At the beginning of a new century, the American system of corporate governance finds itself in tumult. Propelled by genuine outrage at abuses within companies like Enron, Worldcom, Tyco, Global Crossing, and Adelphia, and by fear of being held accountable for previous inaction, the federal government (through the Sarbanes-Oxley Act of 2002) and the nation’s two largest Stock Exchanges (through committee reports that will, subject to Securities and Exchange Commission approval, generate new listing requirements).
have adopted important new initiatives designed to improve the integrity of corporate America—what we will call the 2002 Reforms.

Notably, the 2002 Reforms do not target only the core problems that gave rise to some of the more publicized scandals, but instead concentrate more generally on the manner in which public corporations should be governed. Indeed, one senses that it was easier for Congress and the Stock Exchanges to gain consensus on this broader corporate governance agenda than on measures that would (it can be argued) more specifically redress some of the incentives that gave rise to the past years’ abuses. These include an obvious perception that fast-and-loose accounting and expenditure practices would not be easily detected nor prosecuted by federal and state governmental authorities, weak accounting principles that gave corporations leeway to engage in risky practices, and human greed tempted by perverse accounting and tax rules that encouraged questionable compensation arrangements. It is remarkable that neither Congress nor the Exchanges took action to rectify the perverse accounting incentives that now exist for executive and director compensation. Currently, for


This Article was based on the SEC and Exchange rule proposals that existed as of February 24, 2003. All citations to the final rule proposals after this date are included only for the reader’s convenience.

In fairness, Congress did take action to more closely regulate and ensure the independence of public accountants. See, e.g., Sarbanes-Oxley § 201 (identifying nine non-audit services that impair an accounting firm’s independence); id. §§ 201-202 (requiring audit committee pre-approval of allowable services provided by auditor and requiring disclosure of non-audit services approved by the audit committee); id. § 203
example, a public corporation that desires to grant its executives restricted stock or stock options tied to genuine measures of performance must reflect a current balance sheet charge, but one that simply chooses to give its executives "at-the-money" options need not.\(^5\)

Likewise, the political branches of the federal government have hesitated to give the SEC all the resources it has sought to enforce the many existing laws that were arguably violated in the various scandals now under investigation.\(^6\) Even some at the SEC have expressed reluctance to have the agency play a more full-bodied role in the regulation of the accounting industry.

With debate continuing about issues like these, Congress and the Exchanges chose instead to proceed more aggressively on other fronts. In particular, they adopted a wide array of corporate governance requirements that embody into law, in Congress's case, and into contract, in the case of the Exchanges, recommendations for good corporate governance that have been advocated for many years by commentators like Martin Lipton, Ira Millstein, former Delaware

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\(^6\) See Joseph A. Grundfest, Editorial, Give the SEC Its Due: More Money, WALL ST. J., Oct. 29, 2002, at A22 ("The SEC lacks the resources it needs to prosecute all instances of major fraud.").

\(^7\) See Michael Schroeder & Cassell Bryan-Low, Enron Collapse Has Congress Backing Off Deregulation: Better Financial Reporting, Tighter Accounting Rules Top Bipartisan Call for Changes, WALL ST. J., Jan. 29, 2002, at A22 ("[Harvey] Pitt, who represented big accounting firms as a private attorney before his SEC appointment by President Bush, says he is developing an industry-funded response to the accounting problems, rather than beefing up the SEC staff and budget to directly regulate the accounting industry.").
Chancellor William Allen, and Delaware Chief Justice E. Norman Veasey. These distinguished commentators have long stressed the obligations of corporate directors to be vigilant in their oversight responsibilities and the integrity-assuring benefits of genuinely independent directors whose ability to choose and oversee top management impartially could not be questioned. In aid of their shared vision, these commentators articulated useful techniques (e.g., a majority of independent directors, the identification of a “lead” independent director, director oversight of legal compliance systems, and regular meetings of the independent directors outside of the presence of the management directors) that would facilitate effective monitoring by independent directors and that would limit room for abuse by insiders.

The 2002 Reforms embrace their vision in a substantial manner. Taken together, the Sarbanes-Oxley Act and the proposed Stock Exchange Rules change an aspirational agenda for best corporate practices into a largely invariable model that must be followed by any listed company domiciled in the United States.9


9 The Stock Exchanges generally permit a foreign company to follow its own domestic rules so long as the company discloses the differences. See NYSE PROPOSED RULES, supra note 3, § 303a(11) (“Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.”); NYSE REPORT, supra note 3, at 22-23 (recommending that foreign private issuers be required to reveal differences in corporate governance practices); NASD Manual R. 4320(e)(2)(C) (2003) (“An issuer’s qualifications will be determined on the basis of financial statements prepared in accordance with U.S. generally accepted accounting principles or those accompanied by detailed schedules quantifying the differences between U.S. generally accepted accounting principles and those of the issuer’s country of domicile.”), available at http://www.nasdr.com/pdf-text/nasd_manual.pdf; see also Disclosure of Exemptions
As members of a Delaware judiciary that has voiced strong support for many of the "best practices" that are now embodied in the 2002 Reforms, it would smack of hypocrisy for us to fail to acknowledge the substantial integrity-generating potential of these initiatives. In many respects, the 2002 Reforms reflect a recognition that useful practices that have been encouraged by the more tentative and contextually-specific teachings of the common law of corporations are sufficiently workable and valuable to merit system-wide implementation.

