long have regulated some aspects of corporate governance—such as shareholder voting procedures and trading by a corporation's officers and directors in the company's stock—but these rules were never intended to form a comprehensive federal law of corporations. Instead, they placed a limited gloss on the underlying body of state law. As we shall see, however, over the last several decades the federal role in corporate governance has dramatically increased.

FYI

The separation of ownership and control, of course, is not the corporation's only critical feature. The others include formal creation as prescribed by state law; legal personality; separation of ownership and control; freely alienable ownership interests; indefinite duration; and limited liability.

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1 Adrian Cadbury, Report of the Committee on the Financial Aspects of Corporate Governance 15 (1992).

2 E. Norman Veasey & Christine T. Di Guglielmo, What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments, 153 U. Pa. L. Rev. 1399, 1411 (2005).

Lastly, it is critical to remember that corporate governance consists not only of legal rules, but also an ever-growing body of private contracts and best practice guides. Many of the rules we will study herein, for example, are embedded in stock exchange listing standards. Many more are not really rules at all, but rather recommendations and guidelines promulgated by quasi-governmental bodies and professional organizations.

A. THE MEANS AND ENDS OF CORPORATE GOVERNANCE

Two basic questions lie at the heart of corporate governance: (1) Who decides? In other words, when push comes to shove, who controls the corporation? (2) Whose interests prevail? When the ultimate decision maker is presented with a zero-sum game, in which it must prefer the interests of one constituency class over those of all others, whose interests prevail?

> **FOR MORE INFORMATION**
>
> HG.org offers a useful collection of internet links to materials about corporate governance at https://www.hg.org/corporate-governance-law.html

Any organization needs a governance system that facilitates efficient decision making. Although firms can choose amongst a wide array of options, most decision-making structures fall into one of two categories: "consensus" and "authority."[3] Consensus is utilized where each member of the organization has comparable information and interests. Under such conditions, assuming no serious collective action problems, decision maker preferences can be aggregated at low cost. In contrast, authority-based decision-making structures arise where team members have different interests and amounts of information. Such structures are characterized by the existence of a central agency to which all relevant information is transmitted and which is empowered to make decisions binding on the whole.

American business law allows one to choose between off-the-rack governance systems ranging from an almost purely consensus-based model to an almost purely authority-based model. At one extreme, the decision-making structure provided by partnership law is largely a consensus model. Partners, for example, have equal rights to participate in management of the firm on a one-vote per partner basis.[4] The selection of this one person-one vote standard as the default rule makes sense because all partners are also entitled to share equally in profits and losses,[5] giving them essentially identical interests (namely higher profits), and are entitled to equal access to information,[6] giving them

[3] Kenneth J. Arrow, The Limits of Organization 68–70 (1974).

[4] As with most partnership rules, the off-the-rack rule is subject to contrary agreement among the parties. UPA (1914) § 18(e).

[5] UPA (1914) § 18(a).

[6] UPA (1914) §§ 19 and 20.

essentially identical levels of information. In addition, the small size characteristic of most partnerships means that collective action problems generally are not serious in this setting. (Large multi-jurisdiction law firms are a prominent exception to this rule, which explains why many such firms have created corporation-like governance structures in their partnership agreement.)

At the other extreme, a publicly held corporation's decision-making structure is principally an authority-based one. As a practical matter, most public corporations are marked by a separation of ownership and control.[7] Shareholders, who are said to "own" the firm, have virtually no power to control either its day-to-day operation or its long-term policies. In contrast, the board of directors and senior management, whose equity stake often is small, effectively controls both. As a doctrinal matter, moreover, corporate law essentially carves this separation into stone. Under all corporation statutes, the board of directors is the key player in the formal decision-making structure. As the Delaware code puts it, for example, the corporation's business and affairs "shall be managed by or under the direction of a board of directors."[8]

Having said that, however, several qualifications must be introduced immediately. First, we will use "decision" as a shorthand for a process that often is much less discrete in practice. Second, operational decisions are normally delegated by the board to subordinate employees. The board, however, retains the power to hire and fire firm employees and to define the limits of their authority. Moreover, certain extraordinary acts may not be delegated, but are instead reserved for the board's exclusive determination.

In any case, the statutory separation of ownership and control means that shareholders have essentially no power to initiate corporate action and, moreover, are entitled to approve or disapprove only a very few board actions.[9] The statutory decision-making model thus is one in which the board acts and shareholders, at most, react.[10]

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[7] Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property 84–89 (1932).

[8] DGCL § 141(a). See In re CNX Gas Corp. Shareholders Litig., 2010 WL 2705147, at *10 (Del. Ch. July 5, 2010) ("Delaware law would seem to call for a consistently board-centric approach.").

[9] Under the Delaware code, for example, shareholder voting rights are essentially limited to the election of directors and approval of charter or bylaw amendments, mergers, sales of substantially all of the corporation's assets, and voluntary dissolution. As a formal matter, only the election of directors and amending the bylaws do not require board approval before shareholder action is possible. See DGCL §§ 109 and 211. In practice, of course, even the election of directors (absent a proxy contest) is predetermined by the existing board nominating the next year's board.

[10] To be sure, the shareholders' right to elect the board of directors can give the former de facto control even though the statute assigns de jure control to the latter. Consequently, we can speak of a "control block," i.e., shares held by one or more shareholders whose stockownership gives them effective control. In their classic study, Berle and Means in fact found that relatively small blocks of stock could give their owners effective control of the enterprise. Berle and Means identified such firms as minority-controlled corporations. These firms exhibit a partial separation of ownership and control. The dominant shareholder controls the firm, despite

Of course, the knowledgeable student will point out that the statutory board-centric model doesn't match up to the real world. True, in practice, most corporate actions are actually taken by corporate officers and subordinate employees pursuant to delegated authority. Yet, even a board that has been thoroughly captured by senior management typically retains at least some formal functions.

Accordingly, it is possible to identify several basic roles that most boards perform most of the time. First, and foremost, the board monitors and disciplines senior management. In other words, the board acts to constrain the agency costs that result from giving management the power to run the firm on a day-by-day basis. Second, while boards almost never get involved in making day-to-day operational decision making, most boards have some managerial functions. Broad policymaking is commonly a board prerogative, for example. Even more commonly, however, individual board members provide advice and guidance to senior managers with respect to operational and/or policy decisions. Finally, the board provides access to a network of contacts useful in gathering resources and/or obtaining business.[11]

FYI

The titles of top managers tend to start with the word "Chief": Chief Executive Officer (CEO), Chief Operating Officer (COO), Chief Financial Officer (CFO), Chief Legal Officer (CLO), etc. As a result, the top management team is often referred to as the "C-suite."

