The Irrelevance of State Corporate Law in Governance of Public Companies


University of Denver College of Law
ARTICLES

THE IRRELEVANCE OF STATE CORPORATE LAW IN THE GOVERNANCE OF PUBLIC COMPANIES

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I. INTRODUCTION

With the advent of the new millennium, corporate America found itself mired in scandal. Although the nature of the scandals varied, self-dealing by management was the common denominator.¹ Managers of public companies obtained lucrative salaries, substantial numbers of stock options, rich severance packages, and loans on favorable terms.² Companies engaged in aggressive accounting treatment at the same time insiders sold shares.³

The scandals arose in large part out of a failure of managerial oversight. Officers and directors did not adequately protect the interests of the corporation. Not so much a matter of director indolence, the lack of oversight occurred in large part because state

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1. See infra note 251.
2. See infra notes 258–63 and accompanying text.
3. See infra notes 298–301 and accompanying text.
laws did not impose meaningful obligations on the board of directors in supervising the activities of the company.\(^4\)

This was not the first time states abdicated their role in the regulation of the corporate governance process of public companies. Congressional hearings in the 1930s revealed widespread abuse by officers and directors of the proxy and financial disclosure process.\(^5\) Congress responded with the adoption of the federal securities laws, removing from states the primary authority to regulate shareholder voting and the corporate disclosure process, at least with respect to public companies.\(^6\)

Enactment of the securities laws did not, however, entirely oust states from the corporate governance process. States retained the authority to determine the duties and obligations of directors in the management of the company through the establishment of fiduciary obligations.\(^7\) These obligations imposed on directors a duty to act with care, loyalty, and good faith.\(^8\)

Over time, state courts interpreted the duties in a manner that left little substance. The business judgment rule and universal adoption of waiver of liability provisions all but eliminated causes

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4. See infra notes 112–18 and accompanying text.
5. See infra Part III.B.
6. See infra notes 68–78 and accompanying text. It is not quite accurate to say that the securities laws regulate the corporate disclosure process only for public companies. This is certainly true with respect to required SEC filings, which apply only to companies subject to sections 12(g) and 15(d) of the Securities Exchange Act (codified at 15 U.S.C. § 78 (2000)). See 15 U.S.C. § 78m (2000). The securities laws also regulate corporate disclosure through the antifraud provisions. 15 U.S.C. § 78(a) (2000); see also J. ROBERT BROWN, JR., THE REGULATION OF CORPORATE DISCLOSURE § 2.01, at 2-5 to 2-6 (3d ed. 2003) [hereinafter REGULATION OF CORPORATE DISCLOSURE]. The most significant antifraud provision, Rule 10b-5, applies both to public and private companies. See 17 C.F.R. § 240.10b-5 (2003).
7. See infra notes 126–29 and accompanying text.
8. See, e.g., Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998) (describing the fiduciary duty of a Delaware director); Cede & Co. v. Technicolor, 634 A.2d 345, 361 (Del. 1993) (discussing the definition of the duty of loyalty). The Supreme Court of Delaware has provided little content to an independent duty of good faith. See Malone, 722 A.2d at 10; Cede, 634 A.2d at 361. Moreover, the lower courts have largely ignored it, treating it as a subcategory of loyalty. See In re Gaylord Container Corp. S'holders Litig., 753 A.2d 462, 475 n.41 (Del. Ch. 2000) ("Within which traditional duty [of loyalty] would logically rest the subsidiary requirement to act in good, rather than bad, faith toward the company and its stockholders."). More recently, the Delaware Court of Chancery has equated good faith with intentional disregard of known risks. See In re Walt Disney Co. Derivative Litig., 825 A.2d 275, 289 (Del. Ch. 2003) (finding that directors' "conscious[] and intentional[]" failure to inform themselves when making a decision breaches their duty of care).
of action for breach of the duty of care. The duty of loyalty, particularly self-dealing by officers and directors, could be validated through procedural mechanisms. With proper procedures, the fairness of the transaction was not subject to judicial review. This approach allowed self-dealing by officers and directors almost without limits.

With no serious state-imposed restrictions on self-dealing, the consequences were inevitable. Management took advantage of the circumstances to promote their own interests, culminating in the recent wave of much publicized abuses. Congress responded to these circumstances with the adoption of the Sarbanes-Oxley Act ("Sarbanes-Oxley"), the most far ranging securities law since the 1930s.

Sarbanes-Oxley contains a hodgepodge of provisions, ranging from heightened regulation of accountants to increased criminal penalties for corporate malfeasance. The legislation also imposes new responsibilities on officers and directors. In many respects, Sarbanes-Oxley supplants state law in the regulation of the behavior of management, removing the last significant area of state regulation of the governance of public companies.

Sarbanes-Oxley in some ways resolves a debate that has raged within academic circles for the last thirty years. With states often

9. See infra notes 134-53 and accompanying text.
10. See infra notes 136-48 and accompanying text.
11. See infra notes 158-65 and accompanying text. The only remaining ground for assessing the substance of the transactions is under a standard of waste, something difficult to prove. See infra note 142 and accompanying text. Thus, the application of the business judgment rule largely ended the legal analysis. See Rosser v. New Valley Corp., No. 17272, 2000 Del. Ch. LEXIS 115, at *23 (Del. Ch. Aug. 15, 2000) ("So while fully informed shareholder ratification may not be tantamount to the death penalty for breach of fiduciary duty claims, application of the business judgment rule will lead to the same end result in virtually every case.").
described as competing for charters, considerable disagreement has arisen over whether the competition has generated a "race to the bottom" or a "race to the top." The answer from Congress was a race to the bottom. Sarbanes-Oxley arose out of this failure to impose meaningful standards in the area of corporate governance, resulting in the solution largely proposed by Professor William L. Cary in 1974 and sharply criticized by most commentators thereafter.

Having said that, Sarbanes-Oxley did not complete this process. Congress adopted Sarbanes-Oxley as a reaction to specific problems arising out of the corporate governance scandals, not as a mechanism to fill systematically the gaps created by the lack of meaningful standards at the state level. In some cases, the provisions of Sarbanes-Oxley are overly strict by, for example, prohibiting loans to executive management. In other cases, Sarbanes-Oxley is lax, imposing governance standards that do not address the most significant problem areas.

The absence of systematic federal regulation of the corporate governance process largely left to states the responsibility for determining the duties and obligations of officers and directors. Because Sarbanes-Oxley does not alter the competition for charters—something perhaps more accurately described as a competition to retain charters—meaningful standards are not likely to emerge. As a result, neither the states nor the federal government adequately regulates the behavior of officers and di-

17. The idea that there is competition among states to attract new charters may be wrong. See Marcel Kahan & Ehud Kamar, The Myth of State Competition in Corporate Law, 55 STAN. L. REV. 679, 648–85 (2002) (noting that no state seems to compete directly with Delaware for the charters of public companies). There does appear, however, to be a rigorous effort to retain existing charters, something that may have the same effect as a competition. See infra notes 68–74 and accompanying text.
18. For an overview of the debate, see infra notes 68–74 and accompanying text.
19. See infra Part III.
20. See generally William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 YALE L.J. 663 (1974). Professor Cary called for the adoption of legislation that would, among other things, provide for uniform federal fiduciary duty standards for public companies. Id. at 696–703. To the extent he suggested other uniform federal standards, however, his conclusions are less certain. See infra notes 62–106 and accompanying text; see also infra notes 392–95 and accompanying text.
21. See infra notes 35, 37, and 40–45.
23. See infra notes 371–79 and accompanying text.
rectors. Said another way, the dynamics that resulted in the scandals of the new millennium largely remain in place.

This article will focus on four aspects of the law of corporate governance. Part II will examine the process of competition among states for charters.\textsuperscript{24} Recent commentary in the area suggests that the process is driven less by a competition for charters and more by a desire to retain existing incorporations.\textsuperscript{25} Part III analyzes the history of federal intervention when states failed to adequately regulate aspects of corporate governance, including proxy solicitations and financial disclosure.

Part IV will discuss the unsuccessful efforts by the Securities and Exchange Commission ("SEC") to compensate for the failings of state laws in the corporate governance area.\textsuperscript{26} Without substantive regulatory authority, the SEC tried to use disclosure requirements to improve the degree of deliberation and governance at the board level.\textsuperscript{27} The approach did not work, and in some areas, such as compensation, may have been counterproductive.

Part V will examine the Sarbanes-Oxley Act and will discuss the standards imposed on management of public companies.\textsuperscript{28} Finally, this piece will assess the changes brought about by Sarbanes-Oxley and make the case for the need for increased, meaningful regulation of corporate governance standards for public companies at the federal level. In many respects, Sarbanes-Oxley supplanted state law in the regulation of the duties and responsibilities of managers.

II. CORPORATE LAW AND THE "COMPETITION" FOR CHARTERS

A. Overview

Under the internal affairs doctrine, the standard of behavior for officers and directors is traditionally determined by the law of

\textsuperscript{24} See infra Part II.
\textsuperscript{25} See infra note 69 and accompanying text.
\textsuperscript{26} See infra Part IV.
\textsuperscript{27} See infra notes 187–99 and accompanying text.
\textsuperscript{28} See infra Part V.B.
the state of incorporation. Companies may incorporate in any state. There need not be a meaningful nexus of any kind with the selected jurisdiction. The state of incorporation, therefore, regulates the internal affairs of a public company even if it has no headquarters, shareholders, managers, or business operations within the state.

Management determines the state of incorporation and has an incentive to incorporate in a state that most meets its objectives. To the extent a state does not meet those objectives, the

29. See Edgar v. Mite Corp., 457 U.S. 624, 645 (1982) ("The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders—because otherwise a corporation could be faced with conflicting demands."). Nonetheless, some states, particularly California, have in fact regulated the internal affairs of companies not incorporated in the state. See Western Air Lines, Inc. v. Sobieski, 12 Cal. Rptr. 719, 728 (1961) (holding that California's cumulative voting provision applied to a foreign corporation operating within that state). Even California has, however, left fiduciary duties untouched—that area remains the exclusive purview of the state of incorporation. See Davis & Cox v. Summa Corp., 751 F.2d 1507, 1527 (9th Cir. 1985) ("Claims involving internal affairs of corporations, such as the breach of fiduciary duties, are subject to the laws of the state of incorporation.").

30. David A. Skeel, Jr., Rethinking the Line Between Corporate Law and Corporate Bankruptcy, 72 TEX. L. REV. 471, 517 (1994) (noting that a corporation "ordinarily can incorporate wherever it chooses").

31. See Alfred F. Conard, An Overview of the Laws of Corporations, 71 MICH. L. REV. 621, 633 (1973) ("What is unusual about the race of laxity in corporation codes is that its effect will be felt almost entirely outside the state."); see also Skeel, supra note 30, at 517; Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. LEGAL STUD. 251, 252 (1977).

32. Winter, supra note 31, at 252. To the extent management decides to change states through reincorporation, shareholder approval is also required. See Lucian Arye Bebchuk, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 HARV. L. REV. 1437, 1458 (1992) ("Reincorporation generally requires a decision by the company's board and approval by the company's shareholders.").

33. See Skeel, supra note 30, at 517 ("[C]orporations have an incentive . . . to shop for the state with the most attractive laws."). In the 1970s, a debate existed over the impact of competition among states for corporate charters. Professor Cary argued that it would lead to laws that were lax and did not adequately protect shareholders. Cary, supra note 20, at 665, 668. He used the phenomena to argue for federal incorporation. Id. at 697. Professor Winter in turn contended that the plethora of state laws would lead to competition and laws that better protected shareholders. Winter, supra note 31, at 256 (stating that competition would "optimize the shareholder-corporation relationship."). By the 1980s, one prominent commentator concluded that Cary's analysis had been entirely discredited. See Daniel R. Fischel, Organized Exchanges and the Regulation of Dual Class Common Stock, 54 U. CHI. L. REV. 119, 127–28 (1987) ("In connection with this proposal for federal chartering of corporations, the 'race to the bottom' thesis has been vigorously analyzed and discredited on both a theoretical and an empirical level.").
company can reincorporate into a jurisdiction that does. At the same time, states have an incentive to implement an approach to regulation favored by management. Companies pay a franchise tax to the state of incorporation. Delaware, one of only five states without a sales tax, obtains considerable tax revenues from companies incorporating within the state. This is true even though most of them have no significant operations within Delaware.

As long as one state puts in place a scheme of regulation favored by management, others have an incentive to do the same. Either they wish to engage in the competition for additional companies (and additional franchise taxes) or they wish to keep what they have. In states that do not follow suit, at least some companies will have an incentive to leave the jurisdiction and reincorporate in a more favorable locale.

34. This is usually done through a merger. See David L. Ratner & Donald E. Schwartz, The Impact of Shaffer v. Heitner on the Substantive Law of Corporations, 45 BROOK. L. REV. 641, 642 n.9 (1979) ("The normal technique for changing the state of incorporation is to establish a new corporation under the laws of the desired state and merge the existing corporation into it."). As a result, reincorporation requires shareholder approval. See Bebchuk, supra note 32, at 1458.

35. See Mark J. Loewenstein, Delaware as Demon: Twenty-Five Years After Professor Cary's Polemic, 71 U. COLO. L. REV. 497, 507 (2000) (noting that in 1998 Delaware collected almost $400 million in franchise taxes and "clearly has an economic interest in maintaining its position as a jurisdiction of choice for incorporations").

36. See Stephen M. Bainbridge & G. Mitu Gulati, How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions, 51 EMORY L.J. 83, 149 (2002) ("Delaware earns substantial revenues from corporation franchise fees and taxes."); Lowenstein, supra note 35, at 507 ("[F]ranchise fees in Delaware can range up to $150,000 per year for a large corporation and are a significant portion of the state's tax revenues, typically accounting for fifteen to twenty percent of state revenues.").

37. See Christian C. Day, Corporate Governance, Conrail, and the Market: Getting on the Right Track!, 26 J. CORP. L. 1, 37 n.231 (2000) (noting that most Delaware corporations operate in other states and have few, if any, employees in Delaware). Only two of the Fortune 500 companies are actually headquartered in Delaware, one of which is incorporated in another state. See Fortune 5 Hundred Ranked Within States, FORTUNE, Apr. 14, 2003, at F-22 (noting that two Fortune 500 companies, Du Pont and MBNA, are headquartered in Delaware); see also E.I. du Pont de Nemours and Co., Quarterly Report, Form 10-Q (Aug. 12, 2003) (listing Delaware as state of incorporation and address of principle office in Wilmington, Delaware); MBNA Corp., Current Report, Form 8-K, SEC File No. 001-10683 (Aug. 20, 2003) (listing Maryland as the state of incorporation and Wilmington, Delaware as principal executive offices).

38. See Roberta Romano, Law as a Product: Some Pieces of the Incorporation Puzzle, 1 J.L. ECON. & ORG. 225, 277 (1985) (arguing that Delaware's advantage as a favorable loca-
Commentators characterize this dynamic as a competition for charters, although they vigorously disagree about the impetus for the competition. Some see the competition as a race to the top. They assert that management has an incentive to incorporate in the jurisdiction that provides the most efficient corporate law. To the extent directors elevate self-interest over efficiency, the market for corporate control will result in a change of management. Recognizing that the largest number of public companies incorporate in Delaware, the “race to the top” view requires the conclusion that the corporate law in Delaware is the most efficient.

The main problem with this approach is its excessive reliance upon the market for corporate control to ensure efficiency. The market for corporate control is not sufficiently robust to force management to select states based upon economic efficiency. Moreover, given the high costs of hostile takeovers, a great deal of inefficiency must occur before the market will become a correcting mechanism.

40. The phenomenon of states competing for charters has been widely recognized, although the impact of the competition has been in dispute. A few commentators, however, seem to contend that, in fact, there is no competition for charters but that states still have an incentive to act in a pro-shareholder fashion. See Loewenstein, supra note 35, at 503.

41. See Winter, supra note 31, at 289–90.

42. This is not to say that the two are always different. See infra notes 65–68.

43. If a state has an excessively anti-shareholder regime, the company will incur investor resistance and suffer higher costs of capital. This will, in turn, raise the costs of doing business, rendering the company less efficient and more susceptible to a takeover. See Winter, supra note 31.

44. See Jonathan R. Macey & Geoffrey P. Miller, Toward an Interest-Group Theory of Delaware Corporate Law, 65 Tex. L. Rev. 469, 473 (1987) (noting a number of prominent commentators’ conclusions that “Delaware corporate law rules are efficient, that is, they systematically advance shareholder welfare”).