Still, Delaware judges also anticipate being among the first governmental decision makers to confront real-world disputes influenced by the 2002 Reforms. These Reforms purport to mandate a wide range of actions by directors of Delaware corporations. Thus, it is unavoidable that the Delaware judges charged with adjudicating directorial compliance with legal and equitable duties will confront cases in which the mandates of the 2002 Reforms make their legal debut. Appropriate candor, therefore, requires us to acknowledge our concerns regarding some aspects of the 2002 Reforms.

First, many appear to have been taken off the shelf and put into the mix, not so much because they would have helped to prevent the recent scandals, but because they filled the perceived need for far-reaching reform and were less controversial than other measures more clearly aimed at preventing similar scandals. This is not to say that the asserted motivations behind the 2002 Reforms were not sincere. Rather, it recognizes the reality that this year's scandals gave advocates who had long desired certain aspects of the Reforms an opening to actually obtain serious consideration and adoption of their proposals, regardless of the lack of a clear connection between those proposals and the conduct that caused the scandals. And, unsurprisingly, the 2002 Reforms also have a somewhat random quality, which reveals the desire of many in the political and corporate governance worlds to leave some imprint on the resulting product.

All of this is to say that the 2002 Reforms are typical of major remedial measures that result from our political process. Though the Reforms contain much that is likely to be of enduring value, they also suffer from the rapidity of their enactment and a tendency to deal with many issues somewhat superficially and sporadically, rather than with one or two issues deeply and coherently. Overall, however, the

by Non-U.S. Issuers from Nasdaq's Corporate Governance Listing Standards, 68 Fed. Reg. 41,193 (proposed July 10, 2003) (requiring foreign issuers to disclose any exemptions they may receive from NASDAQ's corporate governance listing standards and to describe alternative practices used in lieu of these requirements).
2002 Reforms promise benefits to the nation's investors, so long as they are implemented with sensitivity by policymakers who are open-minded about the need to tailor the Reforms when necessary to ensure workability.

As a modest contribution to the early stages of that process, this Article seeks to anticipate some of the more interesting potential implications of the 2002 Reforms for substantive state corporation law. Although it is difficult to predict the full ramifications of the 2002 Reforms for state law, what is clear is that the Reforms represent a marked increase in federal government and Exchange regulation of the corporate boardroom. As will be shown, the 2002 Reforms prescribe a host of specific procedures and mechanisms that corporate boards must employ in the governance of their firms. These prescriptions impinge on the managerial freedom permitted to directors by state corporation law and will fuel a new round of dialogue among the three sources of corporate governance policy that predominate in the American system: the federal government (principally through the SEC), state governments (through their corporate codes and the common law of corporations), and the Stock Exchanges (through their rules and listing requirements).10

The dialogue among these policymakers is, of course, not novel. For most of the last century, these policymakers have influenced each other and have intruded on each other's principal domains in the

10 One can actually conceive of the Stock Exchange Rules as part and parcel of the federal regulatory scheme. The Exchange Rules are in fact required by federal law. To wit, section 6 of the Exchange Act limits registration to Exchanges that have rules addressing certain statutory issues. See 15 U.S.C. § 78f(b) (2000) ("An exchange shall not be registered as a national securities exchange unless . . . [it can] enforce compliance by its members and persons associated with its members, with the provisions of this title, the rules and regulations thereunder, and the rules of the exchange."). Section 15A(b)(6) of the Exchange Act describes the purpose of Exchange Rules:

[T]o prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest . . . .

15 U.S.C. § 78o-3(b)(6) (2000); see also id. § 78f(a) (presenting the same criteria to protect investors and the public interest). Because the statutory authorization for the Exchange Rules has not, however, been interpreted to give the SEC regulatory authority over corporate internal affairs, see Bus. Roundtable v. SEC, 905 F.2d 406, 407 (D.C. Cir. 1990), and because the Exchanges retain considerable, if not unlimited, freedom to shape their own rules, we treat them for discussion purposes as independently important elements of a tri-cornered system of corporate governance for public companies.
overall American system of corporate governance. That said, the 2002 Reforms appear to be a relatively aggressive move by the federal government and the Exchanges into the realm of board decision making and composition, an area where, traditionally, the states have been predominant. As we will show, the Reforms generate creative friction with some state law concepts, which may result in adaptations in state law or in amendments to the Reforms themselves.