Among these functions, the board's monitoring role reigns supreme. To be sure, at one time, corporation statutes affirmatively required the board to manage the corporation. Delaware's statute, for example, formerly provided: "The business and affairs of every corporation organized under this chapter shall be managed by a board of directors."[12] It was only when the legislature added the phrase "or under the direction of" that the statute expressly contemplated the delegation of managerial functions to corporate officers.

In practice, of course, the old statutory formulation did not preclude the board from delegating management responsibility. Indeed, as early as 1922, the Delaware Chancery Court held that the directors' role was

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owning less than 50% of the outstanding voting shares, leaving the minority shareholders without significant control power. Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property 80–84 (1932). Majority controlled firms, in which a dominant shareholder (or group of shareholders acting together) owns more than 50% of the outstanding voting shares, likewise exhibit a partial separation of ownership and control. Id. at 70–72. Where no such control block exists, however, Berle and Means found that control passes from the firm's shareholders to its managers. Although shareholders of such firms retain the right to elect directors, management controls the election process, and thus the firm. Id. at 86–87. At the time they wrote, about half of the 200 largest U.S. corporations exhibited total separation of ownership and control. Id. at 94.

[11] Lynne L. Dallas, The Relational Board: Three Theories of Corporate Boards of Directors, 22 J. Corp. L. 1, 10–16 (1996).

[12] Delaware General Corporation Law § 141(a), quoted in Ernest L. Folk III, The Delaware General Corporation Law: A Commentary and Analysis 50 (1972).

one of supervision and control, with the detailed conduct of the business being a matter that properly could be delegated to subordinate employees.[13] The modern statutory formulation that the firm shall be "managed by or under the direction of" the board of directors simply codifies this understanding.

But towards what end should the board run the corporation? Put another way, what is the purpose of the corporation? One important school of thought contends corporations should be run so as to maximize shareholder wealth. The other major school of thought argues that directors and managers should consider the interests of all corporate stakeholders in making corporate decisions.[14] Judges and scholars in the latter camp advocate what they call "corporate social responsibility." Hence, they define the "socially responsible firm" as "one that becomes deeply involved in the solution of society's major problems."[15] In particular, they emphasize the corporation's obligation to consider the impact of its actions on nonshareholder corporate constituents, such as employees, customers, suppliers, and local communities. We consider this debate in further detail in Chapter 2.

We thus have an organization in which decisions are made by one body—the board—that is supposed to put the interests of its members to one side in pursuit of the interests of others, whether those others be shareholders or stakeholders. How can we assure that the directors use their powers responsibly? This has been the central problem of corporate governance at least since either the 1932 publication of Adolf Berle and Gardiner Means' famous book THE MODERN CORPORATION AND PRIVATE PROPERTY, which began the modern era of corporate governance scholarship.

Berle and Means demonstrated that public corporations were characterized by a separation of ownership and control—the firm's nominal owners, the shareholders, exercised virtually no control over either day-to-day operations or long-term policy. Instead, control was vested in the hands of professional managers, who typically owned only a small portion of the firm's shares. Separation of ownership and control occurred, they argued, because stock ownership was dispersed amongst many shareholders, no one of whom owned enough shares to materially affect the corporation's management.[16]

According to Berle and Means, "separation of ownership from control produces a condition where the interests of owner and of ultimate

13 Cahall v. Lofland, 114 A. 224, 229 (Del. Ch. 1921), aff'd, 118 A. 1 (Del. 1922).

14 The term "stakeholders" reportedly originated in a 1963 Stanford Research Institute memorandum as a descriptive term for "those groups without whose support the organization would cease to exist." R. Edward Freeman & David L. Reed, Stockholders and Stakeholders: A New Perspective on Corporate Governance, 25 Cal. Mgmt. Rev. 88, 89 (1983).

15 Robert Hay and Ed Gray, Social Responsibilities of Business Managers, in Managing Corporate Social Responsibility 8, 11 (Archie B. Carroll ed. 1977).

16 Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property 6–7 (1932).

manager may, and often do, diverge."[17] Will the board of directors use its control of the corporation to further the selfish interest of the board members rather than the best interests of the corporation's shareholders and other constituencies? To ask the question is to answer it. Given human nature, it would be surprising indeed if directors did not sometimes shirk or self-deal. Consequently, much of corporate law is best understood as a mechanism for constraining agency costs.

Organizing production within a firm creates certain costs, of which the class known as agency costs is the most important for our purposes. Agency costs are defined as the sum of the monitoring and bonding costs, plus any residual loss, incurred to prevent shirking by agents.[18] In turn, shirking is defined to include any action by a member of a production team that diverges from the interests of the team as a whole. As such, shirking includes not only culpable cheating, but also negligence, oversight, incapacity, and even honest mistakes. In other words, shirking is simply the inevitable consequence of bounded rationality and opportunism within agency relationships.[19]

A sole proprietorship with no agents will internalize all costs of shirking, because the proprietor's optimal trade-off between labor and leisure is, by definition, the same as the firm's optimal trade-off. Agents of a firm, however, will not internalize all of the costs of shirking: the principal reaps part of the value of hard work by the agent, but the agent receives all of the value of shirking. In a classic article, Professors Alchian and Demsetz offered the useful example of two workers who jointly lift heavy boxes into a truck.[20] The marginal productivity of each worker is difficult to measure and their joint output cannot be separated easily into individual components. In such situations, obtaining information about a team member's productivity and appropriately rewarding each team member are very difficult and costly. In the absence of such information, however, the disutility of labor gives each team

[17] Id. at 6.

[18] Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976).