45. See Guhan Subramanian, The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the “Race” Debate and Antitakeover Overreaching, 150 U. Pa. L. Rev. 1795, 1873 (2002) (“The evidence presented in this Article suggests that, as a matter of public policy, we cannot rely on the product market, the capital market, or the market for corporate control to exert pressure on managers so that they migrate away from the typical antitakeover statutes.”).

46. This assumes the market could even value the risk accurately. See Loewenstein, supra note 35, at 537–38 (“[T]he ‘Holy Grail’ economic efficiency analysis assumes that markets can accurately price the value of all terms of corporate governance, but there is evidence that markets do not do a particularly good job of valuing even significant terms of corporate governance.”).

47. See J. Robert Brown, Jr., In Defense of Management Buyouts, 65 Tul. L. Rev. 57,
Largely recognizing this, proponents increasingly rely upon event studies and other statistical data to make the case.48 The data, however, does not prove their case, as recent commentary has shown.49 In addition, the importance of the data seems to break down in practice. The data suggests that, at most, reincorporation results in a relatively small increase in share prices.50 There is little evidence suggesting that management is aware of, and has actually used, the data as a basis for reincorporation.51

Indeed, to the extent that the impetus for reincorporation is attributed to non-managers, commentators point to lawyers.52 Advice on reincorporation as a strategy for increasing share prices would seemingly emanate from investment bankers and other financial advisors.53 Moreover, given the seeming certainty of the data, at least for some commentators, it is hard to imagine why all public companies do not reincorporate in Delaware.54

61–67 (1990) (discussing reasons why the market for corporate control does not correct management inefficiency); see also Loewenstein, supra note 35, at 531 ("The otherwise inefficient corporate statute must have a dramatic effect on the stock price, as the typical hostile takeover is at a premium of twenty-five to thirty-five percent over market.").

48. See, e.g., Romano, supra note 39, at 246; Wells M. Engledow, Handicapping the Corporate Law Race, 28 J. CORP. L. 143 (2002).


50. The average of six studies shows an increase of around one percent, while two of the studies actually show a negative increase. See Bebchuk et al., supra note 49, at 1792 ("Thus, a 1% positive abnormal return is probably as fair a measure as any if one were inclined to rely on these event studies to measure the effect on stock price of reincorporation to a superior corporate law regime.").

51. See Robert Daines, The Incorporation Choices of IPO Firms, 77 N.Y.U. L. REV. 1559, 1561 (2002) (stating that the "question of where firms incorporate and how they choose [where to incorporate]" has not been well studied).

52. See Kahan & Kamar, supra note 17, at 743 ("[N]oncompeting states respond mostly to the lobbying efforts of local managers and lawyers."); see also Macey & Miller, supra note 44, at 502–06; Loewenstein, supra note 35, at 503–06; William W. Bratton, Delaware Law as Applied Public Choice Theory: Bill Cary and the Basic Course After Twenty-five Years, 34 GA. L. REV. 447, 460–61 (2000); Kahan & Kamar, supra note 17, at 694–99.

53. See Romano, supra note 39, at 275 n.72.

54. While concluding that companies engaging in initial public offerings ("IPOs") would only incorporate in states that provide the greatest IPO price, Engledow does not explain why, given event study data suggesting that Delaware had the most "efficient" state law, all companies do not incorporate there before conducting an IPO. See Engledow,
Others see the motivation for selecting the state of incorporation as more self-serving, characterizing the competition as a race to the bottom. Management will select a jurisdiction that favors its own self-interest. Among other things, the goal is to select the state of incorporation that permits management to extract the most benefit for itself, without regard to efficiency or the interests of shareholders.

This approach also has problems. First, changes in state corporate codes often cannot be characterized as being for or against the interests of management. Second, even if management opposes the changes, the harm must outweigh the costs (financial and reputational) before reincorporation will occur. Third, management self-interest and efficiency are not always antithetical notions.

supra note 48, at 149–61.

55. See generally Cary, supra note 20. In addition to Cary and the commentators cited in his article, see also Bebchuk, supra note 32, at 1444–45 (discussing Cary's race to the bottom analysis).

56. One commentator has taken the position that Delaware in fact attracts charters because of the "indeterminacy" of its corporate law. Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 COLUM. L. REV. 1908, 1909 (1998) ("Yet state competition theories fail to explain the well-documented indeterminacy of Delaware corporate law, which is evident in the state's ample use of vague standards that make prediction of legal outcomes difficult."); see also Jill E. Fisch, The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters, 68 U. CIN. L. REV. 1061, 1072–1100 (2000) (noting the importance of courts in making law as an explanation for Delaware's preeminent position). Both Kamar and Fisch are correct in emphasizing the importance of Delaware court decisions as a significant explanation for the state's preeminence in attracting corporate charters. They are also correct in emphasizing that corporate laws are largely templates, with the courts determining the outcome of each particular fact pattern. To the extent that they conclude that Delaware decisions are indeterminate, they are not correct. In fact, the strength of the Delaware courts is the ability to apply broad doctrines to varied fact patterns and consistently rule in a manner that favors management. See infra notes 133–86 and accompanying text.

57. For a recent article that provides an empirical basis for this conclusion, see Subramanian, supra note 48, at 1872.

58. See Kahan & Kamar, supra note 17, at 701–07.

59. Reincorporation is not a cost free process, although the significance of the expense has been a subject of debate. Compare Bernard S. Black, Is Corporate Law Trivial?: A Political and Economic Analysis, 84 NW. U. L. REV. 542, 585–89 (1990) (arguing that the costs of reincorporation are not significant), with Romano, supra note 39, at 246 (asserting that costs of reincorporation can be significant). Either way, the benefits of reincorporation would have to outweigh the costs for management to consider reincorporation. Not all unfavorable managerial provisions would meet this threshold requirement.

60. See Macey & Miller, supra note 44, at 470–71.
B. *Competition or No Competition?*

Some commentators question whether the characterization of a competition accurately explains the evolution of corporate law.\(^{61}\) Professors Kahan and Kamar, in a thoughtful piece, view the notion of a competition as a myth.\(^{62}\) They note that only Delaware generates significant revenues from franchise taxes and that no other state appears to be taking the steps necessary to compete significantly for the revenues.\(^{63}\) They conclude that, for reasons unrelated to a competition for charters and a race to the bottom, all states have a pro-management bias in the development of corporate law.\(^{64}\) In fact, Delaware has less of a bias because, in attracting reincorporations, the state has an incentive to make its laws "more favorable to shareholders than the laws of noncompeting states."\(^{65}\)

The article is certainly correct in concluding that corporate law in its entirety cannot be explained through reference to a competition or race. Virtual shareholder meetings,\(^{66}\) the insolvency test for dividends, and the elimination of the labels of common and preferred stock, to name a few, hardly seem to have resulted from a competition to attract or retain corporate charters. Some of these changes cannot be accurately characterized as pro-management. Even if they could, they hardly seem the types of

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63. *Id.* at 688.

64. *See id.* at 749. Kahan and Kamar have concluded that, even absent a "competition" for charters, a pro-management bias exists in the corporate reform process. *See id.* ("[B]oth Delaware and noncompeting states, albeit for different reasons, skew their laws in favor of managers."). In fact, they propose that "[t]he laws of noncompeting states therefore tend to be more favorable to managers than they would be if they competed for incorporations." *Id.* at 737.


66. Section 211(a)(1) of the Delaware Code now permits stockholder meetings entirely by remote communications, without the need for physical attendance. *Del. Code Ann. tit. 8, § 211(a)(1)* (Repl. Vol. 2001). Companies may do so, however, only if they have implemented measures to ensure that all stockholders have an opportunity to participate in the meeting. *Id.* § 211(a)(2). Moreover, the authority to hold a meeting in cyberspace rests exclusively with the board of directors. *Id.*
changes that would cause companies to incur the expense of re-incorporation.\textsuperscript{67}

Having said that, Kahan and Kamar's reasoning is not complete. First, while they make a strong case that states do not actually compete for additional charters,\textsuperscript{68} they are less convincing when they argue that states do not aggressively seek to prevent reincorporations.\textsuperscript{69} While Delaware does generate the largest amount of revenue from franchise taxes, this does not mean that the payments in other jurisdictions are so insignificant that states will stand by as companies reincorporate.\textsuperscript{70} The recent efforts by the governor of Texas to close the "Delaware loophole" in order to preserve franchise taxes is one example.\textsuperscript{71}

Nor are franchise taxes the only reason states seek to prevent reincorporation. Reincorporation may result in loss of prestige when large companies headquartered in the state move to an-

\textsuperscript{67} Professor Romano has placed the typical cost of reincorporation at $40,000, although that figure was from the 1980s. Romano, supra note 39, at 246. Some commentators have argued that companies should reconsider the reliance on Delaware as a location for incorporation. In describing the advantages of a non-Delaware jurisdiction, they invariably make the case that the other state provides even greater managerial flexibility and reduced liability. See, e.g., Byron F. Egan & Curtis W. Huff, Choice of State of Incorporation—Texas Versus Delaware: Is It Now Time to Rethink Traditional Notions?, 54 SMU L. REV. 249, 251 (2001) (noting that Texas, among others, expanded indemnification provisions for officers and directors, allowed liability to be removed for a violation of the law and a breach of the duty of loyalty, and expanded the type of information directors and officers may rely upon in performing their duties).

\textsuperscript{68} There is anecdotal evidence to the contrary. See, e.g., William Gruber, George Ryan to Ask Local Corporations to Charter in State, CHI. TRIB., June 14, 1996, § 3, at 3 (reporting that Illinois Secretary of State George Ryan encouraged companies operating in Illinois to incorporate in the state, and noting Ryan's opinion that "Illinois corporate laws now match the laws of Delaware—or any other state—in terms of simplicity, clarity and the benefits for business").

\textsuperscript{69} They devote two paragraphs to the issue. Kahan & Kamar, supra note 17, at 699–700. The desire to prevent reincorporation rather than seek additional charters can create a race to the bottom dynamic. Changes in the law favorable to management in one state might result in reincorporation unless duplicated in the state of incorporation. See Bebchuk et al., supra note 49, at 1779–80 (arguing that the conclusions based on empirical studies supporting the race to the top view are unjustified). But see Engledow, supra note 48, at 148–50 (taking the position that states are not racing to the bottom).

\textsuperscript{70} Focusing exclusively on franchise taxes may also be too narrow and not fully reflect the tax advantages of incorporating in Delaware. See Jay Hancock, Maryland Needs to Close Out-of-State Tax Loophole, BALTIMORE SUN, Feb. 5, 2003, at 1D (discussing a tax loophole for companies incorporated in Delaware and doing business in other states).

\textsuperscript{71} See Monica Wolfson, Companies Can Breathe Easy Knowing They Avoided Franchise Tax Again, CORPUS CHRISTI CALLER-TIMES, June 20, 2003, at A6 (noting that Texas subsidiaries reincorporated in Delaware to avoid franchise taxes and reporting that the total state franchise tax revenues were predicted to decline by $144 million in 2003).
other state. There may be a loss of work for local lawyers and other professionals. Perhaps most importantly, many non-Delaware companies have their headquarters and significant operations in their respective states of incorporation.\textsuperscript{72} Companies reincorporating because of the perceived unfriendliness of the local corporate law may be tempted to do more than just change the location of legal incorporation by moving headquarters or operations, something that could result in a loss of jobs and a diminution of the tax base.

In fact, Kahan and Kamar's analysis illustrates the degree to which states will go to retain companies within their jurisdictions. As they correctly note, anti-takeover laws arose not in Delaware but in states seeking to protect local companies.\textsuperscript{73} In adopting these laws, states were probably motivated less by a desire to protect franchise taxes and more by a desire to avoid the loss of prestige and the economic consequences associated with a takeover of a local company.\textsuperscript{74}

Second, the article correctly notes that a number of reforms cannot be explained by conventional notions of competition,\textsuperscript{75} but then ignores reforms that can.\textsuperscript{76} Kahan and Kamar conclude "that ogive diffusion of statutory innovations is consistent with legislative motives other than competition for incorporations."\textsuperscript{77} Moreover, they challenge the conclusion in Professor Romano's article that the diffusion pattern for corporate law reform suggests competition.\textsuperscript{78}

\begin{itemize}
\item \textsuperscript{72} See Romano, \textit{supra} note 39, at 278 ("It is no coincidence that in most of these cases, statutory domicile coincides with the location of valuable physical assets, major operating facilities, and/or executive offices.").
\item \textsuperscript{73} Kahan & Kamar, \textit{supra} note 17, at 703–04.
\item \textsuperscript{74} The combined entity would presumably have its headquarters at the location of the bidder. The target could also incur job reductions and plant closures in an effort to reduce costs, all of which could have a detrimental impact on the state of the target's incorporation.
\item \textsuperscript{75} Kahan & Kamar, \textit{supra} note 17, at 701–07.
\item \textsuperscript{76} Others make the same mistake. See Engledow, \textit{supra} note 48, at 177 (concluding that all of the reviewed reform measures produce costs that outweigh any benefits).
\item \textsuperscript{77} Kahan & Kamar, \textit{supra} note 17, at 716.
\item \textsuperscript{78} \textit{Id.} at 715–16. Professor Romano studied the pattern of reform in connection with four matters: indemnification, short-form mergers, elimination of appraisal rights for companies whose shares trade on a national exchange, and anti-takeover statutes. Romano, \textit{supra} note 39, at 233.
\end{itemize}
In rejecting competition as an explanation for reform, Kahan and Kamar largely rely on four changes in the Revised Model Business Corporation Act\(^7\) and the pattern of adoption by the states.\(^8\) These include the authorization of share exchanges, the use of the insolvency test for dividends, the replacement of majority with plurality vote requirements, and the exclusive nature of dissenter’s rights.\(^9\) The article also analyzes anti-takeover statutes and concludes that their adoption cannot be explained by a competition for charters.\(^10\)

The article is almost certainly correct in rejecting competition as an explanation for most of these reforms. Some of them are arguably not pro-management.\(^11\) Others, while arguably pro-management, do not significantly implicate areas of substantial managerial interest.\(^12\)

Nevertheless, the case concerning anti-takeover statutes illustrates the limits of their conclusion. The anti-takeover statutes were not designed to attract additional charters, as Kahan and Kamar acknowledge.\(^13\) They are designed to prevent reincorporations.\(^14\) Delaware’s relative slowness in adopting these provisions is most likely explained not by the absence of competition but by other factors.

Because of the number of companies incorporated in Delaware, the state’s population includes both targets and bidders, making a consensus among public companies within the state a slower process.\(^15\) Moreover, the statutes are complex and can interfere

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80. Kahan & Kamar, supra note 17, at 702–03.
81. Id. at 702 n.70.
82. Id. at 703–04.
83. The insolvency test for dividends makes economic sense. Nonetheless, the stated capital test probably provides management of public companies with greater flexibility to pay dividends. For most public companies, stated capital is a negligible amount.
84. See, e.g., Kahan & Kamar, supra note 17, at 702 n.70 (noting that one significant change was the authorization of share exchanges).
85. Id. at 704.
86. States adopting anti-takeover statutes were largely interested in protecting companies that, while incorporated within the jurisdiction, also had operations within the state. Id. at 704 n.77.
87. In most states, the prospect of takeovers presented the possibility of layoffs, plant closures, and other negative economic consequences. Delaware, on the other hand, had to consider anti-takeover legislation in the context of companies that largely had no significant operations within the state. Moreover, Delaware also had to consider that bidders were often as likely to be incorporated within the state as targets. It is therefore too sim-
with traditional corporate transactions. They, for example, often impose restrictions on the ability of large shareholders to acquire the company. In contrast, Delaware was the innovator in the development of other, more flexible anti-takeover tactics, such as poison pills.

C. Competition for Charters, Director Liability, and Job Preservation

The conclusion that these provisions cannot be explained through competition does not rule out the possibility of competition in other areas. Only those areas important enough to management to result in reincorporation can be explained as a product of competition among states. Three areas seem likely to have paramount importance to management: (1) maximizing decision-making flexibility (particularly for self-dealing transactions); (2) minimizing liability (particularly for breach of fiduciary duties); and (3) job preservation. Moreover, even changes in these areas will not result in reincorporation unless the costs outweigh the benefits. Presumably only a small number of provisions will fall into this category.