In this Article, we do not seek to predict the outcome of this upcoming dialogue. Rather, we limit ourselves largely to identifying areas that are likely to generate policy intersection in the litigation process and to advancing some tentative perspectives on the resulting possibilities (pro and con) for the American corporate governance system. Our goal is not to be exhaustive, but to concentrate on a few subjects where some level of policy conflict or evolution might reasonably be expected. We use the law of our own state, Delaware, as being generally representative of state corporate laws to help make our discussion more concrete.

In order to rationally pursue this objective, we begin Part I with a brief overview of those aspects of the 2002 Reforms that address areas of corporate responsibility that are traditionally the primary focus of

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11 The incursions into untraditional territory within the past year have not all come from the federal government and the Exchanges. The creativity of New York Attorney General Eliot Spitzer in using a unique New York statute enabled him to play a major role in areas of securities industry enforcement and policy that were traditionally dominated by the SEC, a role that in turn put pressure on the SEC to undertake new regulatory measures it otherwise might not have. See Charles Gasparino & Michael Schroeder, Pitt and Spitzer Butted Heads to Overhaul Wall Street Research, WALL ST. J., Oct. 31, 2002, at A1 ("Mr. Spitzer so effectively launched his crusade to punish Wall Street that he forced Mr. Pitt to take action.").

12 We intentionally choose not to discuss the implications the new federal mandate for the "fair presentation" of the financial condition of public companies will have on the state law duty of disclosure required of corporate directors as fiduciaries. See Sarbanes-Oxley § 302, 15 U.S.C.A. § 7241 (West Supp. 2003). See generally Certification of Disclosure in Companies' Quarterly and Annual Reports, Securities Act Release No. 33-8124, Exchange Act Release No. 34-46,427, 67 Fed. Reg. 57,276 (Sept. 9, 2002) (enacting rules implementing section 302 of Sarbanes-Oxley). This is not because it is not an important subject; it is. Given the deference states have paid to federal disclosure standards in shaping the state fiduciary duty of disclosure, see, e.g., Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del. 1985) (adopting the federal materiality standard), the apparently heightened duty of disclosure required by Sarbanes-Oxley may give rise to interesting state law cases, particularly in the context of injunction applications connected to stockholder votes. Disclosure regulation is traditionally a core federal concern, however, and our focus is on those aspects of the 2002 Reforms that appear to reflect a more expansive policy domain for the federal government and the Exchanges.
state law. We move from there to address specific policy consequences that we perceive as resulting from these Reforms.

Specifically, in Part I, we note the overall discord between the prescriptive quality of the 2002 Reforms—particularly the proposed Exchange Rules—and the enabling approach to corporate regulation taken by the Delaware General Corporation Law. Under the Delaware approach, boards are given wide authority to pursue lawful goals unhampered by numerous procedural mandates, but with the constraints of fiduciary duty and targeted statutory requirements (such as mandates for stockholder votes on key transactions) as the primary safeguards. By contrast, the 2002 Reforms require that corporate boards establish an array of specific committees comprised of directors with certain characteristics, which must carry out specific tasks. Although many of these mandates have been recommended by Delaware courts as best practice, there is inarguable tension between the Delaware approach of avoiding prescriptive procedural requirements and that of the 2002 Reforms.

In Part II, we articulate worries that arise out of this tension: have the 2002 Reforms left boards with sufficient time to grapple with key business issues, like the company's strategic direction and oversight of managerial performance? Will the 2002 Reforms be workable for small- and mid-cap public companies without large legal and auditing staffs?

In Part III, we note the reality that the 2002 Reforms will likely generate new shareholder litigation in the state courts. This litigation will put pressure on states to harmonize their laws with the Reforms and expose some features of the Reforms that may need alteration.

In Part IV, we turn to the implications of the 2002 Reforms' treatment of the independent director concept. We first note that there is a great deal of harmony between the sentiments behind the 2002 Reforms and Delaware case law, to the extent that the Reforms recognize the independence-compromising effects of consulting contracts,13

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13 Although both Sarbanes-Oxley and Delaware law are suspicious of the independence of directors who receive consulting fees from their companies, the former favors a bright-line approach to the problem, while the latter focuses on the context in which the consulting fees were paid and their materiality. Compare Sarbanes-Oxley § 301, 15 U.S.C.A. § 78j-1(m)(3)(B)(i) (West Supp. 2003) (prohibiting audit committee members from receiving certain consulting, advisory, and compensatory fees from the company) to the following Delaware cases taking a more contextual approach: In re The Limited, Inc. S'holders Litig., No. 17148, 2002 WL 537692, at *6 (Del. Ch. Mar. 27, 2002); Orman v. Cullman, 794 A.2d 5, 29-30 (Del. Ch. 2002); In re Ply Gem Indus., Inc. S'holders Litig., No. 15779, 2001 WL 755133, at *9 (Del. Ch. June 26, 2001); In re
familial ties, and other factors that create structural bias. Because of this, the 2002 Reforms may have the virtue of simplifying some aspects of corporate litigation (e.g., derivative actions), and that simplifying effect could be beneficial.