[19] A simple example of the agency cost problem is provided by the bail upon which alleged criminals are released from jail while they await trial. The defendant promises to appear for trial. But that promise is not very credible: The defendant will be tempted to flee the country. The court could keep track of the defendant—monitor him—by keeping him in jail or perhaps by means of some electronic device permanently attached to the defendant's person. Yet, such monitoring efforts are not free—indeed, keeping someone in jail is quite expensive (food, guards, building the jail, etc.). Alternatively, the defendant could give his promise credibility by bonding it, which is exactly what bail does. The defendant puts up a sum of money that he will forfeit if he fails to appear for trial. (Notice that the common use of bail bonds and the employment of bounty hunters to track fugitives further enhances the credibility of bail as a deterrent against flight.) Of course, despite these precautions, some defendants will escape jail and/or jump bail. Hence, there will always be some residual loss in the form of defendants who escape punishment. Notice, by the way, that this example illustrates how the economic analysis can be extended beyond the traditional agency relationship.

[20] Armen A. Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, 62 Am. Econ. Rev. 777 (1972).

member an incentive to shirk because the individual's reward is unlikely to be closely related to conscientiousness.

Although agents ex post have strong incentives to shirk, ex ante they have equally strong incentives to agree to a corporate contract containing terms designed to prevent shirking. Bounded rationality, however, precludes firms and agents from entering into the complete contract necessary to prevent shirking by the latter. Instead, there must be some system of ex post governance: some mechanism for detecting and punishing shirking. Accordingly, an essential economic function of management is monitoring the various inputs into the team effort: management meters the marginal productivity of each team member and then takes steps to reduce shirking. (No implication is intended that ex post governance structures are noncontractual.)

The process just described, of course, raises a new question: who will monitor the monitors? In any organization, one must have some ultimate monitor who has sufficient incentives to ensure firm productivity without himself having to be monitored. Otherwise, one ends up with a never-ending series of monitors monitoring lower level monitors. Alchian and Demsetz solved this dilemma by consolidating the roles of ultimate monitor and residual claimant. According to Alchian and Demsetz, if the constituent entitled to the firm's residual income is given final monitoring authority, he is encouraged to detect and punish shirking by the firm's other inputs because his reward will vary exactly with his success as a monitor.

Unfortunately, this elegant theory breaks down precisely where it would be most useful. Because of the separation of ownership and control, it simply does not describe the modern publicly held corporation. As the corporation's residual claimants, the shareholders should act as the firm's ultimate monitors. But while the law provides shareholders with some enforcement and electoral rights, these are reserved for fairly extraordinary situations. In general, shareholders of public corporation have neither the legal right, the practical ability, nor the desire to exercise the kind of control necessary for meaningful monitoring of the corporation's agents.

The apparent lack of managerial accountability inherent in the modern corporate structure has troubled legal commentators since at least Adolf Berle's time.[21] To be sure, agency costs are an important component of any viable theory of the firm. A narrow focus on agency costs, however, easily can distort one's understanding. In the first instance, corporate managers operate within a pervasive web of accountability mechanisms that substitute for monitoring by residual claimants. The capital and product markets, the internal and external

[21] Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 6 (1932) ("The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear.").

employment markets, and the market for corporate control all constrain shirking by firm agents.

In the second, agency costs are the inescapable result of placing ultimate decision-making authority in the hands of someone other than the residual claimant. Because we could substantially reduce agency costs by eliminating discretion, but do not do so, one infers that discretion has substantial virtues. In a complete theory of the firm, neither discretion nor accountability can be ignored, because both promote values essential to the survival of business organizations.[22] At the same time, however, the power to hold to account is ultimately the power to decide.[23] Managers cannot be made more accountable without undermining their discretionary authority. Establishing the proper mix of discretion and accountability therefore is critical.

The separation of ownership and control thus emerges as the overarching organizational principle around which this text is organized. How can we align the incentives of directors and managers with shareholders? How can we help directors do a better job of monitoring management and shareholders to do a better job of managing both directors and managers? What alternative constraints can we devise besides monitoring and bonding? These are the central corporate governance questions.

QUESTIONS

1. Cathy Capitalist recently purchased a farm in California's Central Valley. Cathy is a hedge fund manager who lives and works in another part of the state and thus is unable to run the farm herself on a day to day basis. Cathy recently met Oliver Douglas, a young, enterprising farmer in the area. Oliver has the necessary equipment and expertise to run the farm on a daily basis. Cathy is considering two options with regard to Oliver: (1) leasing the farm to him in return for a fairly sizable rent or (2) hiring Oliver as an employee to manage the farm. In the first scenario, Cathy is engaged in a market transaction; in the second, she will have formed what we can describe as firm with herself as employer and Smith as employee. Why is some economic activity conducted across markets and some within firms? What are the economic costs and benefits of each? What factors is Cathy likely to consider most important?

2. Which of the following statements is more accurate?

a. Investors are more likely to lose money because managers are incompetent and make too many mistakes.

b. Investors are more likely to lose money because manage are self-interested and put their preferences ahead of the be interests of the company.

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[22] Michael P. Dooley, Two Models of Corporate Governance, 47 Bus. Law. 461 (1

[23] Kenneth J. Arrow, The Limits of Organization 78 (1974).

3. Shareholders are the corporation's residual claimants. Whatever assets and profits are left over after all other claimants—such as creditors and employees—have been paid belong to the shareholders. It is the separation of ownership and control that causes agency costs, because shareholders have very little say over what happens to those residual assets and profits. Instead, control over them is vested in the board of directors and the top managers in the C-suite. It would seem logical to reduce agency costs by increasing shareholder control, but that has not happened. Why not?

B. THE FEDERAL ROLE IN REGULATING CORPORATE GOVERNANCE

As we have seen, corporate governance consists not just of laws and regulations but also norms and practices. Having said that, however, law obviously matters a lot. But whose law? Historically, the answer was the states. Today, the answer is much more complex.

1) THE RACE TO THE BOTTOM DEBATE

Although Congress has never seen fit to promulgate a federal law of corporations, no one seriously doubts its powers under the Commerce Clause of the Constitution to do so. Instead, Congress and the Securities and Exchange Commission (SEC) have nibbled around the edges of corporate governance, regulating various aspects of it without preempting the field. Much of this book is devoted to those regulations. We begin, however, with the fundamental question: Should Congress nationalize corporate law?

William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware

83 Yale LJ 663 (1974)[24]

Delaware is both the sponsor and the victim of a system contributing to the deterioration of corporation standards. This unhappy state of affairs, stemming in great part from the movement toward the least common denominator, Delaware, seems to be developing on both the legislative and judicial fronts. In the management of corporate affairs, state statutory and case law has always been supreme, with federal intrusion limited to the field of securities regulation. Perhaps now is the time to reconsider the federal role.