A number of examples of this type of competition exist. In the context of liability, Delaware amended its corporate code in 1986 to permit companies to waive monetary liability for breach of the duty of care by directors. In a relatively short time, every juris-

89. See supra notes 101–03 and accompanying text.
90. See Bebchuk et al., supra note 49, at 1779 (“[S]tate competition induces states to provide rules that managers, but not necessarily shareholders, favor with respect to corporate law issues that significantly affect managers’ private benefits of control, such as rules governing takeovers.”). Even in these areas of importance it would be wrong to state that every change will cause reincorporations. Only if there were significant differences (which could be a single significant difference or a collection of smaller differences) among the states in these areas would management likely incur the costs associated with reincorporation. See id. at 1792–97 (analyzing the confounding events that accompany reincorporations); see also supra note 59 (discussing costs of reincorporation).
91. Alternatively, the benefits of reincorporation could outweigh the costs where a number of less important changes, in the aggregate, resulted in a more pro-management regulatory scheme.
92. Delaware law allowed companies to include in their charter a provision that would waive monetary damages for breach of a director's fiduciary duties. See DEL. CODE ANN. tit. 8, §102(b)(7). The provision, however, specifically prohibited waivers for breach of the
diction followed suit. Given the ostensible justification for the provision (to ensure that companies could attract qualified directors by eliminating the fear of liability), it is possible that the other states found the analysis persuasive and acted quickly. More likely, however, states implemented the change to forestall the possibility that companies would reincorporate if the legislature failed to act.

Similarly, managers have a desire to retain their jobs. They confront the risk of losing their positions in the event of a hostile takeover. While Delaware was slow to adopt anti-takeover statutes, the state did not delay when it came to authorizing defensive tactics subject to the discretion of the board of directors. In
this area, Delaware has again had a profound impact on other states. 97

The most effective anti-takeover tactic is a shareholder rights plan or poison pill. 98 The poison pill was invented in the 1970s and judicially validated in the 1980s. 99 While the invention of the poison pill may have required some creative lawyering, the device would not work unless state corporate law agreed to permit discrimination among shareholders of the same class. 100

In Unocal Corp. v. Mesa Petroleum Co., 101 the Supreme Court of Delaware approved for the first time discrimination among shareholders of the same class. 102 Although Unocal involved a self-tender offer, the same principal was later extended to poison pills. 103 In the aftermath of the decision, courts in at least three jurisdictions found the principal of discrimination troubling and declined to follow it. 104 The effect was to outlaw poison pills. In each of these states, however, the legislature stepped in and over-
turned the court decisions. In other words, within a short time, all jurisdictions addressing poison pills developed laws that mimicked Delaware's.

Delaware, therefore, took the lead in minimizing liability for directors and maximizing job retention by validating the most flexible and virulent defensive tactic, the poison pill. Thereafter, states followed Delaware's lead in quick order. It is difficult to characterize these changes as a gradual process of reform arising out of notions of innovation and efficiency. Both matters were sufficiently important to management to raise the specter of reincorporation, thereby causing other states to quickly implement these changes.

III. FIDUCIARY DUTIES, THE RACE TO THE BOTTOM, AND A HISTORY OF FEDERAL INTERVENTION

A. Overview

In addition to waiver of liability provisions and defensive tactics, states also arguably compete in determining concerns the duties of managers. Not all fiduciary obligations are of equal concern to management. States diverge (and do not automatically follow Delaware) in a number of areas, such as the corporate opportunity doctrine. In other areas, however, states follow the Delaware courts in minimizing the obligations of management. Delaware courts have reduced the duty of care to a series of formalities. In the area of conflicts of interest, courts no longer have the right to review the fairness of the transaction, at least if properly approved by independent directors. Finally, the courts have not imposed meaningful obligations on directors to monitor the activities of the company.

105. See Brown; Discrimination, supra note 95, at 582–84.
106. See infra note 189.
107. See infra notes 187–88 and accompanying text.
B. Federal Intervention and the Evolution of Corporate Governance

The competition for charters began in the 1880s and, at least initially, accelerated necessary reforms of state corporate codes. Afraid of the corporate form, states originally imposed significant limitations on size. Corporations could not own shares of another, were subject to limits on duration and size, and were required to have narrow purpose clauses. Management sought the removal of these limitations in order to permit the use of the corporate form to aggregate capital. Eventually, all states repealed these restrictions.

Following the repeal of restrictions on size, those running public corporations wanted maximum discretion to conduct business. As a result, corporate codes were amended to shift authority from shareholders to directors. The best example was probably the universal adoption of provisions allowing for the insertion of blank check stock provisions in the articles of incorporation. Directors received the discretion to create new classes of stock, something that could be used both to facilitate capital raising and stop hostile takeovers.

\[108. \] Id. at 545–46.
\[109. \] See Louis K. Liggett Co. v. Lee, 288 U.S. 517, 550–64 (1933) (Brandeis, J., dissenting) (describing early limitations state laws imposed on corporations). Gradually, these restraints were repealed and became a matter of board discretion. Blank check preferred stock provisions allowed management to issue new classes of shares without shareholder approval. The elimination of purpose clauses enabled managers to dramatically change the nature of the business without shareholder consent. See infra note 112 and accompanying text. More recently, Delaware courts have eliminated long standing prohibitions on discriminatory treatment of shareholders within the same class. See Unocal Corp. v. Mesa Petroleum, 493 A.2d 946, 956–57 (Del. 1985). Delaware courts also have eliminated the requirement that fiduciaries not usurp a corporate opportunity without first presenting the matter to the board of directors. See Broz v. Cellular Info. Sys., Inc., 673 A.2d 148, 157 (Del. 1996).

\[110. \] Brown, Discrimination, supra note 95, at 546–47.
\[111. \] See id. at 546–47.
\[112. \] See id. at 547. The number of matters that required shareholder approval were reduced, nonvoting stock was permitted, cumulative voting ceased to be a requirement, and super-voting requirements for shareholder actions were largely eliminated. See Alfred F. Conard, An Overview of the Laws of Corporations, 71 Mich. L. Rev. 623, 636–37 (1992) (noting elimination of cumulative voting under Michigan law).

\[113. \] See DEL. CODE ANN. tit. 8, § 151(a) (2001).
\[114. \] Brown, Discrimination, supra note 95, at 548.
While authority shifted to the board, shareholder rights did not receive commensurate protection. Corporate codes were not updated to reflect the separation of ownership and management in public companies. Instead, state statutes were built around the notion that shareholders could participate in management and also attend meetings to vote their shares. States did not regulate the proxy process in any meaningful manner or require companies to distribute information to shareholders.\(^\text{115}\) Instead, shareholders were largely left with the affirmative obligation to obtain information under their statutory right of inspection.\(^\text{116}\)

By the 1930s, it was clear that state law did not adequately protect the rights of shareholders in the context of voting or disclosure.\(^\text{117}\) As the legislative history of the Securities Exchange Act of 1934 ("Exchange Act") demonstrates, management used the gaps in state regulation to its advantage.\(^\text{120}\) The proxy process and lack of disclosure facilitated self-perpetuation in office and self-interested behavior, particularly insider trading. As the House Report to the Exchange Act noted:

Fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange. Managements of properties owned by the investing public should not be permitted to perpetuate themselves by the misuse of corporate proxies. Insiders having little or no substantial interest in the properties they manage have often retained their control without an adequate disclosure of


\(^{116}\) See Brown, Discrimination, supra note 95, at 549.

\(^{117}\) See Brown, REGULATION OF CORPORATE DISCLOSURE, supra note 6, § 2.02[1] n.32. In addition, states largely left the voting process unregulated. Id. Other than validating voting by proxy, the statutes did not impose any specific disclosure requirements or otherwise limit the ability of management to manipulate the voting process. Id.

\(^{118}\) Id. § 2.02[3]. With respect to disclosure, the majority of state statutes accepted that shareholders needed information about the operations of the company and the decisions of management. States responded to the need by adopting inspection rights statutes. See id. § 2.01. Rather than affirmatively require companies to provide the information, corporate codes placed the onus on shareholders. They had to provide the appropriate demand, have a proper purpose, and travel to company headquarters to look at records. Id.


\(^{120}\) See, e.g., H.R. REP. NO. 73-1383, pt. 2, at 12 (1934) (noting that disclosure requirements are necessitated in part by "a growing tendency toward extreme broadness and flexibility in the corporation laws of many States").
their interest and without an adequate explanation of the management policies they intend to pursue. Insiders have at times solicited proxies without fairly informing the stockholders of the purposes for which the proxies are to be used and have used such proxies to take from the stockholders for their own selfish advantage valuable property rights.121

As a direct result of these abuses and the failure of states to adequately regulate the voting and disclosure process, Congress included in the Exchange Act comprehensive provisions transferring regulatory authority to the newly created Securities and Exchange Commission ("SEC").122 Perhaps the broadest provision, section 14(a) of the Exchange Act, gave the SEC plenary authority to regulate the proxy process.123 Similar authority appeared in section 13(a) with respect to corporate disclosure.124

The adoption of the federal securities laws took away from the states two important areas of oversight in connection with the corporate governance process for public companies.125 Congress, however, made no effort to directly interfere with or regulate the duties and obligations of directors.126 Federal law did require that public companies disclose self-interested transactions, including

121. Id. at 13–14.
122. See Pub. L. No. 73–404, § 4, 48 Stat. 885 (codified as amended at 15 U.S.C. § 78(d) (2000)). Initially, responsibility for enforcing the securities laws was given to the Federal Trade Commission. The Exchange Act, however, created a new regulatory body, the SEC, to handle the task. Id.
125. The Exchange Act originally imposed the requirement on companies traded on a national stock exchange. In 1964, Congress extended the requirements to companies in the over-the-counter market. For a discussion of these changes, see Brown, Shareholder Communication Rules, supra note 124, at 710–14.
126. The legislative history of the Exchange Act contained an express disavowal of any desire to interfere in managerial responsibilities. See S. Rep. No. 73-792, pt. 2, at 10 (1934) ("The principal objection directed against the provisions for corporate reporting is that they constitute a veiled attempt to invest a governmental commission with the power to interfere in the management of corporations.").
executive compensation,\textsuperscript{127} and prohibited one form of self-dealing—insider trading.\textsuperscript{128} Otherwise, the securities laws made no concerted effort to regulate the duties and obligations of corporate fiduciaries.\textsuperscript{129}

C. The Disappearance of Director Duties

The adoption of the federal securities laws stripped from states certain responsibilities in the area of corporate governance. The securities laws did not, however, supplant state regulation of fiduciary duties. The laws also did not change the dynamics of the competition for charters or otherwise alter the preeminence of Delaware. States still had an incentive to put in place a management friendly approach to regulation.

In the area of corporate governance, therefore, Delaware law continued to evolve in a direction that favored management’s self-interest. Courts replaced substantive review of board decisions with procedural safeguards that did not adequately ensure the protection of shareholder interests.\textsuperscript{130} This was particularly true with respect to the duty of loyalty. In addition, changes in corporate law significantly reduced the risk of monetary liability for directors, particularly for violations of the duty of care.

Under Delaware law, approval by “disinterested” and independent directors of a self-interested transaction results in the


\textsuperscript{128} Section 10(b) and Rule 10b-5 have emerged as the primary provisions used to prevent insider trading. See Pub. L. No. 73-291, § 10(b), 48 Stat. 881, 891 (1934) (codified at 15 U.S.C. § 78j (2000)). This, however, was a later development. Congress inserted section 16 in an effort to end the practice. See Pub. L. No. 88-467, § 16(a), 78 Stat. 565, 579 (1964) (codified at 15 U.S.C. § 78p (2000)). A strict liability provision, section 16 did not require an examination of motivation or intent. Id.

\textsuperscript{129} Greater substantive regulation did occur in the Investment Company Act of 1940. Pub. L. No. 76-768, §§ 1–53, 54 Stat. 789, 789–847 (1940). The Investment Company Act, for example, required that at least forty percent of the directors of an investment company be disinterested. See 15 U.S.C. § 80a-10(a) (2000) (stating that “[n]o registered investment company shall have a board of directors [with] more than 60 per centum of the members who are interested parties).

\textsuperscript{130} Commentators have provided a possible explanation for this bias. See, e.g., Cary supra note 20, at 690–701 (noting the close connection between the legislature, judiciary, and bar in Delaware).
application of the business judgment rule. The affect is to replace fairness with waste as the only substantive standard courts can use to review the transaction. Given the difficulty in establishing waste, the change in the standard effectively limits judicial review to the procedures used by the board in making the decision. In addition, the courts did not impose on directors meaningful obligations to monitor the activities of the corporation. Absent a meaningful duty to monitor, directors benefitted from remaining uniformed, and had little incentive to put in place systems designed to funnel information to the board.

1. Duty of Care

The duty of care applies to board decisions that do not involve conflicts of interest. Directors must discharge their duties in the honest belief that the action taken was in the best interests of the company. Best interests will be met if the board can show "any rational business purpose" for the action.

With respect to board decisions, courts will not consider whether behavior violates the duty of care unless plaintiffs rebut the presumption of the business judgment rule. The business judgment rule protects decisions made in good faith, on a fully informed basis, and in the best interests of shareholders. Rebutting the presumption requires a showing of gross negligence, a

131. Brown, Shareholder Ratification, supra note 12, at 642.
132. Id. at 650–51.
133. Id. at 646.
136. See Aronson, 473 A.2d at 813 (noting that "the business judgment rule operates only in the context of director action"). In at least some cases, the business judgment rule has been found inapplicable to deliberate inaction by directors. See In re Walt Disney Derivative Litig., 825 A.2d 275, 289 (Del. Ch. 2003) ("Knowing or deliberate indifference by a director to his or her duty [of care] ... is conduct ... that may not have been taken honestly and in good faith to advance the best interests of the company."); see also In re Abbott Labs. Derivative S'holders Litig., 325 F.3d 795, 809 (7th Cir. 2003).
137. See McMullin v. Beran, 765 A.2d 910, 916–17 (Del. 2000). Successfully rebutting the presumption of the business judgment rule does not result in per se liability. Id. Instead, the burden shifts to the directors to show the "entire fairness" of the transaction. Id.; Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).
139. Id. Violations of the duty of care are "predicated upon concepts of gross negligence." Id.; see also Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000) (noting that deci-
standard higher than the one supported by the language of the corporate code.\textsuperscript{140}

In addressing the presumption, courts largely limit the analysis to the process used in making the decision.\textsuperscript{141} To the extent boards follow the proper procedures, plaintiffs are reduced to claims for waste, an extraordinarily difficult standard to meet.\textsuperscript{142} The result of this approach is a "rubber-stamp" of director behavior.\textsuperscript{143} Only one significant Supreme Court of Delaware case in the last thirty years has resulted in the inapplicability of the business judgment rule and the imposition of liability for breach of the duty of care by directors of a public company.\textsuperscript{144} In Smith v. Van Gorkom,\textsuperscript{145} the supreme court agreed that plaintiffs had rebutted the business judgment rule by showing that the board was uninformed.\textsuperscript{146} In what was really a duty of loyalty case,\textsuperscript{147} the opinion

\textsuperscript{140} See REVISED MODEL BUS. CORP. ACT § 8.30(a) (1984) (stating that directors "shall discharge [their] duties... with the care an ordinarily prudent person in a like position would exercise under similar circumstances"). This type of language has traditionally amounted to a negligence standard, something that has sometimes generated confusion. See Charles Hansen, The Duty of Care, the Business Judgment Rule, and the American Law Institute Corporate Governance Project, 48 BUS. LAW. 1355, 1374 (1993) ("It now is generally accepted that in a corporate context, the reasonably prudent person formulation is not only incorrect, but dangerously misleading. More than one court has followed this language literally to reach unintended and damaging results.").

\textsuperscript{141} Wells M. Engledow, Structuring Corporate Board Action to Meet the Ever-Decreasing Scope of Revlon Duties, 63 ALB. L. REV. 505, 508 (1999). ("Thus, at bottom, the business judgment rule reflects little more than process inquiry.") [hereinafter Structuring Corporate Board Action].

\textsuperscript{142} See Steiner v. Meyerson, No. C.A. No. 13139, 1995 Del. Ch. LEXIS 95, at *3 (July 19, 1995) (stating that claims for waste are difficult to advance); see also In re The Ltd., Inc. S'holders Litig., C.A. No. 17148-NC, 2002 Del. Ch. LEXIS 28, at *37 (Del. Ch. 2002) ("The plaintiffs have failed to demonstrate that the Company received no benefit in exchange from these two transactions or that these transactions, taken together, served no corporate purpose."); Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 892 (Del. 1999) ("The pleading burden on a plaintiff attacking a corporate transaction as wasteful is necessarily higher than that of a plaintiff challenging a transaction as 'unfair' as a result of the directors' conflicted loyalties or lack of due care."); Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997) ("Waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade.").

\textsuperscript{143} Engledow, Structuring Corporate Board Action, supra note 141, at 507.

\textsuperscript{144} See generally id.; Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 VA. L. REV. 247, 299–300 (1999) (stating that "the duty of care is all but eviscerated by... the 'business judgment rule'").

\textsuperscript{145} 488 A.2d 858 (Del. 1985).