But the implications of the 2002 Reforms' definitional exercise are not uniformly positive. Notably, the 2002 Reforms take a less optimistic view of the independence of directors who own, or are affiliated with owners of, substantial but non-controlling blocks of stock. In Part IV.A, we question the wisdom of this skepticism—which is contrary to Delaware case law and the recommendations of respected corporate governance advocates—because it seems to discourage director service by a class of persons who would seem to have the right incentives to act as faithful monitors of corporate integrity.


14 See Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 889 (Del. Ch. 1999) ("Close familial relationships between directors can create a reasonable doubt as to impartiality."); NASDAQ Proposed Amendments, supra note 3, R. 4200(a)(15)(C) (defining "independent directors" so as to exclude those with certain familial relationships to other corporate employees); NYSE PROPOSED RULES, supra note 3, § 303A(2)(a) cmt. ("Material relationships can include . . . familial relationships.").

15 For instance, the NYSE has recognized the potential for charitable relationships to have independence-compromising effects. See NYSE PROPOSED RULES, supra note 3, § 303A(2)(a) cmt. ("Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships (among others)." (emphasis added)); NYSE REPORT, supra note 3, at 8, 19 (describing the issue of director independence raised when a company makes substantial charitable contributions to organizations affiliated with a director). Likewise, Delaware law recognizes that charitable relationships between a director and another constituent of the corporation (or the corporation itself) should be considered as factors in determining whether the director's independence has been compromised. The Delaware Court of Chancery has reasoned that if a director's favorite charity receives donations from the corporation (or from certain corporate officers), then the director might feel beholden to certain officers within the corporation. The supposedly independent director, then, might compromise his independence with the hope that pleasing (or at least not displeasing) these officers will lead to future donations to the charity. The approach of the court has not, however, been a bright-line one. Rather, the court evaluates the effect of donations to a charity affiliated with a supposedly independent director on a fact-intensive, case-by-case basis. For examples of cases where charitable relationships influenced the determination of whether a director was independent, see In re The Limited, Inc. Shareholders Litigation, 2002 WL 537692, at *7; In re Walt Disney Co. Derivative Litigation, 731 A.2d 342, 359 (Del. Ch. 1998), aff'd in part, rev'd in part sub nom. Brehm v. Eisner, 746 A.2d 244 (Del. 2000); Lewis v. Fuqua, 502 A.2d 962, 966-67 (Del. Ch. 1985).
and performance at a time when these same Reforms will create an increased demand for quality independent directors.

On a different tack, in Part IV.B, we note the care with which the independent director concept must be used. As a general matter, the 2002 Reforms apply a blanket label to directors, identifying a broader class of directors as “non-independent” without as much regard for context as state corporation law has had. Common law courts must be careful to remember that the label placed on a director is not determinative of whether the director has breached his fiduciary duties. In particular, judges must be mindful of the distinction between those directors who have a conflicting “interest” in a transaction and those directors whose ability to act impartially—i.e., independently—on a transaction might be questioned because of their relationship to another person who has an interest. Before monetary damages are imposed on a non-independent director, however, due process requires an inquiry into whether the director in fact acted with the requisite culpability to sustain a damages award. Absent the assurance of judicial conformity with this principle, the 2002 Reforms may deter well-qualified people from serving on boards.

Next, in Part V, we point out that the 2002 Reforms deepen the American corporate governance system’s reliance upon independent directors who (in this ideal conception) feel accountable only to the corporation and its stockholders. At the same time, however, the 2002 Reforms leave in place an incumbent-dominated electoral system that provides little opportunity for competitive elections in the absence of a hostile takeover bid. The absence of action on this front arguably leaves our system of corporate democracy incomplete, and is a subject that is worthy of attention by state lawmakers, in whose domain the responsibility for reform of this kind primarily resides.

In Part VI, we note that one likely consequence of the 2002 Reforms will be a continuing reduction in management directors. This reduction will not, we venture, coincide with any diminution in the importance of top managers in the actual management of public companies. In order to ensure that the deterrent and remedial value of fiduciary duty suits are not, for practical reasons, decreased in the process, we identify useful changes to Delaware statutory law that will enable our courts to exert personal jurisdiction over key executives who are charged with breaches of fiduciary duty, but who are not directors of the company.

Finally, in Part VII, we conclude on an optimistic note. Although the 2002 Reforms will have a somewhat destabilizing effect on the
traditional division of responsibilities among the federal government, the Stock Exchanges, and the states, there is no need for despair at the state level. So long as the states participate fully and actively in the process of implementing the 2002 Reforms and, as importantly, improving state corporate law to promote integrity and stockholder welfare, the basic tripartite division of policy responsibility that has served our nation well should remain largely intact.