I. The History of State Corporation Laws

A. Legislative Developments

. . .

In 1896 New Jersey adopted what is regarded as the first of the modern liberal corporation statutes. As Mr. Justice Brandeis pointed out

[24] Reprinted by permission of the Yale Law Journal.

. . ., this act is commonly credited with attracting the incorporation of the New Jersey trusts, such as the old Standard Oil Company, which were not trusts at all but corporations operating as consolidated or holding companies. While corporation statutes had been restrictive, the leading industrial states began removing the limits upon both the size and powers of business units. The states, realizing that local restriction would be circumvented by foreign incorporation and eager for the revenue derived from the traffic in charters, joined in advertising their wares. In Brandeis' words, the race was not one of diligence but of laxity.

Shortly afterwards, Delaware, seeking new sources of revenue, copied very largely from the New Jersey act to establish its own statute. Then in 1913, at the insistence of Governor Woodrow Wilson, New Jersey drastically tightened its law relating to corporations and trusts with a series of provisions known as the seven sisters. Since Delaware did not amend its statute, it took the lead at that time and has never lost it . . . .

B. The Primacy of Delaware

. . . With some justification Delaware corporate counsel take pride in their role and enjoy the fees that flow from it. The system "engenders a volume of business for the bar which tends to be regarded as a vested interest, so that any attempt to retrace steps would encounter opposition in powerful quarters."[39] Most important, the *raison d'etre* behind the whole system has been achieved—revenue for the state of Delaware.

FYI

Today, more than a million corporations and limited liability companies are domiciled in Delaware, including 60 percent of the Fortune 500 corporations.

Stimulating incorporation in Delaware has some of the flavor of a community chest drive. According to a state official, "The response 'has greatly exceeded our expectations.' So far this year 6,556 companies have incorporated themselves in Delaware . . . . The total may hit 9,000 by Dec. 31 . . . . The influx boosted the state's incorporation tax take by $2.9 million in fiscal 1968 . . . ."[40] In 1971 corporation franchise taxes represented $52 million out of a total of $222 million in state tax collections, approximately one-quarter of the total.[41] For revenue reasons, "creating a favorable climate" is declared to be the public policy of the state.

Some of the features of Delaware law demonstrating liberality have been recited in publications for practitioners. These include:

> greater freedom to pay dividends and make distributions; greater ease of charter amendment and less restrictions upon selling assets, mortgaging, leasing, and merging . . . freedom from mandatory cumulative voting; permission to have staggered boards of directors; lesser pre-emptive rights for

[39] [E. Dodd & R. Baker, Cases and Materials on Corporations 38 n.7 (1951).]

[40] Wall St. J., Nov. 21, 1968, at 1, col. 5.

[41] State Tax Collections in 1972, at 16 (Dep't of Commerce, Dec. 1972).

> shareholders; [and] clearer rights of indemnification for directors and officers . . . .[43]

. . .

> **THINK ABOUT IT**
>
> Do any of these provisions seem objectionable as a matter of public policy? Do any of them seem contrary to shareholder interests?

A few illustrations of the legislative approach reveal the Delaware position. For example, shareholders meetings may now be dispensed with if a consent is signed by the number of votes necessary to take the intended action, thus offering a technique to avoid disclosure. Protection from this abuse is provided through the proxy rules under federal law but they do not apply to firms that are [registered with the SEC under the Exchange Act]. Under § 109 of the Delaware law any corporation may in its certificate of incorporation confer the power to amend or repeal by-law provisions upon the directors and thus possibly foreclose any initiative outside the management.

. . .

II. Judicial Developments

> **THINK ABOUT IT**
>
> What incentives, if any, do Delaware judges have to encourage incorporation in Delaware? Do Delaware judges have incentives to pursue some other policy? If so, what?

Judicial decisions in Delaware illustrate that the courts have undertaken to carry out the "public policy" of the state and create a "favorable climate" for management. Consciously or unconsciously, fiduciary standards and the standards of fairness generally have been relaxed. In general, the judicial decisions can best be reconciled on the basis of a desire to foster incorporation in Delaware. . . .

. . . The necessary high standards of conduct cannot be maintained by courts shackled to public policy based upon the production of revenue, pride in being "number one," and the creation of a "favorable climate" for new incorporations. The view is widely held that Delaware corporate decisions lean toward the status quo and adhere to minimal standards of director responsibility both to the corporation and its shareholders. Although these generalizations are difficult to prove absolutely, a series of cases illustrates that this reputation is based upon an accurate analysis of the courts' decisions and that Gresham's law applies. One of the striking aspects of these opinions is that among the three supreme court justices there is rarely a dissent.

[Professor Cary next reviewed seven doctrines, as to each of whom he concluded that Delaware law favored managers over shareholders. We

[43] [Kaplan, Foreign Corporations and Local Corporate Policy, 21 Vand. L. Rev. 433, 436 (1968).]

will excerpt selected portions of this section of the article at appropriate places later in the text.]

III. Hypothetical Tests of Public Policy

Perhaps there is no public policy left in Delaware corporate law except the objective of raising revenue. . . .

IV. The Freedom to Litigate in Delaware—
The Other Side of the Coin

In response to such criticisms of Delaware's policy approach, counsel may point to the relative ease of entry into Delaware courts for suits against corporate directors. . . .

Delaware's approach to litigation, both legislatively and judicially, appears clearly contrary to its general attitude presented in the preceding sections of this article. Although there is no legislative history to support it, the concept of a competing interest in the Delaware bar, members of which draft the statutes and constitute the court, seems to provide a reasonable explanation. To summarize in the salty words of Professor Bishop, "Delaware's general approach to stockholder litigation . . . is to make it easy to sue the executives of Delaware corporations, no matter where they reside or where the corporation does business, so long as the suit is in Delaware Courts, and conducted by Delaware counsel."[145]

. . .

VII. Up from Delaware—Federal Standards
of Corporate Responsibility

A. Underlying Premises

Even if it is assumed that the Delaware courts have contributed to shrinking the concept of fiduciary responsibility and fairness, and indeed have followed the lead of the Delaware legislature in watering down shareholders' rights, the question is whether anything should be done about it. The principle of states' rights and the idea that each state is a laboratory are strong in this country.