\textsuperscript{146} Id. at 874. On remand, the directors were found liable for a $23 million undervaluation. Robert H. Rosh, Note, New York's Response to the Director and Officer Liability Crisis: A Need to Reexamine the Importance of D&O Insurance, 54 BROOK. L. REV. 1305,
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did little more than require boards to paper the file and create the appearance of deliberation.\footnote{148}

Any doubt about the desire to exonerate directors from liability under the duty of care disappeared with Delaware's introduction in the 1980s of section 102(b)(7) to title eight of the Code of Delaware.\footnote{149} A direct response to Van Gorkom,\footnote{150} this section allows corporations to insert into their articles a provision that waives monetary damages for breach of the duty of care.\footnote{151} The provision has become ubiquitous. Moreover, following Delaware's lead, most other states quickly adopted a similar provision.\footnote{152}

As a result, directors with skilled legal representation do not confront significant risk of liability in the context of the duty of care. To the extent that directors follow proper procedures, particularly the requirement of an informed decision, the business judgment rule insulates from challenge most business decisions that cause loss to shareholders. Even in the absence of proper procedures, the universal presence of the waiver of liability provision will prevent the imposition of monetary damages on directors.\footnote{153}

\footnote{1308 n.17 (1989). More recent cases have suggested that Van Gorkom may not, after all, be an isolated event. \textit{See infra} note 165. In addition, at least one recent case outside of Delaware has imposed liability for breach of fiduciary obligations. \textit{See} Pereira v. Cogan, 294 B.R. 449, 519 n.69 (S.D.N.Y. 2003).
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\footnote{147. The facts in the case make clear that Van Gorkom wanted to sell his shares. Van Gorkom was both the chairperson and the CEO of the company. \textit{Van Gorkom}, 488 A.2d at 864–65. The case does not address whether the board could have approved the merger out of deference to Van Gorkom. \textit{See} Edward Rock & Michael Wachter, \textit{Corporate Law as a Facilitator of Self Governance}, 34 GA. L. REV. 529, 538–39 (2000) (noting that \textit{Van Gorkom} case could be approached as “suspected self-dealing”).
}

\footnote{148. \textit{See} R. Franklin Balotti et al., \textit{Equity Ownership and the Duty of Care: Convergence, Revolution, or Evolution?}, 55 BUS. LAW. 661, 663 (2000) (describing \textit{Van Gorkom} as emphasizing the "procedural rituals that a board should follow in making a decision").
}

\footnote{149. \textit{DEL. CODE ANN. tit. 8, § 102(b)(7) (1988).}
}

\footnote{150. \textit{See} Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1166 n.18 (Del. 1995) (stating that "[t]he statute was, in fact, a legislative response to Supreme Courts of Delaware's liability holding in \textit{Van Gorkom}").
}

\footnote{151. \textit{DEL. CODE ANN. tit. 8, § 102(b)(7) (1988); see, e.g., Egan & Huff, supra note 67, at 272–73 (discussing Texas' statutory limitation on director liability).}

\footnote{152. Within twenty years, all fifty states had some type of provision that limited director liability. \textit{See} Bishop, \textit{supra} note 93, at 1079–81.
}

\footnote{153. One interesting development concerns the chancery court's decision in \textit{In re Walt Disney Co. Derivative Litig.}, 825 A.2d 275 (Del. Ch. 2003). In that decision, the court concluded that the business judgment rule (and the waiver of liability provision) did not apply upon a finding of bad faith. Bad faith occurred where the board acted with intentional disregard of its duties. \textit{Id.} at 289. At least in cases where directors are aware of facts suggest-
2. Duty of Loyalty

Duty of loyalty cases generally involve a conflict of interest.\(^{154}\) The existence of a conflict raises the possibility that the fiduciaries are acting in a self-interested fashion engaging in self-dealing at the expense of shareholders.\(^{155}\) The transactions were originally considered voidable.\(^{156}\) Eventually, they were permitted, but the fiduciaries retained the burden of showing the fairness of the transaction.\(^{157}\)

Court decisions, however, sharply restricted the reach of the duty of loyalty, minimizing its use as a mechanism to impose standards of behavior on directors.\(^{158}\) Procedural mechanisms largely eliminated any analysis of the fairness of the transaction.\(^{159}\) Disinterested and independent approval by informed directors or shareholders resulted in the application of the business judgment rule, reducing a plaintiff's claim to one for corporate waste.\(^{160}\) Courts could not examine the fairness of the transaction no matter how compelling the facts.\(^{161}\)

\(^{154}\) See Brown, Discrimination, supra note 95, at 641.

\(^{155}\) Id. at 647.


\(^{157}\) See Brown, Discrimination, supra note 95, at 652.

\(^{158}\) See id. at 643.

\(^{159}\) See id. at 642; see also Park McGinty, The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism, 46 Emory L.J. 163, 240–47 (1997) (noting the growing impotence of the duty of loyalty and the ability to protect almost any transaction through the use of procedural mechanisms).

\(^{160}\) See Brown, Discrimination, supra note 95, at 660–52 (discussing the applicability of the business judgment rule to transactions approved by disinterested directors or shareholders); see also Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 366 n.34 (Del. 1993) (defining the business judgment rule and explaining its application). For discussions of how the business judgment rule limits plaintiffs' claims to those involving corporate waste, see Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997) (“In all events, informed, uncoerced, disinterested shareholder ratification of a transaction in which corporate directors have a material conflict of interest has the effect of protecting the transaction from judicial review except on the basis of waste.”) and Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) (“On the other hand, approval by fully-informed disinterested . . . stockholders . . . permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction.”); see also supra note 142.

\(^{161}\) The exception is in the case of self-interested transactions between the company and a majority shareholder. In those circumstances, the burden simply shifts to the plaintiff to show the unfairness of the transaction. See Kahn v. Tremont Corp., 694 A.2d 422, 429 (Del. 1997) (explaining that the burden of proving unfairness shifts to the plaintiff in a
Applying the business judgment rule seemed to presuppose that the procedures had effectively expunged the conflict of interest from the approval process.\textsuperscript{162} In fact, this was not the case. "Disinterested" approval notwithstanding, interested directors' influence invariably remained in the decision-making process.\textsuperscript{163} Delaware courts made no effort to ensure that interested approval meant a complete absence of disinterested influence.\textsuperscript{164} Delaware courts also did not ensure that participation in the approval process was limited to truly disinterested and independent directors.\textsuperscript{165}

3. Duty to Monitor

The lack of meaningful standards of behavior can also be seen in connection with the failure to impose an effective duty to moni-

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\textsuperscript{162} See Brown, Discrimination, supra note 95, at 642.
\textsuperscript{163} Id.
\textsuperscript{164} See id.

\textsuperscript{165} Two Delaware Court of Chancery opinions suggest a possible shift in this area, with the opinions imposing a more rigorous definition of "independent." See In re Oracle Corp. Derivative Litig., 824 A.2d 917, 942, 945 (Del. Ch. 2003) (concluding that two directors on the special litigation committee were not independent because, among other things, the directors and defendants had ties with the same university); Biondi v. Scrushy, 820 A.2d 1148, 1166 (Del. Ch. 2003) (refusing to stay discovery during an investigation of a special litigation committee where the chairperson of the committee made public statements indicating that a report written by a law firm investigating allegations had vindicated the defendant CEO). Of the two opinions, Oracle is the more interesting and has broader potential impact. The decision suggests that relationships outside the corporation can result in a loss of independence. Oracle, 824 A.2d at 945. The case seems to conflict with the reasoning in In re Walt Disney Co. Derivative Litig., 731 A.2d 342 (Del. Ch. 1998), rev'd on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000), particularly the portions of which suggest that outside business and personal relationships are not enough to render a director interested. Id. at 355–56 (discussing the relationship between Eisner and Ovitz). On this particular issue, the Supreme Court of Delaware in Brehm affirmed the Delaware chancery court's Disney analysis. Brehm, 746 A.2d at 274. Oracle could also call into question the language in Disney suggesting that directors who work for non-profit organizations are only interested if they obtain some type of direct benefit from the relationship. Disney, 731 A.2d at 359 (discussing the case of Father O'Donovan, President of Georgetown University).
The duty of care and loyalty applied to any action (or deliberate inaction) by the board. The board was not held accountable for the failure to act when it had no knowledge of the matter that caused the harm. This approach provided directors with an incentive to remain uninformed. As a result, directors had little interest in putting in place procedures designed to ensure that they became aware of problems within the company.

Delaware courts encouraged the practice, refusing to impose on directors a duty to monitor. Graham v. Allis-Chalmers Manufacturing Co., a 1963 Supreme Court of Delaware decision, was widely interpreted to mean that directors had no obligation to investigate or otherwise create procedures to alert it to problems without some type of notice or red flag. As the court reasoned: "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."

In the absence of procedures designed to funnel information to the board, directors had limited information about the operations of the company. Presumably directors reviewed some SEC filings, and received any information provided by the chief executive officer ("CEO"). The CEO, however, had little incentive to give directors information that would encourage active oversight or otherwise call into question the wisdom of his or her decision. Disputes with outside auditors, for example, were often resolved at the officer level, without board involvement. Similarly, directors had little incentive to routinely seek other sources of information, which could increase their oversight obligations and legal exposure.

Events, however, outpaced the Delaware courts. Prophylactic measures designed to ensure legal compliance became a factor in mitigation whenever violations actually occurred. This was true

166. But see In re Walt Disney Co. Derivative Litig., 825 A.2d 275, 289 (Del. Ch. 2003) (declaring that the business judgment rule is inapplicable where directors "consciously and intentionally disregard their responsibilities").
168. 188 A.2d 125 (Del. 1963).
169. Id. at 130.
170. Id.
171. Directors must sign the annual report on Form 10-K. In general, those who sign filings are charged with some level of knowledge of the contents. See infra notes 315 & 317.
under the sentencing guidelines and the securities laws, among others. As a result, while Delaware courts continued to avoid imposing a duty to establish procedures as part of the fiduciary obligations of directors, companies were doing it anyway.

Delaware only began to take notice of these changed circumstances in 1996 when the court of chancery issued its opinion in *In re Caremark.* The case suggested that directors had a fiduciary obligation to monitor and to put in place procedures designed to keep themselves informed about the activities of the company. The decision specifically questioned the interpretation of *Graham* that suggested directors had no duty to monitor absent “cause for suspicion.”

In many ways, however, the *Caremark* decision was not particularly remarkable or useful in imposing meaningful standards of behavior on directors. First, it largely required what had already become common practice. Second, the decision came from the Delaware Court of Chancery. Neither the *Caremark* decision nor its rationale ever received approval by the Supreme Court of Delaware. Indeed, in the aftermath of the decision, Delaware opinions have not made extensive use of *Caremark.*

Third, the standard employed by *Caremark* meant that directors would almost never be liable for a failure to monitor as a result of inadequate procedures. The court made clear that boards would only be liable in the event of a “systematic failure” of the

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172. 698 A.2d 959 (Del. Ch. 1996).
173. Id. at 970.
174. See id. at 969–70 (advocating a narrower interpretation of *Graham* that might impose a duty to monitor even in the absence of cause for suspicion).
175. Thus, Professor Loewenstein’s argument that *Caremark* embodies a “high standard of fiduciary duty for Delaware directors” is not accurate. Loewenstein, supra note 35, at 513.
176. The Supreme Court of Delaware has simply noted the existence of the claim. See *White v. Panic,* 783 A.2d 543, 551–52 (Del. 2001) (“Although the derivative complaint includes allegations that seem designed to support a ‘failure to supervise’ claim, the plaintiff has elected not to pursue such a claim in the Court of Chancery or in this Court.”) (citations omitted). Some Delaware Court of Chancery decisions have, however, recognized the existence of the duty to monitor. See, e.g., *Gutman v. Jen-Hsun Huang,* 823 A.2d 492, 505–06 (Del. Ch. 2003) (“A *Caremark* claim is a difficult one to prove.”) (citation omitted).
177. In fairness, a number of cases outside of Delaware have cited *Caremark* favorably, some interpreting Delaware law. See, e.g., *Dellastatious v. Williams,* 242 F.3d 191, 196 (4th Cir. 2001); *Pereira v. Cogan,* 294 B.R. 449, 529–30 (S.D.N.Y. 2003). Prudent lawyers and their corporate clients have typically treated the reasoning in *Caremark* as controlling law that had to be followed.
The case, therefore, seemed to require procedures designed to keep the board informed but did nothing to ensure that the procedures were meaningful.

The facts of Caremark established the modest nature of the new duties. Caremark, a company with 7000 employees and ninety branch offices, engaged in patient care. Much of its revenue came from Medicare and Medicaid reimbursement. Under the Anti-Referral Payments Law, Caremark could not provide remuneration for the referral of patients by physicians. The prohibition notwithstanding, Caremark sometimes executed service or research agreements with doctors who also referred patients. As the court noted, "[s]uch contracts were not prohibited . . . but they obviously raised a possibility of unlawful 'kickbacks.'"

Ultimately, it turned out that doctors were paid for referrals. Caremark eventually pled guilty to a single criminal count and paid approximately $250 million in fines and settlement amounts. Despite the obvious concern, the apparently wide-

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178. Caremark, 698 A.2d at 971. A number of cases have noted but dismissed claims alleging a failure to monitor. See Beam v. Stewart, No. 19844, 2003 Del. Ch. LEXIS 98, at *18 (Del. Ch. Sept. 30, 2003) ("Plaintiff's allegation, however, that the Board has a duty to monitor the personal affairs of an officer or director is quite novel. That the Company is 'closely identified' with Stewart is conceded, but it does not necessarily follow that the Board is required to monitor, much less control, the way Stewart handles her personal financial and legal affairs."); In re Citigroup Inc. Shareholders Litig., No. 19827, 2003 Del. Ch. LEXIS 61, at *3 (Del. Ch. June 5, 2003) ("The complaints then allege, in wholly conclusory terms, that all of the nineteen directors breached his or her fiduciary duties by failing to exercise reasonable control and supervision over the 'officers, employees, and agents of Citigroup and its subsidiaries.' In a similarly conclusory fashion, the complaints further allege that the directors either knew about or should have known about the Enron transactions and either approved of those transactions or are liable for a 'sustained and systematic failure' to supervise the activities of their corporate subordinates.") (citations omitted); Litt v. Wycoff, No. 19083, 2003 Del. Ch. LEXIS 23, at *41 (Del. Ch. Mar. 28, 2003) (plaintiffs had not alleged sufficient "particularized allegations" to sustain Caremark action that directors had failed to exercise supervision over the loan program or compensation plan).

179. Caremark, 698 A.2d at 962.
180. Id. at 961.
181. Id. at 961–62.
182. Id. at 962.
183. Id.
184. Id. at 960, 962.
185. Id. at 960–61.
spread nature of the practice, and the lack of supervision by the board, the court held that no failure to monitor had occurred.186

4. Conclusion

The duty of care has become a set of procedures, with courts no longer required to review the substance of the transaction with little examination of the substance of the underlying transaction. Fairness largely ceased to be a matter for judicial review in duty of loyalty cases. Finally, directors had little affirmative obligation to monitor. As a result, case law evolved in a manner that imposed few meaningful duties on directors.

D. Application of Corporate Common Law in Other States

Delaware decisions interpreting management's fiduciary obligations are widely followed by other states.187 Delaware is perceived to have a deep body of case law and a high level of expertise.188 In addition, a state must apply Delaware law to companies

186. Id. at 972. The company had a policy prohibiting payments for referrals. Id. at 961–62. Regional officers had to approve the contracts. Id. at 963. In general, however, the board played little role in the oversight of the agreements. See also Pereira v. Cogan, 294 B.R. 449, 529–30 (S.D.N.Y. 2003) (applying Delaware law and finding a violation of the Caremark standard).

187. See NCR Corp. v. AT&T, Co., 761 F. Supp. 475, 499 (S.D. Ohio 1991) ("[T]he Court recognizes that the decisions of Delaware courts are often persuasive in the field of corporate law."); Arnaud v. Stockgrowers State Bank of Ashland Kansas, 992 P.2d 216, 217 (Kan. 1999) ("Kansas courts have a long history... of looking to the decisions of the Delaware courts involving corporation law, as the Kansas Corporation Code was modeled after the Delaware Code.").