I. A BRIEF OVERVIEW OF THE 2002 REFORMS

Because this Article concentrates on the likely consequences the 2002 Reforms will have on the intersection of state corporation law with federal law and the Exchange Rules, the overview we present is intentionally selective. It omits many important aspects of the Reforms (e.g., those dealing with the process for preparing financial statements of public companies) because they address areas that have traditionally been a concern of the federal government and, to a lesser extent, the Exchanges. We emphasize only those features of the 2002 Reforms that best illustrate the extent to which the Reforms address subjects that are traditionally the primary province of substantive corporation law, as articulated by the legislatures and courts of the states.

A. The 2002 Reforms Will Create a Need for Additional Independent Director Candidates

A good way to understand the effect that the 2002 Reforms will have on corporate boardrooms is to imagine a Delaware corporation listed on the New York Stock Exchange in the year 2004.16 By that time, as a result of the combined force of Sarbanes-Oxley and the new NYSE Rules, our hypothetical Delaware company would be required to have:

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16 The NYSE has articulated less-exacting independence requirements for subsidiaries controlled by a cohesive voting block of more than 50%, which generally only subject such subsidiaries to the audit committee provisions of its board reforms. See NYSE PROPOSED RULES, supra note 3, § 303A(1) cmt. ("A company of which more than 50% of the voting power is held by an individual, a group or another company need not have a majority of independent directors on its board or have nominating/corporate governance and compensation committees comprised of independent directors."); see also NASDAQ Proposed Amendments, supra note 3, R. 4350(c)(5) (exempting controlled companies, which are defined as “companies of which more than 50% of the voting power is held by an individual, a group or another company,” from director independence requirements).
• A majority of independent directors on its board;\textsuperscript{17}
• An audit committee comprised entirely of independent directors that performs certain mandated tasks. The audit committee also must have a financial expert as defined in Sarbanes-Oxley, or the company must disclose why it does not have such a financial expert;\textsuperscript{18}
• A nominating/corporate governance committee comprised entirely of independent directors;\textsuperscript{19}

\textsuperscript{17} NYSE PROPOSED RULES, supra note 3, \S 303A(1); NYSE REPORT, supra note 3, at 6; see also NASDAQ Proposed Amendments, supra note 3, R. 4350(c)(1) (stating that a "majority of the board of directors must be comprised of independent directors").

\textsuperscript{18} Sarbanes-Oxley required the SEC to adopt rules by January 26, 2003, that would require companies to disclose whether at least one member of the audit committee is a financial expert, and to explain why if not. Sarbanes-Oxley \S 407, 15 U.S.C.A. \S 7265 (West Supp. 2003). The final version of this rule was recently adopted and narrowed the term "financial expert" to "audit committee financial expert." Press Release, Securities and Exchange Commission, SEC Adopts Rules on Provisions of Sarbanes-Oxley Act (Jan. 15, 2003), http://www.sec.gov/news/press/2003-6.htm. The rule also broadened somewhat the definition of an audit committee financial expert to address concerns about the ability of companies to find qualified experts. See id. (explaining the attributes that a person must possess to qualify as an "audit committee financial expert," and suggesting various alternative means by which a person might acquire the requisite attributes); see also NYSE PROPOSED RULES, supra note 3, \S 303A(6) (requiring that "director’s fees are the only compensation an audit committee member may receive from the company"); NYSE REPORT, supra note 3, at 11-17 (discussing the requirements for audit committee membership, the requirements for audit committee chairperson, and the increased authority and responsibilities of the audit committee).

The NYSE also requires each member of the audit committee to be "financially literate" or to become "financially literate within a reasonable period of time after his or her appointment to the audit committee ...." N.Y. STOCK EXCH., NYSE LISTED COMPANY MANUAL \S 303.01(B)(2)(b) (2002) [hereinafter LISTED COMPANY MANUAL]; see also id. \S 303.01(B)(2)(c) ("At least one member of the audit committee must have accounting or related financial management expertise, as the Board of Directors interprets such qualification in its business judgment."); NYSE PROPOSED RULES, supra note 3, \S 303A(6) cmt. (maintaining the NYSE’s requirement that each member of a company’s audit committee be “financially literate” and that at least one member of a company’s audit committee “have accounting or related financial management expertise”). “Financially literate,” which is a term of imprecise meaning, is, according to the NYSE, “interpreted by the company’s Board of Directors in its business judgment.” LISTED COMPANY MANUAL, supra, \S 303.01(B)(2)(b). The NASDAQ Proposed Amendments require that each member of a company’s audit committee be able “to read and understand fundamental financial statements, including a company’s balance sheet, income statement, and cash flow statement” and that “each issuer ... certify that it has, and will continue to have, at least one member of the audit committee who is a financial expert.” NASDAQ Proposed Amendments, supra note 3, R. 4350(d)(2)(A)(ii).