On the other hand, one can fairly hope that the growth of the law in a civilized society should be evolutionary. It therefore seems reasonable to suggest several principles on which we should proceed. The first is to recognize the importance of an independent and impartial judiciary. The second is to preserve public policy as a standard to be observed by the courts. The third is to emphasize the need for uniformity, so that states shall not compete with each other by lowering standards for competitive reasons or for the purpose of generating revenue. Finally, there should be as much federal concern about the management of the public issue company and about its share owners as about the investor engaged in the purchase and sale of its stock.

[145] [See Bishop, Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 YALE L.J. 1078, 1084 (1968).]

With respect to public policy, the question arises whether the policy of a single state occupying a critical position should be permitted to grant management unilateral control untrammeled by other interests. Should one state set social policy in the corporate field when a corner-stone of that policy is to stay ahead of (or behind) the rest? It is understandable that Delaware would choose not to let its premier position in American corporate law go by default, but it must also be understood that the generic reason for attaining it was revenue.

. . .

B. The Need for Federal Standards

The discussion thus far might seem to lead to the recommendation of federal incorporation. In my opinion, however, this is politically unrealistic. It has been raised many times in Congress and in the literature but has no public appeal. American business would unanimously reject such a convenient vehicle for government control of the major industries of this country. . . .

However, in order to remedy the Delaware syndrome it does appear that federal standards of corporate responsibility are called for. This can best be achieved by prescribing minimum corporation law provisions which shall be applicable to companies doing business in interstate commerce and construed by federal judicial standards. Uniformity is of the essence. Efforts must be made to insure that provisions are not interpreted differently owing to varying state interpretations of public policy. There should also be wide-ranging service of process upon directors and officers of corporations. The participation of a government agency such as the Securities and Exchange Commission is not contemplated in this proposal.

. . .

C. A Proposed Federal Corporate Uniformity Act

. . . I propose a Federal Corporate Uniformity Act applying to all corporations having more than $1 million of assets and 500 shareholders. . . . To prevent disparity in the law, however, it might be preferable to make such an act apply to all public companies engaged in or affecting interstate commerce. . . .

The proposal is to continue allowing companies to incorporate in the jurisdiction of their choosing but to remove much of the incentive to organize in Delaware or its rival states. Such companies, nevertheless, must be subject to the jurisdiction of the federal courts under certain general standards. To illustrate, some of the major provisions of such a federal statute might include (1) federal fiduciary standards with respect to directors and officers and controlling shareholders; (2) an "interested directors" provision prescribing fairness as a prerequisite to any transaction; (3) a requirement of certain uniform provisions to be incorporated in the certificate of incorporation: for example, authority to amend by-laws, initiate corporate action, or draw up the agenda of shareholders' meetings shall not be vested exclusively in management; (4) a more frequent requirement of shareholder approval of corporate transactions, with limits placed upon the number of shares authorized at any one time; (5) abolition of nonvoting shares; (6) the scope of indemnification of directors specifically prescribed and made exclusive; (7) adoption of a long-arm provision comparable to § 27 of the Securities Exchange Act to apply to all transactions within the corporate structure involving shareholders, directors, and officers.

The foregoing suggestions do not pretend to offer a complete model for a minimum standards act. . . .

Conclusion

THINK ABOUT IT

What other provisions would be necessary or appropriate to create a complete minimum standards act under today's conditions?

In summary, as long as we operate within a capitalist society and as long as confidence in management is prerequisite to its continuance, there should be a federal interest in the proper conduct of the corporation itself as much as in the market for its securities. A civilizing jurisprudence should import lifting standards; certainly there is no justification for permitting them to deteriorate. The absurdity of this race for the bottom, with Delaware in the lead—tolerated and indeed fostered by corporate counsel—should arrest the conscience of the American bar when its current reputation is in low estate.

NOTES AND QUESTIONS

1. Cary's article is the classic articulation of the so-called "race to the bottom" hypothesis, which contends that managers rather than shareholders choose the state of incorporation and to attract incorporations states will therefore cater to the interests of managers in making corporate law. In response to Cary, Yale corporate law professor and later U.S. Circuit Court of Appeals Judge Ralph Winter argued that state competition for corporate charters produced a race to the top:

> Owners of firms going public will want to maximize revenues from initial public offerings, and managers will be constrained by their need to ensure that the company performs successfully in the marketplace. Thus, they will choose the state that is likely to produce the greatest profit for the firm over time. States will recognize that to attract firms, they must worry not about attracting managers but about attracting the owners of firms undergoing initial public offerings. Thus, the states will adopt corporate law structures that maximize shareholder wealth. These structures will also maximize the returns from initial public offerings, because bidders will be willing to pay more for shares in companies with shareholder-maximizing corporate law than for

> shares in companies that allow managers to expropriate superoptimal private benefits.[25]

Which version strikes you as more plausible?

2. Both Cary's and Winter's argument depends on an assumption that states compete to attract incorporations. When a firm incorporates in a state it pays, among other things, annual franchise taxes to that state for the privilege of being incorporated in it. In Delaware's admittedly extreme case, those franchise taxes typically amount to around one-fifth of the state's annual revenues. Accordingly, or so the argument goes, because states can raise substantial revenues for providing a service—i.e., incorporation—that costs the state almost nothing, the states have strong incentives to attract as many incorporations as possible. Race to the bottom proponents think this leads states to favor management over investors, while race to the top believe the opposite.

But do states really compete? Scholars have run various empirical analyses of the problem, which have failed to put the issue to rest. Nevertheless, there does seem to be an emerging consensus that while states do compete, that competition is more of a brisk walk than a 100-yard dash. As Judge Winter explained in a subsequent article:

> First, . . . state legislatures are political bodies and may be governed by a variety of motives. A race to the top argument applies only when a state legislature is guided solely by a desire to maximize franchise taxes. Other motives may well prevail, however.
>
> Second, . . . there are cases in which management may seek legal rules allowing side payments where those payments outweigh the negative effects of the capital market. These cases seem limited to changes in legal rules, including charter amendments or reincorporation in a new state, that occur after investors have become locked in and that involve, or are accompanied by, measures that impede takeovers. States that offer such impediments to takeovers may thus attract some chartering business. Of course, . . . the purpose of impediments to takeovers is precisely to reduce the discipline of the capital market and that may well seem attractive to inefficient managers.
>
> Third, the race to the top may be slow because Delaware is the only state devoted exclusively to maximizing franchise taxes and may need only to offer a code marginally more efficient than other states which may be influenced by law professors, the American Law Institute or management. It thus may not be difficult for Delaware to compete with such states for franchise taxes. In fact, the history of state antitakeover statutes may support the view that the race to the top is a leisurely walk. In both the first and second generation of takeover statutes, Delaware waited until its principal competitors had passed such legislation and then enacted a

[25] Michael Abramowicz, Speeding Up the Crawl to the Top, 20 Yale J. on Reg. 139, 161–62 (2003).