188. See, e.g., McMurray v. De Vink, 27 Fed. Appx. 88 (3d Cir. 2002) ("We share the appellees' high regard for the courts and jurists of Delaware, and we are well aware of the unique statute of corporate law in Delaware."); Swope v. Siegel-Robert, Inc., 243 F.3d 486, 496 (8th Cir. 2001); Teamsters Local Nos. 175 & 505 Pension Trust Fund v. IBP, Inc., 123 F. Supp. 2d 514, 519 (D. S.D. 2000) ("Not only does Delaware law apply to this case, but the Delaware chancery court, through its daily interpretation of that law, has earned a reputation for its expertise concerning corporate governance."); Computer Sciences Corp. v. Computer Assoc. Int'l, 1999 U.S. Dist. LEXIS 21803, at *83 n.24 (C.D. Cal. Aug. 12, 1999) ("In corporate matters where there is little or no Nevada law, Delaware law is persuasive."); Burcham v. Unison Bancorp, Inc., 77 P.3d 130, 144 (Kan. 2003) ("In the past, we have found Delaware decisions regarding corporation law persuasive, noting that the Kansas General Corporation Code has been patterned after, and at times contains identical provisions of, the Delaware general corporation law.") (citation omitted); Cargill, Inc. v. Lone Star Techs., Inc., 2003 Minn. App. LEXIS 106, at *7 (Minn. App. Feb. 4, 2003)
incorporated in Delaware bringing suit within its jurisdiction. By using Delaware law for foreign and domestic companies, courts avoid the problem of divergent legal principles applicable to different companies operating within the same state.

This is not to say, however, that uniformity exists. Differences exist in such areas as corporate opportunity and the dismissal of derivative suits. The differences, however, appear at best modest and at worst non-existent. In any event, they are apparently insufficient to cause companies to reincorporate in Delaware.

As a result, most states follow Delaware and do not impose meaningful duties on managers of public companies. Moreover, court decisions deviating from Delaware law in a way that could

("Finally, we note that Delaware 'has long been recognized as the fountainhead of American corporations and that its Courts of Chancery are known for their expert exposition of corporate law.") (quoting In re Ivan F. Boesky Sec. Litig., 129 F.R.D. 89, 97 (S.D.N.Y. 1990)); Woolf v. Universal Fid. Life Ins. Co., 849 P.2d 1093, 1095 (Ok. App. 1992) ("However, since the Oklahoma General Corporation Act is based on the Delaware Act, decisions of the Delaware Courts are very persuasive.").

189. See N.E. Harbor Golf Club, Inc. v. Harris, 661 A.2d 1146, 1148-50 (Me. 1995) (discussing various tests applied by courts when dealing with the corporate opportunity doctrine). Whether these legal differences are significant in actual application is an open question. Many jurisdictions still look to Delaware law, even in this area. Id. at 1149 (describing Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939), as "[t]he seminal" case in applying line of business test of corporate opportunity). See Ostrowski v. Avery, 703 A.2d 117, 122 (Conn. 1997) (describing Guth as seminal); Suburban Motors of Grafton, Inc. v. Forester, 396 N.W.2d 351, 353 (Wis. Ct. App. 1986) (describing Guth as the "seminal case from which the law of corporate opportunity springs").

190. In reviewing a special litigation committee's decision to dismiss a derivative suit, courts will examine whether the members are independent and disinterested and whether the committee conducted a proper investigation. See Auerbach v. Bennett, 395 N.E.2d 994, 996 (N.Y. 1979). Assuming the procedural requirements are met, Delaware also allows courts to apply their own "business judgment" in determining whether the decision to dismiss the derivative suit was valid. See Zapata Corp. v. Maldonado, 430 A.2d 779, 789 (Del. 1981). A number of courts, have disagreed with this approach. See Auerback, 393 N.E.2d at 1000; Hirsch v. Jones Intercable, Inc., 984 P.2d 629, 637 (Colo. 1999) ("[T]he role of a Colorado trial court in reviewing an SLC's decision regarding derivative litigation should be limited to inquiring into the independence and good faith of the committee."). For a discussion of the issue and citation to a number of cases on both sides of the issue, see generally Finley v. Superior Court, 96 Cal. Rptr. 2d 128, 132-35 (Cal. App. 2000).

While this could seem to be a significant difference, the truth is that Delaware courts have not made significant use of the additional discretion second prong. Thus, while they leave open the possibility that courts can apply their own business judgment, in practice they do not.

191. See Finley, 96 Cal. Rptr. 2d at 128.

192. See notes 187-88; see also Brown, Discrimination, supra note 96, at 582.
encourage local companies to reincorporate elsewhere are susceptible to legislative reversal. 193 This occurred in connection with the handful of court opinions that declined to accept the reasoning in Unocal and validate the use of poison pills. 194 The same was true with the de facto overruling of Van Gorkom through waiver of liability provisions. 195

IV. THE SEC AND THE REGULATION OF CORPORATE BEHAVIOR

The lack of state standards regulating the behavior of directors of public companies was not lost on the SEC. The SEC had two distinct reasons for influencing board behavior. Foremost was the concern over the efficacy of the disclosure regime. 196 Greater oversight by the board presumably meant increased likelihood of compliance. 197 Secondarily, the SEC understood that directors were not adequately policing self-dealing transactions such as executive compensation. 198

In trying to increase board involvement in the disclosure process, the SEC had limited tools. 199 The agency lacked the rulemaking authority to directly affect the fiduciary obligations of direc-

193. Id.
194. See supra note 105.
195. See also supra note 93.
196. For a relatively early example, see In the Matter of Occidental Petroleum Corporation, Exchange Act Rel. No. 16950 (admin. Proc July 2, 1980) (where periodic reports were inaccurate for failing to disclose certain environmental matters, company had to agree as part of relief to designate director who would “Recommend procedures to the full Board of Directors to ensure that Oxy will be in a position to disclose, in accordance with the federal securities laws on a complete, timely and accurate basis, all required information relating to environmental matters.”). See infra note 231.
197. See id. § 229.306.
198. See id. § 229.402; Executive Compensation Disclosure, Exchange Act Release No. 33-6940, 57 Fed. Reg. 29582 (June 23, 1992) (codified at 17 C.F.R. pts. 229 & 240) (“Boards of directors are obligated, as state-law fiduciaries, to protect the interests of shareholders through effective monitoring of senior executive performance. An important aspect of this duty, frequently discharged by the board through a compensation committee, is determining the level and structure of compensation that is appropriate for senior executives. Shareholders who ultimately fund executive compensation packages are entitled to know the basis for the board’s compensation decisions.”).
At most, the SEC could impose disclosure requirements that highlighted weaknesses in the procedures used by directors, presuming that boards would make them more effective rather than disclose the deficiencies.\textsuperscript{201} The SEC also used enforcement proceedings to encourage a shift in behavior by allowing companies to use the adequacy of their procedures as a defense or at least mitigation.\textsuperscript{202}

The first significant example was probably the requirement to disclose in a current report on Form 8-K that the company had changed independent auditors and the reasons for the change.\textsuperscript{203} A decision usually made by top officers, companies objecting to accounting treatment could simply change firms and find a more compliant auditor.\textsuperscript{204} Auditors not wanting to lose business had an incentive to defer to the company’s management.\textsuperscript{205}

The SEC rules sought to minimize these effects. The agency did so, not by transferring responsibility for replacing auditors to the board, but by requiring companies to make public the reasons for any change—including the basis of the disputes with management.\textsuperscript{206} The approach was designed to give auditors leverage. Companies had an incentive to resolve matters rather than risk public disclosure of the disputes.\textsuperscript{207} The numerous amendments to the original provision demonstrated doubts about the overall approach and the ease of circumvention.\textsuperscript{208}

Subsequent efforts sought to use disclosure to force changes at the board level.\textsuperscript{209} This occurred in connection with the disclosure

\textsuperscript{200} Id.
\textsuperscript{201} Id.
\textsuperscript{202} Id.
\textsuperscript{205} See id.
\textsuperscript{206} Id. at 12,927.
\textsuperscript{207} Id.
\textsuperscript{208} Id.; see also Daniel L. Goelzer, The SEC and Opinion Shopping: A Case Study in the Changing Regulation of the Accounting Profession, 52 BROOK. L. REV. 1057, 1069–74 (1987).
\textsuperscript{209} The Commission also tried to use disclosure to ensure greater compliance with securities law provisions not directly related to corporate governance. For example, public companies had to disclose violations of the Section 16(a) reporting requirements by execu-
of executive compensation.\textsuperscript{210} In the 1990s, the agency amended Item 402 of Regulation S-K to impose intricate and detailed rules requiring complete disclosure of the amount paid to senior executives.\textsuperscript{211} For the first time, companies had to include a single amount aggregating all compensation paid to the CEO and other top officers.\textsuperscript{212}

In addition, the board had to reveal information about its deliberative process. First, the company had to disclose a report of the board committee responsible for determining compensation.\textsuperscript{213} In effect, the requirement forced boards to form compensation committees and draft reports concerning compensation decisions.\textsuperscript{214} Second, the company had to disclose a chart illustrating the company's stock prices relative to other comparable companies.\textsuperscript{215} The information and the requirement of a report arguably made it more difficult to engage in seemingly inexplicable increases in executive compensation.\textsuperscript{216}

The SEC also tried to influence (read increase) the board's role in overseeing the company's financial disclosure. Item 306 of Regulation S-K mandated the annual disclosure of a report by the audit committee.\textsuperscript{217} The report had to reveal whether the audit committee had reviewed and discussed the audited financial statements with management and recommended inclusion of the financial statements in the annual report.\textsuperscript{218} Presumably, the

\textsuperscript{210} See 17 C.F.R. § 229.402.

\textsuperscript{211} Compensation disclosure has long been required but the reforms in the early 1990s substantially increased the level of detail. See Executive Compensation Disclosure, Exchange Act Release Nos. 33-6962 & 34-31,327, 57 Fed. Reg. 48,126, 48,150 (Oct. 21, 1992) (codified at 17 C.F.R. § 229.402).

\textsuperscript{212} Id.

\textsuperscript{213} Id. at 48,157.

\textsuperscript{214} Id.

\textsuperscript{215} See id.


\textsuperscript{218} See id. at 73,390.
board of directors would ensure that these steps took place before making the requisite disclosure.

Finally, the SEC sought to step up board oversight by making sure that directors attended the meetings.\textsuperscript{219} The SEC, therefore, required companies to disclose in their proxy materials the attendance records of directors at meetings of the board and board committees.\textsuperscript{220} Presumably, directors would rather attend meetings than publicize their absences.

The SEC also used enforcement proceedings to induce companies to adopt more effective procedures designed to improve financial disclosure.\textsuperscript{221} This occurred mostly in connection with management's discussion and analysis ("MD&A"), the narrative discussion required anytime companies filed financial statements with the agency.\textsuperscript{222} With no private right of action for violations, companies routinely ignored the requirements for the MD&A.\textsuperscript{223}

To ensure greater compliance, the SEC brought a number of enforcement proceedings against companies for deficient MD&A disclosure.\textsuperscript{224} The decisions gradually made clear that the agency expected companies to implement procedures designed to ensure the efficacy of the disclosure.\textsuperscript{225} Perhaps the most unusual exam-
ple of the use of enforcement proceedings to influence board behavior occurred in *In re W.R. Grace & Co.*

In that case, W.R. Grace & Co. failed to disclose in its annual report a related party transaction and "substantial retirement benefits" paid to a departing CEO. The company had in place procedures designed to ensure accurate disclosure, including the circulation of a questionnaire to officers and directors. In addition, the directors relied on counsel to ensure the sufficiency of the disclosure.

Despite the procedures, the SEC took the position that the directors failed to properly ensure the accuracy of the disclosure process.

Serving as an officer or director of a public company is a privilege which carries with it substantial obligations. If an officer or director knows or should know that his or her company's statements concerning particular issues are inadequate or incomplete, he or she has an obligation to correct that failure. An officer or director may rely upon the company's procedures for determining what disclosure is required only if he or she has a reasonable basis for believing that those procedures have resulted in full consideration of those issues.

Unlike prior SEC actions, *W.R. Grace* did not involve fraud, the traditional area of concern to the agency. Instead, the decision, while tied to disclosure, addressed actions that more closely resembled traditional oversight functions of directors. Indeed, the

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227. *Id.*
228. *Id.*
229. *Id.*
230. *Id.* at 89,893.
231. *Id.* at 89,897. Prior cases had examined the role of management. As the SEC noted in *W.R. Grace*, however, these actions "focused on the failure of non-management directors to act effectively when confronted with evidence of management's involvement in possible securities fraud." *Id.* at 89,894 n.4. *W.R. Grace*, on the other hand, dealt "with the obligations of officers and directors where a company's violations do not constitute fraud." *Id.*
232. *Id.* at 89,894, n.4 ("Each of these Reports focused on the failure of non-management directors to act effectively when confronted with evidence of management's involvement in possible securities fraud. The present matter, in contrast, deals with the obligations of officers and directors where a company's violations do not constitute fraud.").
apparent purpose of the section 21(a) report was to encourage increased oversight of the disclosure process by directors.\textsuperscript{233}

To the extent it was attempting to alter board behavior, the SEC was largely unsuccessful. First, there was no meaningful enforcement of the requirements. For provisions adopted under section 13(a) of the Exchange Act, a private right of action did not exist for violations.\textsuperscript{234} As a result, only the SEC could police the requirements. With limited resources and perhaps 14,000 public companies to examine, the SEC could not give significant attention to the disclosure requirements.\textsuperscript{235} Unsurprisingly, therefore, not a single enforcement proceeding was brought for violations of the audit or compensation committee disclosure requirements.

A private right of action did exist for violation of the proxy rules.\textsuperscript{236} In general, however, courts were not particularly open to causes of action based on false compensation disclosure. Courts have, for example, concluded that a proxy statement does not become misleading because of the failure to disclose certain valuations placed on options.\textsuperscript{237} Plan documents and “reasonable estimates” as to the total number of shares required need not be included.\textsuperscript{238} Similarly, proxy statements need not include information about the compensation process that is already widely known.\textsuperscript{239}

\begin{footnotesize}
\begin{enumerate}
\item See Seinfeld v. Bartz, 322 F.3d 693, 697 (9th Cir. 2003), cert. denied, 72 U.S.L.W. 3246 (U.S. Oct. 6, 2003) (“We conclude that SEC regulations do not require the use of the Black-Scholes valuation and that the proxy statement is not materially false and misleading.”).
\item See Vides v. Amelio, 265 F. Supp.2d 273, 281 (S.D.N.Y. 2003) (“The regulations do not require disclosure of the fact that directors determine and vote for their own compensation.”).
\end{enumerate}
\end{footnotesize}
Second, companies often resorted to boilerplate disclosure.\textsuperscript{240} Rather than provide true insight into the decision-making process, audit and compensation committee reports often contained vague and largely unverifiable statements.\textsuperscript{241} As a result, board committees could make the requisite disclosure without engaging in truly meaningful oversight.

Third, the fundamental premise of the approach was flawed. The requirements were meant to provide shareholders with increased disclosure about the board’s decisionmaking process.\textsuperscript{242} To the extent the board did not act in a rigorous fashion, shareholders could presumably bring suit for a breach of fiduciary duty.\textsuperscript{243} In fact, however, the standards under state law were so weak that the additional disclosure did not increase the risk of a suit for mismanagement or disloyalty.\textsuperscript{244}

Fourth, the disclosure requirements suffered from the rule of unintended consequences. Rather than shame the board into reducing compensation, they probably had the opposite effect. By making total compensation clear, they provided officers with an argument that they should be compensated in a manner not unlike their competitors (or any other company used for comparison).\textsuperscript{245} Thus, the disclosure may well have had an upward effect on compensation.\textsuperscript{246}

Finally, efforts to force greater managerial oversight through enforcement actions were unsuccessful. The decision in \textit{W.R. Grace} had little basis in the securities laws and instead rested squarely on traditional notions of fiduciary obligations.\textsuperscript{247} Given the weak grounding in the securities laws, it was little surprise that the SEC never brought a follow-up action that expanded on


\textsuperscript{241} \textit{Id.}


\textsuperscript{243} See supra notes 8, 108–86 and accompanying text.

\textsuperscript{244} \textit{Id.}

\textsuperscript{245} Stabile, supra note 240, at 131.

\textsuperscript{246} \textit{Id.}

\textsuperscript{247} See supra note 231.
the reasoning in *W.R. Grace* Imposing obligations on directors to manage the disclosure process would have to wait for a firmer legal foundation.

V. THE CONSEQUENCES OF INACTION

A. The Scandals

The lack of meaningful standards for directors generated little debate. Occasional concerns surfaced over inflated compensation for executive officers. Other than to note the growth of executive salaries, the observations generated at best modest calls for reform. In part, this may have occurred because the compensation ordinarily resulted from stock options and was therefore tied to increased share prices. Corporate excess mattered less when everyone, including shareholders, benefited.

Throughout the 1990s, therefore, self-dealing remained largely unchecked. State law did not impose effective limitations. Neither did the market. The SEC required greater disclosure but otherwise did not regulate the substance of the transactions. Executive officers could profit from their company with little concern over the impact on shareholders.