\textsuperscript{19} NYSE PROPOSED RULES, supra note 3, \S 303A(4); NYSE REPORT, supra note 3, at 9.
• A compensation committee comprised entirely of independent directors;\textsuperscript{20} and

• Regularly scheduled meetings of the non-management directors outside the presence of the management directors. If a single presiding director is selected, his or her identity must be publicly disclosed. Alternatively, a rotating presiding director may be used if the company designates and discloses the selection procedure for the rotating director.\textsuperscript{21}

A Delaware company listed on the NASDAQ would confront similar requirements.\textsuperscript{22}

Accompanying these mandates is a panoply of specific action items that are required of these independent directors. For example, listed companies are required under the proposed NYSE rules to issue corporate governance guidelines addressing:

• Director qualification standards;

• Director responsibilities;

\textsuperscript{20} NYSE PROPOSED RULES, supra note 3, § 303A(5); NYSE REPORT, supra note 3, at 10.

\textsuperscript{21} NYSE PROPOSED RULES, supra note 3, § 303A(3); NYSE REPORT, supra note 3, at 8. The proposed NYSE rules specifically recognize that some non-management directors will not fall within the Exchange's definition of independence. See NYSE PROPOSED RULES, supra note 3, § 303A(3) (using the term "non-management" directors rather than "independent").

\textsuperscript{22} For the sake of brevity, we concentrate our narrative mostly on the proposed NYSE Rules, but do note, when pertinent, differences in the approaches of the two key Exchanges. The NASDAQ differs somewhat from the NYSE. NASDAQ does not require separate nominating and compensation committees, but does require that nomination and compensation decisions be approved by a majority of the independent directors on the board. NASDAQ Proposed Amendments, supra note 3, R. 4350(c)(3). NASDAQ allows non-independent directors to serve on the various committees, including the audit committee, in exceptional and limited circumstances when doing so is in the best interests of the company and when disclosure of those circumstances is made. Id. R. 4350(d)(2)(B). A non-independent director cannot serve more than two years on an audit committee and cannot be the chair of the committee. Id. But a new proposed rule may extinguish this flexibility for non-independent directors on audit committees by requiring Exchanges to delist issuers that do not comply with audit committee requirements in the Sarbanes-Oxley Act. Standards Relating to Listed Company Audit Committees, Securities Act Release No. 33-8137, Exchange Act Release No. 34-47,137, 68 Fed. Reg. 2638, 2660-63 (proposed Jan. 8, 2003) [hereinafter Proposed Audit Committee Standards]. NASDAQ also requires the independent directors to meet separately from the non-independent directors at least twice per year. NASDAQ Proposed Amendments, supra note 3, R. 4350(c)(2). Thus, the Exchanges differ in how they separate the directors. NYSE separates directors on the basis of management status; NASDAQ separates based on independence.
• Director access to management and outside advisors;
• Director compensation;
• Director orientation and continuing education;
• Management succession; and
• Annual self-evaluation of the board.23

Supplementing this requirement is a mandate for each corporation to adopt a code of business conduct and ethics for directors and officers, addressing, among other things, conflicts of interest, corporate opportunities, confidentiality, and legal compliance.24 Any waivers granted under the code must be made by the board, or a board committee, and be disclosed to stockholders.25 This NYSE requirement comes on top of the requirement in Sarbanes-Oxley for listed companies to develop a code of ethics for senior financial officers, including the CFO, or disclose why they have not done so.26 Like the NYSE requirement, any waivers granted under the statutorily mandated code must be disclosed.27

Taken in their entirety, the 2002 Reforms will certainly increase the demand for quality independent directors. Some of the remaining companies that lack a majority of independent directors will have to find new board members.28 Other companies with an existing

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25 NYSE PROPOSED RULES, supra note 3, § 303A(9) cmt.; NYSE REPORT, supra note 3, at 18-20.
24 NYSE PROPOSED RULES, supra note 3, § 303A(10) & cmt.; NYSE REPORT, supra note 3, at 20-22. The NASDAQ Proposed Amendments require a similar “code of conduct for all directors, officers and employees.” NASDAQ Proposed Amendments, supra note 3, R. 4350(m). This code will have to address compliance and conflicts issues and must provide for an enforcement mechanism. SR-NASD-2002-139: Adoption of a Code of Conduct for all Directors, Officers, and Employees, supra note 3, at 9-10.
25 NYSE PROPOSED RULES, supra note 3, § 303A(10) & cmt.; NYSE REPORT, supra note 3, at 20.
independent majority will have to add more directorial slots in order to have the horsepower to carry out all the tasks required of independent directors under the 2002 Reforms. This increased demand for independent directors will also confront a supply diminished by the tighter standards of independence embraced by the Reforms, which may well render directors currently categorized as independent unable to serve on key board committees.

B. The 2002 Reforms' Definition of an Independent Director

Unsurprisingly, the 2002 Reforms' approach to defining director independence has largely been a negative exercise, which rules out those persons whose attributes seem to undermine their ability to impartially monitor management, ensure overall corporate integrity, and selflessly pursue the interests of the company and its stockholders. For the most part, this aspect of the 2002 Reforms is embodied in the proposed Exchange Rules rather than in Sarbanes-Oxley.