> relatively mild statute. It may thus be that what we need is not a federal chartering statute but rather a second Delaware that pursues franchise taxes and nothing else.[26]

Could a leisurely walk still result in corporate law rules that systematically trend either towards the bottom or the top?

3. Setting aside the question of how fast Delaware is racing and the direction of that race, there are numerous other reasons Delaware dominates the market for incorporations:

> [P]ublicly traded companies incorporate in Delaware (and pay its high franchise taxes) at least in part because of its high-quality and specialized courts and, as a general matter, want important and high-profile cases to be decided by Delaware judges. The Delaware court system rests on a highly respected Chancery Court that decides cases without juries and specializes in corporate law adjudication, combined with a Supreme Court that offers quick review and brings its own considerable expertise—three of the five current Delaware Supreme Court justices are former members of the Chancery Court, and all regularly hear appeals from the Chancery Court on corporate law issues. The Delaware Supreme Court and Chancery Court judges are not only experts, but are few in number and communicate regularly with each other and members of the corporate bar. In such a system, much of the shared understanding of Delaware doctrine resides between the lines of the judicial opinions.[27]

4. Some products become more valuable as the number of persons using them increases. Each person who adopts the product thus confers positive externalities on other users. Personal computers (PCs) are a commonly cited example of this phenomenon. The value of Microsoft's Windows operating system, for example, depends in part on how many people use it and thus create markets for compatible hardware and software. The more people who use Windows, the larger the market for ancillary products becomes, thus encouraging the development of more ancillary products of higher quality and lower price. This phenomenon is known as a "network effect" or "network benefit." How might network effects help explain Delaware's dominance of the market for charters?

5. What is the purpose of laws regulating corporate governance? To benefit society? To benefit shareholders? Or something else?

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[26] Ralph K. Winter, The "Race for the Top" Revisited: A Comment on Eisenberg, 89 Colum. L. Rev. 1526, 1528–29 (1989).

[27] Marcel Kahan & Edward Rock, How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware, and the Strategic Use of Comity, 58 Emory L.J. 713, 748–49 (2009).

2) A BRIEF HISTORY OF FEDERAL CORPORATE GOVERNANCE REGULATION

Until the 1930s, corporate law and governance were exclusively the province of state law. In the wake of the stock market crash of 1929 and the Great Depression that followed, however, President Franklin Delano Roosevelt's New Deal program included a series of laws designed to regulate the stock markets and securities transactions. The second of those statutes—the Securities Exchange Act of 1934—contained a number of provisions that, for the first time, involved the federal government in corporate governance.

On its face, of course, the Exchange Act said nothing about regulation of corporate governance. Instead, the Act's basic focus was trading of securities on the secondary market and securities pricing. Virtually all of its provisions are addressed to such matters as the production and distribution of information about issuers and their securities, the flow of funds in the market, and the basic structure of the market.

> **FYI**
>
> The New Deal was not the first time a federal law of corporations was considered. James Madison, for example, proposed that the Constitution give the federal government power to grant charters of incorporation, which presumably would have led to the development of a detailed body of federal statutory and common law. More recently, just 20 years prior to the adoption of the Exchange Act, the Pujo Committee suggested that "much-needed reforms in the organization and methods of our corporations" could be affected through stock exchange listing standards. H.R. Rep. NO. 1593, 62d Cong., 3d Sess. 114–15 (1913).

When the bill that became the Exchange Act was pending before Congress, moreover, the bill's supporters strenuously denied that they intended to regulate corporate management. The Senate Banking and Currency Committee went to the length of adding a proposed section 13(d) to the bill, which would have provided: "Nothing in this Act shall be construed as authorizing the Commission to interfere with the management of the affairs of an issuer."[28] The conference committee deleted the provision because it was seen "as unnecessary, since it is not believed that the bill is open to misconstruction in this respect."[29]

Subsequently, however, there were a number of direct efforts to create a federal corporate law. While the Exchange Act was being drafted, the Roosevelt administration considered developing a comprehensive federal corporation law. The Senate Banking and Currency Committee's report on stock exchange practices also suggested that the cure for the nation's "corporate ailments . . . may lie in a national

[28] S. 3420, 73d Cong., 2d Sess. § 13(d) (1934).

[29] H.R. Conf. Rep. No. 1838, 73d Cong., 2d Sess. 35 (1934).

incorporation act."[30] In the late 1930s, then SEC Chairman William O. Douglas orchestrated yet another effort to replace state corporate law with a set of federal rules administered by the SEC.[31]

Although none of these efforts came to fruition, judicial and regulatory interpretations of the Exchange Act gradually expanded the SEC's role in corporate governance. The proxy rules play a dominant role in shareholder voting. A federal prohibition of insider trading created by judicial interpretations of Rule 10b–5 essentially displaced state fiduciary duty law governing such trading. We will see numerous other examples throughout this text.

Congress and the SEC have created a dual system in which federal and state law uneasily coexist. The recurring question we will address throughout this text thus is where to draw the line.

NOTE ON CORPORATE FEDERALISM IN THE SUPREME COURT

As the D.C. Circuit observed in *Business Roundtable v. SEC*, validating rule 19c–4 would "overturn or at least impinge severely on the tradition of state regulation of corporate law."[32] In a series of cases, the Supreme Court has made clear that this is not a step to be taken lightly.

In the early 1970s, courts gave SEC Rule 10b–5, designed originally as a catch-all anti-fraud provision, an increasingly expansive reading that in time might have led to a federal common law of corporations. The Supreme Court applied the brakes in a series of cases, most notably *Santa Fe Industries v. Green*.[33] Santa Fe attempted to freeze out minority shareholders of one of its subsidiaries by means of a statutory short-form merger. The plaintiffs had state law appraisal rights available, but chose to seek redress under Rule 10b–5. Plaintiffs claimed a Rule 10b–5 violation arose because the minority shareholders did not receive prior notice and the merger lacked any legitimate business purpose. They also claimed that their shares had been fraudulently undervalued.