248. *See Elson, supra* note 242, at 939; *see also* Mark A. Salky, Comment, *The Regulatory Regimes for Controlling Excessive Executive Compensation: Are Both, Either, or Neither Necessary?,* 49 U. MIAMI L. REV. 795 (Spring/Summer 1995). In the 1990s, Congress amended the tax law to prohibit corporations from deducting executive compensation over one million dollars, although the provision contained exceptions including one for performance based compensation. 26 U.S.C. § 162(m) (2001).

249. Thus, Michael Eisner may have earned $500 million from options in the mid-1990s, but he also increased the market capitalization of Disney from $2 billion to $50 billion. *See Peter H. King, The Big Fish in the Pond, L.A. TIMES,* Feb. 26, 1997, at A3.

250. Of course, even during this period, officers and directors could earn large returns without significant benefit to shareholders. Following a drop in share prices, the options could be repriced, with the official making a positive return despite a net loss to shareholders. *See Self-Regulatory Organizations, Exchange Act Release No. 34-48,108, 68 Fed. Reg. 39,995, 39,996 (July 3, 2003) (discussing proposed rules by self-regulatory organizations that would require, among other things, shareholder approval of changes to option plans that permit repricings).*

251. The problem of self-dealing was not limited to the 1990s. *See Elvin R. Latty, Why Are Business Corporation Laws Largely “Enabling”?,* 50 CORNELL L.Q. 599, 605 (1965) (“The power of the insiders—management—to make self-serving decisions has always been a source of problems in corporation law.”).

252. *See Elson, supra* note 242, at 939; *see also supra* notes 155–66.


254. *See Martin Lipton, The Millennium Bubble and Its Aftermath: Reforming Corporate America and Getting Back to Business,* Address to the Commercial Club of Chicago
approach became clear with the corporate law scandals that occurred early in the new millennium.\textsuperscript{255}

With the collapse of Enron in November 2001, the market confronted widespread examples of corporate excess.\textsuperscript{256} Corporate misbehavior was nothing new. Even in the 1990s, the SEC had brought enforcement actions against a number of large companies for inaccurate disclosure and/or self-dealing.\textsuperscript{257} In general, however, the cases were lost in the euphoria of a growing economy and a booming stock market. Moreover, they did not, at the time, suggest a systematic failure of the regulatory system.

The bursting of the high-tech and dot-com bubbles, however, ushered in a new set of circumstances. In addition to the collapse of a vast array of start-up companies, the market witnessed the sudden unraveling of some of the largest, and what were thought to be the safest, public companies. At the same time, examples surfaced of managerial excess.

While the circumstances in these companies varied, they generally had a common denominator. Top officers profited handsomely. Their self-dealing tended to fall into three categories. Some involved rich compensation packages, including charitable contributions in the officer's name,\textsuperscript{258} deferred compensation with high guaranteed annual returns,\textsuperscript{259} and expansive severance packages.\textsuperscript{260} Others entailed significant trading profits in companies that later saw dramatic declines in share prices.\textsuperscript{261} Finally,\textsuperscript{255,256,257,258,259,260,261}

(Oct. 2002) (labeling the 1980s and the 1990s as eras of the "imperial" CEO who "dominated" the board).

255. See, e.g., Brown, Shareholder Ratification, supra note 12, at 641–42.

256. See, e.g., id.


258. See, e.g., Stephanie Strom, In Charity, Where Does a C.E.O. End and a Company Start?, N.Y. TIMES, Sept. 22, 2002, § 3, at 1 (discussing corporate contributions to charities supported by executive officers and noting that “[m]any retirement packages include philanthropy as a perk”).


261. See, e.g., David Olive, Many CEOs Richly Rewarded for Failure, TORONTO STAR,
allegations arose that executive officers used corporate funds for their own personal benefit, with large corporate loans on favorable terms a possible example of this type of behavior. The self-dealing transactions did not appear to have arisen as a result of board malfeasance. They did, however, suggest a certain lack of oversight. Directors did not act as a meaningful check on managerial self-interest. Nonetheless, they arguably did not indicate a systematic failure to comply with supervisory duties imposed under state law. In fact, the problem was that most boards probably had complied with applicable requirements.

B. Sarbanes-Oxley

The problems highlighted the need for reform. State law did not impose meaningful standards of behavior. The SEC's attempts to encourage higher standards through the use of disclosure had not worked. Nor, despite all of the ink spilt on the subject, had the market generated meaningful limits on director behavior. Some type of regulatory intervention at the federal level was, therefore, inevitable. Congress stepped in and adopted the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), intruding into areas previously left to state regulation.

Aug. 25, 2002, at A10 (listing trading profits of officers in companies that either failed or saw significant drops in share prices).


263. See, e.g., James F. Peltz & Lisa Girion, Crisis in Corporate America: Bush Spurs Debate over Loans to Execs, L.A. TIMES, July 11, 2002, at C1 (noting that senior managers often received loans at below-market interest rates).


265. See id.; Strom, supra note 258, at 13.

266. Id.


268. See, e.g., id.


270. See id; see also supra notes 45-47.

271. Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of titles 11, 15, 18, 28, and 29 of the United States Code) [hereinafter Sarbanes-Oxley]. Federal intervention is not, in and of itself, proof that the system of state regulation was inefficient. Nonetheless, it does call into question the argument that Delaware moderates its pro-management bias in an effort to ward off federal intervention. See Kahan & Kamar, supra note 17, at 740 ("Because Delaware earns substantial profits from incorporations, its lawmakers want to avoid federal intervention."); see also Engledow, supra note 48, at 148.
Sarbanes-Oxley took on a number of important tasks in connection with the regulation of public companies. It addressed problems associated with the perceived lack of independence of outside auditors through the creation of a self-regulatory organization to oversee accounting firms and the imposition of limitations on consulting activities of audit clients. Officers and directors were given shorter time periods to disclose trading activity and subjected to prohibitions on trading during black out periods. In the area of disclosure, Sarbanes-Oxley extended the statute of limitations for actions under Rule 10b-5 and mandated a more systematic and enhanced review of corporate filings by the SEC. Sarbanes-Oxley also required the adoption of rules designed to regulate the activities of analysts.

In the area of corporate governance, the legislation made a number of changes in the responsibilities of officers and directors of public companies. The CEO and CFO had to certify financial statements, with draconian penalties for willful violations.

("However, this race to the bottom would have to occur in a manner that does not raise the specter of federal intervention.").


273. Id. § 201(a), 116 Stat. at 771–72 (to be codified at 15 U.S.C. § 78j-11(g)).

274. Id. § 403, 116 Stat. at 788 (to be codified at 15 U.S.C. § 78p(a)(2)(C)).

275. Id. § 306(a)(1), 116 Stat. at 779 (to be codified at 15 U.S.C. § 7244(a)(1)).

276. Id. § 804(b), 116 Stat. at 801 (to be codified at 28 U.S.C. § 1658(b)). An action could be maintained within two years of the date of discovery or five years from the date of the violation. Id. The provision altered the statute of limitations established in Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 361 (1991). While Sarbanes-Oxley generally applies to public companies, the change in the statute of limitations for actions under Rule 10b-5 would affect both public and private companies. See Sarbanes-Oxley § 804(b), 16 Stat. at 801 (to be codified at 28 U.S.C. § 1658(b)).

277. Sarbanes-Oxley § 408, 116 Stat. at 790–91 (to be codified at 15 U.S.C. § 7266). The provision required the SEC to review filings of all companies traded on an exchange or listed in NASDAQ "on a regular and systematic basis." Id. § 408(a). Moreover, the review had to include the financial statements. Id. In determining the scheduling of reviews, the SEC had to take into account a number of factors, including market capitalization, the existence of prior restatements, volatility in share prices, disparities in price-earning ratios by "emerging companies," and the importance of the company to any material sector of the economy. Id. § 408(b). Whatever the schedule, an examination had to occur at least every three years. Id. § 408(c).

278. Id. § 103(a), 116 Stat. at 755–56 (to be codified at 15 U.S.C. § 7213(a)).

279. Id. § 302(a), 116 Stat. at 777 (to be codified at 15 U.S.C. § 7241(a)).

280. Id. In addition, Sarbanes-Oxley defined securities fraud as a criminal offense and provided a maximum of twenty-five years in prison. Id. § 807, 116 Stat. at 804 (to be codified at 18 U.S.C. § 1348). The provision did not limit securities fraud to instances where a purchase or sale has occurred. Id.
Executive officers could no longer borrow from the company\(^{281}\) and were subjected to a code of ethics.\(^{282}\)

With respect to directors, Sarbanes-Oxley altered the responsibilities of the audit committee in connection with the review of financial information.\(^{283}\) The audit committee, which had to consist of outside directors,\(^{284}\) was given responsibility for hiring and firing the company's independent accountant.\(^{285}\) Otherwise, Sarbanes-Oxley did little to regulate the board. Standards for approving self-interested transactions did not change.\(^{286}\)

1. Duties of Officers

Sarbanes-Oxley uses four different approaches in regulating officer behavior. These include: (1) categorical prohibitions on certain activities,\(^{287}\) (2) certification of reports filed with the SEC,\(^{288}\) (3) imposition of a code of ethics for top officers,\(^{289}\) and, (4) the forfeiture of bonuses and trading profits following certain financial restatements.\(^{290}\) In addition, Sarbanes-Oxley (and the implementing regulations by the SEC) effectively impose on public companies the obligation to put in place procedures designed to ensure adequate supervision of the disclosure process.\(^{291}\)

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\(^{281}\) Id. § 402(a), 116 Stat. at 755–56 (to be codified at 15 U.S.C. § 78m(k)(1)).


\(^{283}\) Sarbanes-Oxley § 301, 116 Stat. at 775–77 (to be codified at 15 U.S.C. § 78j-1(m)(2)).

\(^{284}\) Id. (to be codified at 15 U.S.C. § 78j-1(m)(3)(A)).

\(^{285}\) Id. (to be codified at 15 U.S.C. § 78j-1(m)(2)).


\(^{287}\) See Sarbanes-Oxley § 303(a), 116 Stat. at 778 (to be codified at 15 U.S.C. § 7242(a)).

\(^{288}\) See id. § 302(a), 116 Stat. at 777 (to be codified at 15 U.S.C. § 7241(a)).

\(^{289}\) See id. § 406(a), 116 Stat. at 789 (to be codified at 15 U.S.C. § 7264(a)). Sarbanes-Oxley stopped short of an actual requirement, but provided that companies without a code of ethics would have to provide a public explanation for its absence.


a. Loans

Most straightforward in addressing problems with self-dealing is the categorical prohibition on loans to executive officers. In the lead up to the passage of Sarbanes-Oxley, the corporate treasury often seemed to be a source of funds for the personal needs of executive officers. Funds from the company were lent to insiders to repay stock loans and for outside business purposes. The loans were sometimes made on highly favorable terms and in some cases in extraordinary amounts. As long as they were properly approved by informed and independent directors or disinterested shareholders, state law imposed no meaningful limitations on the loans.

Sarbanes-Oxley addresses this conflict of interest not by raising the standards for board review, but through a categorical prohibition. Except in narrow circumstances, public companies can no longer make loans to executive officers. The provision applies only to personal loans and contains a handful of narrow exceptions.

The categorical prohibition established by Sarbanes-Oxley is both too narrow and too broad. First, the ban is too broad because loans to executives may at times benefit the company. A bridge loan to facilitate a CEO's relocation, a short-term loan to enable executive officers to exercise stock options, or a fully documented personal loan to the CFO at higher than market interest rates, all may conceivably benefit the company. Nonetheless, under Sarbanes-Oxley, all of the above-listed are prohibited.

292. See id. § 402(a), 116 Stat. at 787 (to be codified at 15 U.S.C. § 78m(k)). The prohibition also applies to directors.
294. Sarbanes-Oxley § 402(a), 116 Stat. at 787 (to be codified at 15 U.S.C. 78m(k)).
295. See Sarbanes-Oxley § 402(a), 116 Stat. at 787 (to be codified at 15 U.S.C. § 78m(k)).
296. Id. Sarbanes-Oxley does not address the practical problems of credit extensions that include such transactions like cash advances. These types of “loans” arguably do not fall within the prohibition because they are not “personal.” Nonetheless, the noticeable absence of explanation and legislative history leaves the treatment of even these basic transactions unclear. See id.
At the same time, the provision is too narrow. The loans to executives often effectively amount to an additional form of compensation. Whether at below market interest rates or forgiven over a period of time, they can financially benefit the borrowing officer. Sarbanes-Oxley's prohibition essentially forecloses this type of compensation but otherwise does nothing to address the problem of executive compensation. Indeed, given the ban on loans, the company can simply purchase the asset outright and give it to the officer.297

b. Repayment of Compensation

Sarbanes-Oxley also includes a provision designed to force the CEO and CFO to repay compensation to the company as a penalty for inaccurate financial disclosure.298 The provision was intended to address the practice of corporate insiders selling large amounts of stock while engaging in questionable accounting practices that were later reversed.

Under section 304, bonuses paid, or trading profits realized, in the twelve months after the issuance of financial statements, must be repaid by the CEO and CFO if the financial statements are subsequently restated.299 The provision only applies to restatements that result from material noncompliance with a financial reporting requirement and from misconduct.300 The provision applies to any incentive or equity-based compensation.301

As with the prohibition on loans, the provision seems simultaneously too broad and too narrow. First, the provision is designed to punish misconduct by executive officers, but not otherwise to limit executive compensation. Nothing in the provision prevents a company from richly compensating a CEO or CFO during periods

297. E.g., Allan Sloan, Don't Write Obituary for Options Just Yet, WASH. POST, July 15, 2003, at E3 (noting that Microsoft no longer will give employees stock options, but instead will give them stock).

298. Sarbanes-Oxley § 304(a), 116 Stat. at 778 (to be codified at 15 U.S.C. § 7243(a)).

299. See id.

300. See id.

301. See id. § 304(a)(1), 116 Stat. at 778 (to be codified at 15 U.S.C. § 7243(a)(1)). The CEO or CFO must reimburse the company for "any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the [SEC] (whichever first occurs) of the financial document embodying such financial reporting requirement...." Id.
of aggressive accounting treatment. The company can avoid the risk of forfeiture simply by paying amounts that are not performance or equity-based. A doubling of the CEO's base salary also will not fall within the provision.

Second, section 304 is too broad. For example, it may punish a CEO and CFO who did not engage in, or even know about, the misconduct that caused the restatement. Nor does this section require that the misconduct result from a failure of the CEO or CFO to adequately supervise. The provision can, for example, apply to a restatement necessitated by the discovery of embezzlement by an employee. Thus, in at least some instances, the CEO and CFO may have to disgorge compensation for behavior he or she could not realistically control.

Sarbanes-Oxley also seems to require forfeiture of performance-based compensation even if the performance is unrelated to the restatement. A performance-based bonus paid because a CEO successfully prevents bankruptcy or obtains rapid Food and Drug Administration ("FDA") approval of a new drug will still, apparently, be subject to forfeiture following an unrelated restatement. Moreover, restatements do not necessarily require changes in aggregate profitability. Thus, the provision could result in the forfeiture of a bonus even where the same bonus would have been paid even had the restated financial statements been in place.

c. Code of Ethics

Sarbanes-Oxley also requires public companies to disclose in their annual report whether they have in place a written code of ethics applicable to "senior financial officers." Section 406 stops short of mandating the use of a code but does require an explanation if one does not exist. The company's code must contain standards "reasonably necessary to promote... honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships," accurate and timely disclosure, and compliance with

302. See id. § 406(a), 116 Stat. at 789 (to be codified at 15 U.S.C. § 7264(a)). Section 406(a) specifically includes the principal financial officer and comptroller or principal accounting officer or persons performing similar functions. See id. The Commission, however, extended the requirement to the CEO. See 17 C.F.R. § 229.406(a) (2003).

governmental rules and regulations. In addition, "prompt" disclosure must be made of changes in, or waivers to, the code of ethics. Disclosure may take place through the filing of a current report on Form 8-K, over the Internet, "or by other electronic means."