The definitional direction of the 2002 Reforms accords with best practice recommendations of sophisticated commentators and the policy advocacy of institutional investor activists like the Council of Institutional Investors.\(^{29}\) The Exchanges attempt to cleanse the independent director ranks of corporate America of persons whose familial, personal, professional, or financial affiliations with management cast doubt on their ability to pursue only the interests of the company's stockholders. By this means, the Exchanges seek to end

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\(^{29}\) See generally Brief of Amicus Curiae Council of Institutional Investors at 13, Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (No. 469-1998) (on file with authors) (discussing the Council's definition of an "independent director" as someone whose 'only non-trivial professional, familial or financial connection to the corporation or its CEO is his or her directorship.").
the structural bias in favor of management that has (in the minds of many stockholder activists) characterized the American boardroom.

To this end, the NYSE has defined an independent director as a person who:

- Has (by vote of his or her fellow directors) been determined to have no material relationship to the company other than as a director;\(^{30}\)
- Has not served as an employee or auditor of the company for five years,\(^{31}\) or been a family member of someone who has;\(^{32}\)
- Has not served for five years as an employee or auditor of any other company whose compensation committee includes an executive officer of the company, or been a family member of someone who has;\(^{33}\) and
- Is not a family member of an executive officer of the company.\(^{34}\)

\(^{30}\) NYSE PROPOSED RULES, supra note 3, § 303A(2)(a); NYSE REPORT, supra note 3, at 6.

\(^{31}\) NYSE PROPOSED RULES, supra note 3, § 303A(2)(b)(i); NYSE REPORT, supra note 3, at 6. Under Delaware law, the mere fact that a corporate director is also a former officer of the corporation does not automatically make the director not independent. The nature of the director's former service and the temporal distance between his former employment and his current directorial service are, however, factors a court will consider in determining whether the director's independence is compromised. Cf. Grobow v. Perot, 539 A.2d 180, 184 n.1 (Del. 1988) (defining outside directors to mean non-employee, non-management directors); Citron v. Steego Corp., No. 10171, 1988 WL 94738, at *3 (Del. Ch. Sept. 9, 1988) (“A majority of the Steego board members appear to be independent directors in the sense that they are not current officers of the Company, nor do they appear to derive substantial income from regular transaction of business with the firm.” (emphasis added)). The 2002 Reforms' criticism of the distinction between current and former officers is not novel. See Corporate Director's Guidebook, 33 BUS. LAW. 1591, 1619 (1978) (stating that a “director who formerly was an officer or employee of the corporation, but who no longer has staff or operating responsibilities by reason of retirement or otherwise, should be regarded as a ‘management director since he may often be called upon to review or otherwise act in connection with matters in which he was involved while in active management’.”

\(^{32}\) NYSE PROPOSED RULES, supra note 3, § 303A(2)(b)(iv); NYSE REPORT, supra note 3, at 7.

\(^{33}\) NYSE PROPOSED RULES, supra note 3, § 303A(2)(b)(iii); NYSE REPORT, supra note 3, at 7.

\(^{34}\) NYSE PROPOSED RULES, supra note 3, § 303A(2)(b); NYSE REPORT, supra note 3, at 6. Family members “includes a person’s spouse, parents, children, siblings, mothers[-] and fathers-in-law, sons[-] and daughters-in-law, brothers[-] and sisters-in-law, and anyone (other than employees) who shares such person’s home.” NYSE PROPOSED RULES, supra note 3, § 303A(2)(b)(iv) cmt.
The NASDAQ definition is similar, but differs in these important respects:

- NASDAQ considers any taint from former managerial or officer service to be removed after three years instead of the five required by the NYSE;\(^{35}\)
- NASDAQ has a broader definition of family member that includes any person who is a relative by blood, marriage, or adoption, or who has the same residence;\(^{36}\)
- NASDAQ finds a taint when a person has received more than $60,000 from the company for consulting or other non-director services over the past three years,\(^{37}\) or when the director was a partner, officer, or controlling shareholder of a company that made or received payments to the company in excess of certain amounts within the past three years.\(^{38}\)

Even stricter rules apply to audit committee service. For purposes of service on the audit committee, a director is deemed independent by Sarbanes-Oxley only if he receives no compensation from the company other than as a director and is not an "affiliated person" of the company or one of its subsidiaries.\(^{39}\) Under preexisting federal law, the only precise definition of an "affiliated person" referenced in the Exchange Act suggested that a director who controls, or is affiliated with (e.g., serves as an officer or director of) any stockholder who controls five percent or more of the company's shares would be ineligible to serve as a voting member of the audit committee.\(^{40}\) The SEC,

\(^{35}\) NASDAQ Proposed Amendments, supra note 3, R. 4200(a)(15).
\(^{36}\) Id. R. 4200(a)(14).
\(^{37}\) Id. R. 4200(a)(15)(B).
\(^{38}\) Id. R. 4200(a)(15)(D).