The Supreme Court held that plaintiffs had not stated a cause of action under rule 10b–5.[34] For present purposes, however, *Santa Fe*'s significance

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[30] S. Rep. No. 1455, 73d Cong., 2d Sess. 391 (1934).

[31] Joseph C. O'Mahoney, Federal Charters to Save Free Enterprise, 1949 Wis. L. Rev. 407. Proposals for a federal corporation statute did not stop when the New Deal ended. E.g., Protection of Shareholders' Rights Act of 1980: Hearing Before the Subcomm. on Securities of the Sen. Comm. on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess. (1980); The Role of the Shareholder in the Corporate World: Hearings Before the Subcomm. on Citizens and Shareholders Rights and Remedies of the Sen. Comm. on the Judiciary, 95th Cong., 1st Sess. (1977). In the 1970s, the Commission considered imposing a variety of corporate governance reforms, including various proposed new proxy rules. Exchange Act Release No. 14970 (July 18, 1978). After vigorous objections that the Commission had exceeded its statutory authority, the rules were substantially modified before adoption. Exchange Act Release No. 15384 (Dec. 6, 1978). See generally Homer Kripke, The SEC, Corporate Governance, and the Real Issues, 36 Bus. Law. 173 (1981).

[32] Bus. Roundtable v. SEC, 905 F.2d 406, 412 (D.C. Cir. 1990).

[33] 430 U.S. 462 (1977).

[34] Id. at 470–71. The Court rested its holding on several bases. First, section 10(b) and rule 10b–5 were only intended to reach deception and manipulation. Neither was present on

derives from its recognition that the fundamental purpose of the Exchange Act is to assure full disclosure. Once complete disclosure is made, the transaction's fairness and terms do not become issues under federal law, instead they are a matter for state corporate law. The Court was seemingly concerned that a decision in favor of plaintiffs would result in federalizing much of state corporate law; in many cases, overriding well-established state policies of corporate regulation. This concern was well-founded, for if the Court gave these plaintiffs a federal cause of action, it could not meaningfully justify denying a federal claim in any breach of fiduciary duty case. The Court simply refused to give rule 10b–5 such an expansive reach.[35]

WHAT'S THAT?

"Tender offer: A public offer to buy a minimum number of shares directly from a corporation's shareholders at a fixed price, usually at a substantial premium over the market price, in an effort to take control of the corporation. — Also termed takeover offer; takeover bid." TENDER OFFER, Black's Law Dictionary (10th ed. 2014).

In the 1980s, the Court once again faced the need to draw lines between the state and federal roles in regulating public corporations. At about the same time as Congress adopted the Williams Act to regulate cash tender offers, the states also began adopting tender offer statutes. This first generation of state takeover laws placed significant obstacles in the bidder's path. The Supreme Court's decision in *Edgar v. MITE Corp.,* 457 U.S. 624 (1982), however, rendered these laws invalid. The *MITE* decision, nevertheless, suggested one loophole through which state regulation might pass constitutional muster: the internal affairs doctrine. The states picked up on this hint and quickly began adopting a second generation of takeover laws, this time focusing on matters traditionally viewed as falling within the sphere of state corporate governance regulation: shareholder voting rights, shareholder approval of changes in corporate control, the fairness of post-tender offer mergers, and the like.

In *CTS Corp. v. Dynamics Corp.,*[36] the Supreme Court upheld one of these statutes as valid. When Dynamics made a tender offer for CTS, it challenged the Indiana control share acquisition statute on both preemption and commerce clause grounds. The Seventh Circuit struck down the Indiana Act on both grounds, but a majority of the Supreme Court reversed. In doing so, the Court made a number of observations directly relevant to the later Rule 19c–4 controversy. The Court recognized that states have a legitimate interest in defining the attributes of their corporations and protecting shareholders of their corporations. It also strongly indicated that the substance of corporate voting rights is solely a matter of state concern: "No principle of corporation law and practice is more firmly established than a

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these facts. Id. at 471–77. Second, the implied private right of action under rule 10b–5 should not be extended to cases that do not involve deception or manipulation. Id. at 477–80.

[35] It is, of course, still possible to state a federal claim in some breach of duty cases. However, the correct allegation in such cases derives not from the breach itself, but rather from the failure to disclose the breach. E.g., Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), cert. denied, 434 U.S. 1069 (1978).

[36] 481 U.S. 69 (1987).

State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders."[37]

These two lines of cases suggest that the Supreme Court views the states as the principal regulators of corporate governance. Federal law is seen as placing a gloss on the underlying background of state corporate law, but not as replacing it. Absent a clear expression of congressional intent, the Court has been reluctant to federalize questions traditionally within the state sphere.

3) SOX

As we have seen, although it has never opted to preempt the field of corporate governance, Congress long has been in the business of piecemeal federalization of corporate governance.

> Washington makes corporate law. From 1933 to 2002, that is, from the passage of the securities laws to the passage of Sarbanes-Oxley, Washington has made rules governing the voting of stock and the solicitation of proxies to elect directors. It has made the main rules governing insider trading, stock buybacks, how institutional investors can interact in corporate governance, the structure of key board committees, board composition (how independent some board members must be), how far states could go in making merger law, how attentive institutional investors must be in voting their proxies, what business issues and transactional information public firms must disclose (which often affect the structure and duties of insiders and managers to shareholders in a myriad of transactions), the rules on dual class common stock recapitalizations, the duties and liabilities of gatekeepers like accountants and lawyers, and more.[38]

[37] *CTS,* 481 U.S. at 89. The Supreme Court also has consistently recognized that state law governs the rights and duties of corporate directors. See, e.g., Burks v. Lasker, 441 U.S. 471, 478 (1979) ("As we have said in the past, the first place one must look to determine the powers of corporate directors is in the relevant State's corporation law. 'Corporations are creatures of state law' and it is state law which is the font of corporate directors' powers.").

[38] Mark J. Roe, Washington and Delaware as Corporate Lawmakers, 34 Del. J. Corp. L. 1, 10 (2009).

In this sense, both the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010 simply represent additional milestones in a process of gradual federalization. In another sense, however, they represent a significant departure. Unlike past federal corporate governance regulations, many of those in the two post-crisis laws cross the traditional boundary between state and federal law to directly regulate substantive aspects of corporate governance.