Section 406 seems unlikely to change management's behavior for a host of reasons. First, under the provision, companies need not put codes in place. Second, even if codes are enacted, such ethics provisions may not be particularly rigorous. Third, there is no private enforcement mechanism. Even SEC enforcement is limited in scope. Although flawed in many respects, by extending the corporate code of ethics to the CEO, the SEC narrowed a gap left by Congress.

d. Certification

Sarbanes-Oxley ordered the SEC to adopt, within thirty days, rules requiring top officers to certify the contents of certain reports filed with the SEC. Pursuant to the SEC's rules, each annual and quarterly report filed by a company must be certified. The CEO and CFO must certify that, to the best of their knowledge, the report contains no untrue statement of material fact and that the financial statements "fairly present[]" the condition of the company. Sarbanes-Oxley imposes stiff penalties,

7264(c)(1)).
304. See id. § 406(c)(2)-(3), 116 Stat. at 790 (to be codified at 15 U.S.C. § 7264(c)(2)-(3)).
305. See id. § 406(b), 116 Stat. at 789 (to be codified at 15 U.S.C. § 7264(b)).
306. Id.
308. The SEC determined that the provision did not apply to current reports on Form 8-K because they do not fall within the definition of periodic report. See Certification of Disclosure in Companies' Quarterly and Annual Reports, Exchange Act Release No. 34-46,427, 67 Fed. Reg. 57,276, 57,278 (Sept. 9, 2002) [hereinafter Certification of Disclosure] ("Reports that are current reports, such as reports on Forms 6-K and 8-K, rather than periodic (quarterly and annual) reports are not covered by the certification requirement.").
309. Specifically, the provision applies to the principal financial officer, or officers, and the principal executive officer, "or persons performing similar functions." 17 C.F.R. § 229.406(a) (2003).
310. The rule does provide that persons certifying the filing must physically sign the document. Use of a power of attorney is not permitted. Id. § 240.13a-14(d).
311. Id. The SEC also provided a draft certificate and admonished that the language could not be varied. See Certification of Disclosure, 67 Fed. Reg. at 57,280; see also Management's Report on Internal Control Over Financial Reporting and Certification of Dis-
with fines of up to five million dollars and prison terms of up to twenty years, for violations.\textsuperscript{312}

Certification of the annual and quarterly reports means something more than attesting to compliance with generally accepted accounting principles ("GAAP").\textsuperscript{313} As the SEC has noted, "fair presentation" of the company's financial condition encompasses the selection of appropriate accounting policies, proper application of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations and cash flows.\textsuperscript{314}

The benefits of certification remain unclear. The need to certify does not in any way alter the existing signature requirements.\textsuperscript{315} The adopting release noted only that the officers "providing a false certification" could be liable under section 13(a) of the Exchange\textsuperscript{316} and SEC Rule 10b-5 promulgated thereunder.\textsuperscript{317} Under section 13(a) of the Exchange Act, the failure to maintain proper procedures can violate the provision even if the company makes proper disclosure.\textsuperscript{318} No private right of action exists for violations


\textsuperscript{314.} Id.

\textsuperscript{315.} Id. at 57,280 ("The required certification is in addition to, and, thus, does not alter, the current signature requirements for quarterly and annual reports filed under the Exchange Act."). Those who sign a report can be held liable for the content. See, e.g., Howard v. Everex Sys., Inc., 228 F.3d 1057, 1061 (9th Cir. 2000) (discussing United States v. Gomez-Gutierrez, 140 F.3d 1287, 1288–89 (9th Cir. 1998); Newby v. Enron Corp., 258 F. Supp. 2d 576 (S.D. Tex. 2003)).


\textsuperscript{317.} See Certification of Disclosure, 67 Fed. Reg. 57,280 ("An issuer's principal executive and financial officers already are responsible as signatories for the issuer's disclosures under the Exchange Act liability provisions and can be liable for material misstatements or omissions under general antifraud standards.").

\textsuperscript{318.} See id. at 57,281, n.74 (noting that the failure to implement proper controls and procedures could violate section 13 even if "the failure did not lead to flawed disclosure.").
of this section. The SEC could, however, maintain an action for a violation and impose various penalties and fines.\textsuperscript{319}

e. Procedures

The certificate requirement also embodies broad procedural requirements designed to ensure that officers remain informed.\textsuperscript{320} Specifically, companies must maintain, and the certificate must acknowledge, that officers are responsible for the adoption of internal controls and procedures.\textsuperscript{321} "Disclosure controls and procedures" encompass those necessary to ensure that information in reports filed with the SEC are "recorded, processed, summarized and reported, within the [required] time periods."\textsuperscript{322} This includes anything necessary to assess "developments and risks that pertain to the issuer's businesses" and to meet the completeness requirements in Exchange Act Rule 12b-20.\textsuperscript{323} The procedures also must be sufficient to provide the information necessary for any SEC filing, including those not subject to the certification requirement such as current reports and proxy statements.\textsuperscript{324}

In addition, companies must maintain "internal control over financial reporting."\textsuperscript{325} This includes the process "designed by, or under the supervision of" the CFO or CEO that will "provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles."\textsuperscript{326}


\textsuperscript{322} Management's Report on Internal Control, 68 Fed. Reg. at 36,666 (to be codified at 17 C.F.R. § 240.13a-15(e)).


\textsuperscript{324} See id. at 57,278–79 ("Disclosure controls and procedures, however, are required to be designed, maintained and evaluated to ensure full and timely disclosure in current reports, as well as definitive proxy materials and definitive information statements, even though there is no specific certification requirement relating to reports on those forms.").

\textsuperscript{325} Management's Report on Internal Control, 68 Fed. Reg. at 36,666 (to be codified at 17 C.F.R. § 240.13a-15(c)).

\textsuperscript{326} Id. at 36,640 n.50.
The SEC has not specified any particular procedures, although the adopting release did recommend the formation of a committee "with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis." Moreover, the committee shall "report to senior management." This presumably means the officers are required to execute the certificate.

The release does contain what amounts to a list of objectives. The procedures must ensure that the information is communicated to management, including the CEO and CFO. These procedures must permit "timely collection and evaluation" of information required by Regulation S-X and Regulation S-K. Moreover, the process is not static but requires constant examination. The procedure should "ensure that an issuer's systems grow and evolve with its business and are capable of producing Exchange Act reports that are timely, accurate and reliable."

327. See Certification of Disclosure, 67 Fed. Reg. at 57,280 ("[W]e are not requiring any particular procedures for conducting the required review and evaluation.").
328. Id. The Commission noted that the committee should contain the principal accounting officer, the general counsel, the principal risk management officer, and the chief investor relations officer. Id. at 57,280 n.60. Others may be present on the committee. This may need to include, for example, representatives of significant business segments of the company. Id.
329. Id. at 57,280.
330. See 17 C.F.R. § 240.13a-14(c) (2003). The CEO and CFO must certify that the controls and procedures "ensure that material information" is made known to them during the period when periodic reports are being prepared. Id. § 240.13a-14(b)(4)(i).
332. In addition to the establishment of procedures, companies must undertake a regular evaluation of their effectiveness. The evaluation must occur within the ninety-day period prior to the filing date. 17 C.F.R. § 240.13a-15(b) (2003). The certifying officers must produce a report that includes their conclusions on the effectiveness of the procedures. Id. § 240.13a-14(b)(4)(iii). The certifying officers also have an obligation to disclose to the auditors and to the audit committee any deficiencies in the controls, any fraud by anyone with a significant role in the company's internal controls, and any significant changes in the controls, "including any corrective actions with regard to significant deficiencies and material weaknesses." Id. § 240.13a-14(b)(5)-(6). In assessing effectiveness, the CEO and CFO must determine whether the procedures work. At a minimum, this means that the system assigns the task of accumulating the necessary information and drafting the requisite reports in a timely fashion to the appropriate individuals. In addition to determining whether the system worked and these individuals performed their assigned task, an evaluation should ask about methods to improve the process. This might include the addition of other corporate officials to the process, the reassignment of responsibilities to more appropriate individuals, more detailed review by the board of directors, and changes in the timeline to ensure all of this occurs.
Sarbanes-Oxley also requires an assessment of internal controls and the annual disclosure of a report concerning the assessment. The report must state the responsibility of management for establishing and maintaining "an adequate internal control structure and procedures for financial reporting." In addition, the report needs to contain an assessment of the effectiveness of the procedures and the company's internal control over financial reporting. The auditor must attest to the report.

The new procedures may have some impact on state fiduciary obligations. They will provide executive officers with additional information and require that these officers take steps consistent with their fiduciary duty. The broader impact, however, is likely to be on the federal securities laws. The existence of extensive procedures may make it easier to show scienter. The Private Securities Litigation Reform Act of 1995 ("PSLRA") toughened the requirements for pleading scienter. Cases are often dismissed where, despite evidence of inaccurate disclosure, plaintiffs cannot show that the officers knew that the disclosure was false. By ensuring that top officers receive considerable information about the financial condition of the company, knowledge will be easier to prove.


337. See Reg. S-K, Item 308(b), 68 Fed. Reg. at 36,663 (to be codified at 17 C.F.R. § 229.308(b)).

338. Once the board obtains information, the failure to act can constitute deliberate neglect and bad faith. See In re Walt Disney Co. Derivative Litig., 825 A.2d 275, 289 (Del. Ch. 2003); see also Abbott Laboratories Derivative S'holders Litig., 325 F.3d 795, 808 (7th Cir. 2003).


340. Kushner v. Beverly Enters., 317 F.3d 820, 828 (8th Cir. 2003) ("[I]nvestors attempt to make out a strong inference of scienter based upon circumstantial evidence—namely, that it was reckless for the defendants not to know of the scheme given its sheer size and its effect on the company's core business.").
2. Duties of Directors

Sarbanes-Oxley also imposes additional obligations at the board level. Specifically, Sarbanes-Oxley increases the role of the audit committee by providing additional authority, ensuring the independence of the members, and requiring a certain amount of expertise. Section 301 directs the SEC to require the self-regulatory organizations ("SROs") to adopt rules governing the audit committee of the board. Among other things, the audit committee can only contain independent directors. Moreover, Sarbanes-Oxley mandates a definition of "independent" far more strict than anything required by state law or SROs. Despite these changes, however, Sarbanes-Oxley leaves the duties of directors largely unchanged.

a. The Board

With the exception of the audit committee, Sarbanes-Oxley does little to regulate directly the activities of the board. In addition to executive officers, the categorical prohibition on loans also applies to directors. Directors are prohibited from trading during blackout periods and required to report their trades in a more rapid fashion. The SEC now has the authority to adopt rules prohibiting officers and directors from interfering with audits in an effort to create misleading financial statements.

More significantly, the SROs—the New York Stock Exchange ("NYSE"), the American Stock Exchange ("AMEX") and the National Association of Securities Dealers ("NASD")—have implemented broad changes to the board structure, although these are not directly mandated by Sarbanes-Oxley. Specifically, the NYSE has required greater board independence and an increased role

342. See id. § 301, 116 Stat. at 775–77 (to be codified at 15 U.S.C. § 78j-1(m)).
for independent directors. The listing standards will require a majority of the board to consist of independent directors and will tighten the definition of independent.

The listing standards also require non-management directors to meet in executive session to facilitate "open discussion." Listed companies must form a compensation committee, an audit committee, and a nomination/governance committee. Each must consist entirely of independent directors, have a written charter, and provide for an assessment of its annual performance. The nomination committee has been granted sole authority to hire and fire any search firm used in locating director candidates.

b. Audit Committee

Most significantly, Sarbanes-Oxley contains significant changes to the audit committee, largely preempting state law. In effect, the audit committee of a public company is now directly responsible for the financial disclosure process. In addition, Sarbanes-Oxley also addresses membership requirements, including the need for expertise. Most of the provisions will be imple-

351. See Proposed Rule, 68 Fed. Reg. at 19,053. The sessions should be scheduled on a regular basis. The standards do not require the appointment of a lead director to run the meetings. Companies must disclose the method by which interested parties could communicate with the presiding director or the non-management directors as a group. See id.
353. See id. at 64,158-59 (Section 303A.7).
354. See id. at 64,158 (Section 303A.4).
355. See id. at 64,158-59. The charter must be posted on the company’s Web site. See id. at 64,159.
357. See MODEL BUS. CORP. ACT § 8.25 (2002) (providing that, unless stated otherwise in articles or bylaws, the board has the power to create committees, appoint directors, and determine authority). The only limits on a committee’s authority are those expressly contained in the corporate code. See id. § 8.25(e).
mented through the use of listing standards of the SROs. To the extent that companies fail to comply with the rules, they can be delisted.

Under Sarbanes-Oxley, a company must form an audit committee that "shall be directly responsible for the appointment, compensation, and oversight" of the auditor. The committee must have the ability to engage "independent counsel and other advisers" as necessary and have "appropriate funding" to perform its functions. What constitutes "appropriate funding" is determined by the audit committee not by the board.

Only independent directors can sit on this committee. Independence means that the directors may not accept any consulting, advisory, or other compensatory fees from the company and may only accept those fees associated with serving on the board. In addition, the committee must establish procedures for accepting complaints, including "confidential, anonymous submission[s] by employees."

The audit committee should also have at least one financial expert. Sarbanes-Oxley assigns to the SEC the task of writing the rules defining the qualifications for the expert. An expert must at least have an understanding of GAAP, experience in the preparation of financial statements and the application of accounting principals to "estimates, accruals, and reserves," and "an understanding of audit committee functions."

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359. See id. § 3(b), 116 Stat. at 749 (to be codified at 15 § U.S.C. 7202(b)).
360. Id. § 301, 116 Stat. at 776 (to be codified at 15 U.S.C. § 78j-l(m)(1)(A)).
361. Id. (to be codified at 15 U.S.C. § 78j-1(m)(2)).
362. Id. (to be codified at 15 U.S.C. § 78j-1(m)(5)).
363. Id. (to be codified at 15 U.S.C. § 78j-1(m)(6)).
364. Id. (to be codified at 15 U.S.C. § 78j-1(m)(3)).
365. Id. (to be codified at 15 U.S.C. § 78j-1(m)(3)(B) (i)).
366. Id. (to be codified at 15 U.S.C. § 78j-1(m)(4)).
367. Sarbanes-Oxley actually stops short of mandating the presence of such a director. Instead, the SEC must adopt rules requiring the company to disclose that the audit committee had one such director or the reasons why it did not. Id. § 407(a), 116 Stat. 790 (to be codified at 15 U.S.C. § 7265(a)).
368. Id. § 407(c), 116 Stat. at 790 (to be codified at 15 U.S.C. § 7265(c)).
369. Id. § 407(b), 116 Stat. at 790 (to be codified at 15 U.S.C. § 7265(c)).
c. Problems

The provisions regulating the audit committee, on their surface, reduce the domination of the board by the CEO. Not only does Sarbanes-Oxley prevent the CEO from placing inside directors on the audit committee, but the CEO cannot hire and fire the outside auditor.

Because of Sarbanes-Oxley's reliance on the rules of SROs to enforce provisions, major flaws exist in the Act's structure. First, the rules are largely unenforceable. Implemented primarily through listing standards, a private right of action does not exist for violation of these requirements. Private parties, therefore, cannot bring suit to enforce the listing requirements.

Stock exchange enforcement of listing standards has traditionally been modest given the limited penalties that can be imposed. Sarbanes-Oxley attempts to toughen the sanctions by ordering delisting for violations, but companies must get an opportunity to cure any defects. Directors, therefore, know that there will be little or no consequence for violations until detection, and even then there will be an opportunity to cure.

In addition, Sarbanes-Oxley's definition of independence for the audit committee does not go far enough to ensure a neutral decision making process. Members cannot receive any payment from the company except directors' fees. Sarbanes-Oxley does not tamper with state law cases characterizing a director as independent, even though he or she has longstanding business and personal ties to the CEO. Sarbanes-Oxley does not alter the line of Delaware cases concerning payments to a charity run by a director. The Sarbanes-Oxley also seems to provide that directors'

370. See id. § 301, 116 Stat. at 796 (to be codified at 15 U.S.C. § 78j-1(m)(3)).
371. See id. § 301, 116 Stat. at 776 (to be codified at 15 U.S.C. § 78j-1(m)(2)).
372. See BROWN, REGULATION OF CORPORATE DISCLOSURE, supra note 6, at § 3.06[5].
373. See Sarbanes-Oxley § 301, 116 Stat. at 776 (to be codified at 15 U.S.C. § 78j-1(m)(1)).
374. See id. § 301, 116 Stat. at 776 (to be codified at 15 U.S.C. § 78j-1(m)(3)).
375. Thus, Father O'Donovan, the President of Georgetown, was considered an independent director on the board of Disney despite contributions of one million dollars by Michael Eisner, the CEO, to the University. See In re Walt Disney Co. Derivative Litig., 731 A.2d 342, 359 (Del. Ch. 1998), rev'd in part, aff'd in part by Brehm v. Eisner, 746 A.2d 244 (Del. 2000). See also In re The Ltd., Inc., S'holders Litig., 2002 Del. Ch. LEXIS 28, at *11 (Del. Ch. 2002).
fees will never deprive a director of independence, no matter the amount.\textsuperscript{376}

More noticeably, however, Sarbanes-Oxley's definition of independence extends only to members of the audit committee.\textsuperscript{377} Directors involved in the financial review process will, therefore, have a somewhat higher degree of independence.\textsuperscript{378} The same requirement does not extend to those directors serving on other board committees or directors approving self-dealing transactions by management.

Finally, and perhaps most critically, Sarbanes-Oxley does nothing to alter the director nomination process.\textsuperscript{379} To the extent nominations are controlled or strongly influenced by the CEO, a common phenomenon, boards are likely to contain large numbers of "independent" directors who remain closely aligned with the CEO. Moreover, with the high fees paid to directors of the largest public companies, they have an incentive to engage in behavior

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\textsuperscript{376} Courts in Delaware have indicated that payment of directors fees will not result in a loss of independence. See Grobow v. Perot, 539 A.2d 180, 188 (Del. 1988) ("The only aver-
ment permitting such an inference is the allegation that all GM's directors are paid for their services as directors. However, such allegations, without more, do not establish any financial interest."). See also In re The Ltd. S'holders Litig., 2002 Del. Ch. LEXIS 28, at *17 (Del. Ch. 2002) ("Allegations as to one's position as a director and the receipt of di-
rector's fees, without more, however, are not enough for purposes of pleading demand fu-
tility."). At least one court has noted that this may not be the case where the fees "were shown to exceed materially what is commonly understood and accepted to be usual and customary." Orman v. Cullman, 794 A.2d 5, 29 n.62 (Del. Ch. 2002). Nonetheless, no Delaware case has ever found that the amount of fees resulted in a loss of independence. This is true despite the significant amounts routinely paid to directors. See Lucian Arye Bebchuk & Jesse M. Fried, Executive Compensation as an Agency Problem, Discussion Pa-
pdf421.pdf. (last visited Nov. 13, 2003) (noting that for the 200 largest United States cor-
porations in 2001, the average fee paid to directors was $152,626; directors of Enron were paid $380,000).

\textsuperscript{377} See Sarbanes-Oxley § 301, 116 Stat. at 776 (to be codified at 15 U.S.C. § 78j-
I(m)(3)).

\textsuperscript{378} See id.

\textsuperscript{379} Although not in Sarbanes-Oxley, the SEC has been considering reforms in this area that would facilitate the election of directors not supported by management. See Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors, Division of Corporation Finance, Securities and Exchange Commission (July 15, 2003), available at http://www.sec.gov/news/studies/proxyreport.pdf (last visited Nov. 13, 2003). The staff analysis has resulted in two proposals, one to increase required disclosure about the nominating process (Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Exchange Act Re-
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designed to keep them on the board. To the extent the CEO controls the election process, directors will have an economic incentive to avoid challenging or second guessing the CEO.

VI. IMPLICATIONS AND CONSEQUENCES

In specific areas of corporate governance, many states have opted for a management-friendly approach to regulation. Whether a competition to retain corporate charters or a consequence of lobbying, the result has been the same. States have favored management by adopting waiver of liability provisions, increasing the discretion of the board, particularly in the area of self-dealing, and facilitating management job retention, particularly through approval of anti-takeover tactics. This approach does not appear likely to change.

When states granted excessive discretion to management in the past, Congress intervened and, with the adoption of the federal securities laws, effectively took away their control over the financial disclosure and voting process. Sarbanes-Oxley repre-

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380. See supra notes 16–33 and accompanying text.
381. See supra notes 55–60 and accompanying text.
382. Having said that, it is only fair to note that a number of recent Delaware cases have taken a harder line toward management’s fiduciary duties. In two cases, the chancery court declined to defer to a special litigation committee because the members lacked independence. See Biondi v. Scrushy, 820 A.2d 1148 (Del. Ch. 2003); In re Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003). In another instance, the Supreme Court of Delaware all but inexplicably declined to permit the granting of a motion to dismiss in a duty of loyalty case, again leaving open the possibility that the board may have lacked independence. See Krasner v. Moffett, 826 A.2d 277 (Del. 2003). Finally, the chancery court on remand in Disney allowed the case involving severance payments to Michael Ovitz to go forward on the ground that, to the extent the board acted with intentional disinterest, the business judgment rule did not apply. See In re Walt Disney Co. Derivative Litig., 825 A.2d 275, 285–87 (Del. Ch. 2003). These cases may suggest a desire by the Delaware courts to make fiduciary duties more meaningful. Such an approach would reduce the pressure for further federal preemption of the area. See Coffee, supra note 96, at 5 (noting that one law firm speculated that decisions were motivated by the Delaware court’s desire to prevent further federal legislation). Nonetheless, it is uncertain whether the positions in cases such as Oracle and Disney will be upheld by the Supreme Court of Delaware. See e.g., supra note 176 (nothing that the Supreme Court of Delaware has never expressly approved rationale stated by the court of chancery in Caremark). Subsequent decisions also could construe these opinions so narrowly they would have little impact on the governance process. Finally, these cases did not change areas of critical importance such as the application of the business judgment standard to self-dealing transactions approved by disinterested directors.
resents another instance of federal intrusion seeking to compensate for lax standards at the state level.  

Sarbanes-Oxley forces the board to be more informed, largely supplanting Delaware law concerning the duty to monitor. Counsel must report to management suspected breaches of fiduciary duties. Companies are required to put in place information gathering systems—a requirement that has effectively overturned Delaware law. Sarbanes-Oxley increases both the standards for, and the duties of, directors on the audit committee. Sarbanes-Oxley also addresses self-interested transactions, including loans to executives and performance-based compensation.  

In connection with the duties and obligations of management, however, Sarbanes-Oxley is at best an incomplete solution. While changing some aspects of the governance process, Sarbanes-Oxley does not impose systematic, uniform standards. Sarbanes-Oxley does not alter the fiduciary standards applicable to officers and directors or improve the procedural mechanisms used to supplant substantive review. The definition of "independent director," for purposes of approving self-interested transactions, remains a matter of state law. Sarbanes-Oxley does not change

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383. Sarbanes-Oxley does not, therefore, go as far as Professor Cary suggested. In addition to federal standards for fiduciary duties, Professor Cary recommended federal legislation that would impose uniform standards designed to limit management's authority to control the agenda for shareholder meetings, to increase the number of matters that required shareholder approval, to abolish nonvoting shares, to limit indemnification, and to adopt a long-arm provision designed "to apply to all transactions within the corporate structure involving shareholders, directors, and officers." Cary, supra note 11, at 702.


386. See id. § 301, 116 Stat. at 775–77 (to be codified at 15 U.S.C. § 78j-1(m)).


388. An alternative would be to end the race to the bottom by eliminating the right of states to compete for charters. This could be done by a federal statute that restricted choice when it came to the selection of the state of incorporation. Thus, for example, corporations could be allowed to incorporate in states where they conducted a substantial amount of business. While this would reduce competition, it would not guarantee uniform standards.

the impact of independent approval, including the elimination of fairness in the judicial review of a self-interested transaction.\textsuperscript{390}

Thus, nothing in Sarbanes-Oxley prevents a company from again issuing a retirement package that includes free use of apartments, cut flowers, courtside tickets, and access to the corporate jet.\textsuperscript{391} Nothing in Sarbanes-Oxley prevents a board from issuing millions of stock options to executive officers, thereby providing an incentive to engage in aggressive accounting practices designed to raise share prices.

Sarbanes-Oxley also does nothing to prevent the CEO from controlling the nomination process for directors. As long as the CEO retains the ability to select directors for nomination and election, including independent directors, the board's ability to supervise self-interested transactions remains in doubt.

To address these omissions, federal law needs to address three concerns about the governance of public companies. First, federal law should make the disinterested approval process more rigorous by providing a broader definition of "independent" director. Sarbanes-Oxley does prohibit those serving on the audit committee from receiving any payment from the company other than directors' fees.\textsuperscript{392} This is a fairly objective and reasonable definition of independent and is in some ways more strict than the prevailing definition under Delaware law. The approach, however, applies only to members of the audit committee and omits other factors that could impair independence.\textsuperscript{393}

Any definition should start with the standard for independence used by the Supreme Court of Delaware in \textit{Aronson v. Lewis}\textsuperscript{394}—that the "director's decision [be] based on the corporate merits of the subject before the board rather than extraneous considera-

\textsuperscript{390} See supra notes 157–161 and accompanying text. Of course, if the courts will not examine fairness, the likelihood that the independent committee will do so remains an open question. Thus, it is possible that no one in the transaction ever examines its fairness.

\textsuperscript{391} Jack Welch, the former CEO of General Electric, reportedly received these benefits when he retired from the company. Geraldine Fabrikant, \textit{G.E. Expenses for Ex-Chief Cited in Filing}, N.Y. TIMES, Sept. 6, 2002, at C1. Ultimately, he agreed to give some of them up. Editorial, \textit{Atonement in the Boardroom}, N.Y. TIMES, Sept. 21, 2002, at A14.

\textsuperscript{392} Sarbanes-Oxley, § 301, 116 Stat. at 776 (to be codified at 15 U.S.C. § 78j-1(m)(3)(i)).

\textsuperscript{393} See discussions of Oracle and Scrushy, supra note 382.

\textsuperscript{394} 473 A.2d 805 (Del. 1984).
At some level, it might seem unexpected to start with Delaware law as a basis for a federal standard. With the exception of In re Oracle Corp. Derivative Litigation, however, Delaware courts have narrowly construed “extraneous considerations or influences,” limiting the phrase almost exclusively to directors with a material financial interest in the company. In general, the Aronson standard has been determined not to include: (1) friendships; (2) outside business relationships; (3) directors’ fees, even when they were a material part of an individual’s income; (4) prior and sometimes even current employment with the company; and (5) payments from the company that do not directly benefit the director. The phrase also does not include the receipt of significant payments that are not material to the individual director.

The federal definition would need to recognize explicitly that non-financial interests can impair independence. As a result, the statute, or more likely, implementing rules, should define categories of relationships that presumptively render a director not independent. The NYSE has already proposed to do this, calling for

395. Id. at 816.
396. 824 A.2d 917, 939 (Del. Ch. 2003) (“Without backtracking from these general propositions, it would be less than candid if I did not admit that Delaware courts have applied these general standards in a manner that has been less than wholly consistent.”).
397. Aronson, 473 A.2d at 816.
398. See, e.g., Rales v. Blasband, 634 A.2d 927 (Del. 1993) (discussing that a director will be interested when receiving a personal finance benefit). The phrase “extraneous considerations or influences” also includes certainly family relationships. See Oracle, 824 A.2d at 939 n.53.
399. Oracle, 824 A.2d at 939. (“Likewise, there is admittedly case law that gives little weight to ties of friendship in the independence inquiry.”).
400. In In re Walt Disney Co. Derivative Litig., 731 A.2d 342 (Del. Ch. 1998), the court noted abjectly that Michael Ovitz and Michael Eisner had business relationships outside of the company but refused, with little description or discussion, to conclude that they rendered Eisner interested in the outcome and therefore not independent. Id. at 355. On this ground, the Supreme Court of Delaware affirmed the chancery court, in Brehm v. Eisner, 746 A.2d 244 (Del. 2000).
401. See Disney, 731 A.2d at 359–60 (discussing the independence of elementary school principal).
402. See id. at 358 (discussing the independence of former executives of company).
403. See id. at 356–57 (discussing the independence of Roy Disney who also served as officer of company).
404. See id. at 359 (discussing the independence of Father O’Donovan, President of Georgetown University).
405. See id. at 360 (discussing independent status of Senator Mitchell, who received, in addition to directors’ fees, a $50,000 payment for consulting).
the elimination from the definition any director who, during the previous three years, was or had a family member employed by the company. 406 Similarly, Sarbanes-Oxley defined "independent" for purposes of the audit committee as anyone who does not receive, directly or indirectly, any payment from the company other than directors' fees. 407

Once a broader definition of independent is in place, the second step will be to create a federal standard that alters the consequences of disinterested and independent approval of self-interested transactions. Approval should not result in the application of the business judgment rule and the attendant elimination of judicial review of fairness. Disinterested and independent approval should, however, have some benefit, both to encourage its use and to reduce judicial involvement in the decision-making process. This could be accomplished by a federal standard that shifts the burden of proving fairness (or unfairness) to the plaintiff. Delaware courts already use such a burden, but only in the relatively narrow context of transactions between controlling shareholders and the company. 408

Such a standard would retain some degree of judicial review of fairness. This does not mean excessive involvement of courts in the business of the corporation. At the same time, the courts would have a residual right to examine transactions even if approved by disinterested directors. Thus, the questionable loans to the former CEO of Worldcom, Inc., Bernie Ebbers, would be subject to review even if approved in a procedurally correct manner. 409

Finally, federal law should impose standards that restrict the ability of management to influence the process of electing directors. Assuming an adequate definition of independent director


408. See Brown, Shareholder Ratification, supra note 12, at 642; see also supra note 161.

emerges, the most appropriate approach would be to require the board to form a nominating committee and restrict membership to independent directors. Consistent with Sarbanes-Oxley and the treatment of audit committees, the nominating committee should have independent financing to enable it to adequately perform its duties without untoward influence from interested members of the board. 410

Examples of "unfair" self-dealing will always exist. In the absence of these proposed reforms, future transactions will continue to have few limits, and competition among states will continue to prevent the implementation of meaningful standards. 411 As a result, excessive amounts of improper self-dealing will again occur. Allowing for federal standards in this area will provide more meaningful standards while leaving to states other areas of reform. States could still compete for charters (or to prevent reincorporations) but they would have to do so not by racing to the bottom but rather by devising more efficient laws that enhance the value of the shares of public companies.

VII. CONCLUSION

The competition among states resulted in the weakening of duties imposed on directors. In particular, courts lost the authority to examine the fairness of transactions involving conflicts of interest. The lack of standards contributed to the excesses that resulted in the adoption of Sarbanes-Oxley. Sarbanes-Oxley to some extent filled this void in the governance process primarily by imposing new requirements on officers and directors.

Congress did not oust states entirely from the corporate reform process. 412 Sarbanes-Oxley mostly addresses corporate govern-

410. Perhaps the greatest impediment to insurgent shareholders in the nomination process concerns the costs associated with proxy contests. State law could devise a mechanism whereby the company pays the costs of the distribution of materials concerning the insurgent nominees. Given that public companies distribute the information required in the federal proxy rules, the solution might be an amendment to those rules requiring inclusion in the proxy statement distributed by management. The SEC is considering reforms in this area. See Security Holder Director Nominations, Exchange Act Release No. 48626 (Oct. 14, 2003).

411. But see, e.g., supra text accompanying note 219.

412. Congress' approach stops short of federal incorporation, a notion Professor Cary correctly labeled "politically unrealistic." Cary, supra note 20, at 700. There are many rea-
ance issues. States are left to regulate, compete, and innovate in other areas.\textsuperscript{413} Delaware, for example, became the first state to adopt a provision that permits virtual shareholder meetings.\textsuperscript{414} Other states will likely follow suit, no doubt with some variation.\textsuperscript{415}

Nonetheless, while Sarbanes-Oxley supplanted much of state regulation, the legislation did not do enough to properly reform the governance process. Sarbanes-Oxley did not change the standards for reviewing director behavior or make more meaningful the approval process for self-interested transactions. Nor did Sarbanes-Oxley significantly alter the influence of the CEO over the director nomination process.

The result is that state law will remain the source of duties and responsibilities for directors, at least those not preempted by Sarbanes-Oxley. At the same time, the competition for charters will ensure that the duties are not meaningful. The result will likely be future federal intervention and the more complete removal of states from the governance process.

\footnotesize{\textsuperscript{13}See Kahan and Kamar, supra note 17, at 747 (noting that federal reform would likely be slower than reform at the state level).}

\footnotesize{\textsuperscript{14}See DEL. CODE ANN. tit. 8, § 211 (2001); see also supra note 66. Inforte Corp., the first company to conduct a virtual meeting of shareholders, increased the number of attendees but at the same time did not allow shareholders to ask questions. See Ross Kerber, The Momentum Builds for Online-Only Annual Meetings, BOSTON GLOBE, July 22, 2002, at C1.}

\footnotesize{\textsuperscript{15}Delaware law and the Model Business Corporation Act have already been changed to permit broader use of e-mail as a method of communicating with shareholders. See DEL. CODE ANN. tit. 8, § 211 (2001); MODEL BUS. CORP. ACT § 7.22 (2002). For a comparison of the two approaches, see Michael P. Dooley and Michael D. Goldman, Some Comparisons Between the Model Business Corporation Act And the Delaware General Corporation Law, 56 BUS. LAW. 737 (2001).}