In response to the scandals that followed in the wake of the dotcom bubble, Congress passed the Public Company Accounting Reform and Investor Protection Act of 2002 ("Sarbanes-Oxley" or SOX), which President Bush praised at its signing for having made "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."[39]

FYI

"U.S. institutional investors are not a homogenous or monolithic group. In addition to pension funds, which themselves are divided into public, union, and private funds, institutional investors include mutual funds, private investment funds (including hedge funds), insurance companies, banks, endowments, sovereign wealth funds, and other types of institutions, subject to regulation in varying degrees. Institutional investors are usually intermediaries who hold shares for the benefit of someone else." Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles and Responsibilities, 65 Bus. Law. 107, 140 (2009).

Those reforms included:

- The creation of the Public Company Accounting Oversight Board to oversee the accounting profession.
- A number of mandates requiring companies to adopt more effective internal controls—i.e., the processes the company uses to ensure the reliability of its public financial disclosures and to make sure that it complies with applicable laws and regulations.
- A requirement that the chief executive officer and chief financial officer of a company must certify its financial statements and disclosure reports.
- A number of rules designed to ensure that a company's auditor is truly independent of company management.
- A related requirement that companies have an audit committee consisting of independent directors to deal with the auditor and oversee the company's financial processes.

[39] The Public Company Accounting Reform and Investor Protection Act, Pub. L. No. 107–204, 2002 U.S.C.C.A.N. (116 Stat.) 745 (codified in scattered sections of 15 and 18 U.S.C.) [hereinafter cited as SOX].

- New restrictions on loans to insiders and stock trading by insiders.

WHAT'S THAT?

CHIEF EXECUTIVE OFFICER, Black's Law Dictionary (10th ed. 2014): A corporation's highest-ranking administrator or manager, who reports to the board of directors. — Abbr. CEO.

CHIEF FINANCIAL OFFICER, Black's Law Dictionary (10th ed. 2014): The executive in charge of making a company's accounting and fiscal decisions. — Abbr. CFO.

- Changes in rules governing how corporations disclose information to the public, so as to increase the speed and transparency of such disclosures.
- Protections for whistle blowers and restrictions on document destruction, designed to prevent the sort of obstruction of justice witnessed at Enron.
- New and severe criminal and civil penalties for corporate misconduct.

We will look at most of these provisions in the chapters that follow.

4) DODD-FRANK

After the financial crisis of 2007–08, when the economy suffered through one of the worst downturns in U.S. history following the bursting of the housing bubble and the subprime mortgage crisis, populist outrage motivated Congress to pass The Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank").[40] Although Dodd-Frank's 2319 pages dwarfed SOX in both size and scope, most of Dodd-Frank deals with issues other the corporate governance. We will focus on 6 key provisions in the chapters that follow:

1. Section 951's "say on pay" mandate, requiring periodic shareholder advisory votes on executive compensation.
2. Section 952's mandate that the compensation committees of reporting companies must be fully independent and that those committees be given certain specified oversight responsibilities.
3. Section 953's direction that the SEC require companies to provide additional disclosures with respect to executive compensation.
4. Section 954's expansion of SOX's rules regarding clawbacks of executive compensation.
5. Section 971's affirmation that the SEC has authority to promulgate a so-called "shareholder access" rule pursuant

[40] The Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111–203, 124 Stat. 1376 (2010) (hereinafter cited as "The Dodd-Frank Act").

to which shareholders would be allowed to use the company's proxy statement to nominate candidates to the board of directors.

6. Section 972's requirement that companies disclose whether the same person holds both the CEO and Chairman of the Board positions and why they either do or do not do so.

NOTE ON SEC PERIODIC REPORTING REQUIREMENTS

If a corporation is required to register under the Securities Exchange Act,[41] it becomes subject to the Act's periodic disclosure rules. In addition, the corporation also becomes subject to the proxy rules under § 14, the tender offer rules under §§ 13 and 14, and certain of the Act's anti-fraud provisions. Finally, the company becomes subject to the extensive rules under the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010.

> **WHAT'S THAT?**
>
> STOCKHOLDER OF RECORD, Black's Law Dictionary (11th ed. 2019): The person who is listed in the issuer's books as the owner of stock on the record date.
>
> RECORD DATE, Black's Law Dictionary (11th ed. 2019): The date on which a stockholder must own shares to be entitled to vote or receive a dividend.

There are three basic categories of companies subject to the Securities Exchange Act's requirements. The first two are identified by §§ 12 and 13(a) of the Act. Section 13(a) requires periodic reports from any company registered with the SEC under Section 12 of the Act. In turn, § 12(a) requires that any class of securities listed and traded on a national securities exchange (such as the New York or American Stock Exchanges) must be registered under the Securities Exchange Act. In addition, as amended by the Jumpstart Our Business Startups Act (the "JOBS Act"), § 12(g) and the rules thereunder require all other companies with assets exceeding $10 million and a class of equity securities held of record by either (1) 2,000 or more persons or (2) 500 or more persons who are not accredited investors to register that class of equity securities with the SEC. The third and final group of companies subject to the Securities Exchange Act is identified by § 15(d), which picks up any issuer that made a public offering of securities under the Securities Act. Issuers with less than 1,200 record shareholders, however, are not subject to this requirement except during the fiscal year in which they made the offering.

The periodic reports required by the Securities Exchange Act include: (1) Form 10, the initial Securities Exchange Act registration statement. It is only filed once with respect to a particular class of securities. It closely resembles a Securities Act registration statement. (2) Form 10-K, an annual

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[41] It is sometimes said that the Securities Exchange Act registers companies, while the Securities Act registers securities. In fact, the former registers classes of securities, but the point is otherwise well-taken. A corporation that has registered a class of securities under the Securities Exchange Act must nevertheless register a particular offering of securities of that class under the Securities Act.

report containing full audited financial statements and management's report of the previous year's activities. It usually incorporates the annual report sent to shareholders. (3) Form 10-Q, filed for each of first three quarters of the year. The issuer does not file a Form 10-Q for the last quarter of the year, which is covered by the Form 10-K. Form 10-Q contains unaudited financial statements and management's report of material recent developments. (4) Form 8-K, which must be filed within 4 business days after certain important events affecting the corporation's operations or financial condition, such as bankruptcy, sales of significant assets, or a change in control of the company.

To assess your understanding of the material in this chapter, click here to take a quiz.

PART II

THE BOARD OF DIRECTORS