In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee—

(i) accept any consulting, advisory, or other compensatory fee from the issuer; or

(ii) be an affiliated person of the issuer or any subsidiary thereof.

in proposed Rule 10A-3, recently proposed a definition of the term “affiliated person” in Sarbanes-Oxley that it contends is consistent with its definition of the term “affiliate” in Rule 12b-2 of the Exchange Act and Rule 144 of the Securities Act. The SEC’s proposed definition, however, is more lax than, and therefore conflicts with, the preexisting Exchange Act definition of “affiliated person” in that it establishes a safe harbor that excludes persons who own or are affiliated with entities owning less than ten percent and are not executive officers or directors of the company.

In intellectual harmony with Sarbanes-Oxley, the original NYSE Report recommended that directors affiliated with a stockholder holding more than twenty percent of the company’s shares could not serve as a voting member on the audit committee. The NYSE’s more restrictive proposal was apparently dropped in view of the outright ban on audit committee participation by such owner-directors contained within Sarbanes-Oxley, but the original recommendation is unlikely to be easily forgotten by shareholder activists or plaintiffs’ lawyers. Indeed, if a director is to serve on the audit committee, the

owning or controlling more than this quantity of the issuer’s securities would conclusively fit the definition of an affiliated person of the issuer:

“Affiliated person” of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of any advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.


41 17 C.F.R. § 240.12b-2 (2003) (“An ‘affiliate’ of, or a person ‘affiliated’ with, a specified person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.”).

42 Id. § 230.144(a)(1) (“An affiliate of an issuer is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer.”).

43 This new definition not only raises the percentage of ownership from five percent to ten percent, it also changes the quality of the characterization from a conclusive description to a rebuttable presumption. That is, the SEC’s proposal creates two different definitions of “affiliated person” under the Exchange Act—one for Sarbanes-Oxley purposes and one that will govern under the remainder of the Exchange Act.

44 Proposed Audit Committee Standards, supra note 22, at 2641.

45 NYSE REPORT, supra note 3, at 11.
NASDAQ still requires him to meet the Act's requirements; be independent as described above; and not own or control twenty percent or more of the issuer's voting securities, or such lower measurement as may be established by the SEC under section 301 of Sarbanes-Oxley.\footnote{NASDAQ Proposed Amendments, supra note 3, R. 4350(d)(2)(A)(i).}

C. The Clearest Example of the New Federalism: The New Substantive and Procedural Checks on Director and Officer Compensation

In one subject area, the 2002 Reforms are easy to see as intrusions on the domain of the states.\footnote{Although director and officer compensation is one clear example of federal intrusion into a traditional state domain, it is by no means the only one. For example, establishing and enforcing standards for attorney professional conduct is another area traditionally left to the states. See, e.g., In re Benson, 774 A.2d 258 (Del. 2001) (holding that the Delaware Supreme Court "has the inherent and exclusive authority for disciplining members of the Delaware bar" for violating the Delaware Lawyers' Rules of Professional Conduct). But section 307 of Sarbanes-Oxley directs the SEC to "issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys." Sarbanes-Oxley § 307, 15 U.S.C.A. § 7245 (West Supp. 2003). Accordingly, the SEC recently adopted rules governing attorneys' professional responsibilities. Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 33-8185, Exchange Act Release No. 34-47,276, 68 Fed. Reg. 6296 (Feb. 6, 2003). These proposed "minimum standards" include controversial reporting requirements imposed upon attorneys who come across evidence of an issuer's violation of securities laws or fiduciary duties. In these circumstances, the attorney must report the evidence to the chief legal counsel or chief executive officer (or the equivalent, including an optional qualified legal compliance committee) of the issuer, and then to the audit committee, another committee of independent directors, or even the full board of directors, if the recipient of the initial report does not appropriately respond to it. 17 C.F.R. § 205.3(b)(2) (2003); see also Press Release, Securities and Exchange Commission, SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act (Jan. 23, 2003) (announcing the adoption of final rules to implement section 307 and describing the effect of the adopted rules), http://www.sec.gov/news/press/2003-13.htm.} In section 402 of Sarbanes-Oxley, Congress explicitly bans corporations from making loans to directors...
and officers, with certain limited exceptions. This is a direct federal limitation on the power of state-chartered corporations to engage in a particular type of transaction explicitly authorized by state statutory law, a type of limitation that more traditional minds might think should flow from the chartering states, rather than from the federal government. The ban inspired a group of prominent law firms to write a joint memorandum articulating their shared view of the appropriate scope of the ban. In particular, the law firms addressed whether the ban on loans would deny companies the ability to advance litigation costs to directors and officers in accordance with Delaware law.

The Exchanges have also delved into the compensation area in a manner that would typically find its manifestation in a state corporate code. The proposed Exchange Rules require stockholder approval for certain equity-based compensation plans. In this way, the Exchanges have demonstrated a willingness to go beyond state requirements for stockholder votes when they believe that those requirements are insufficient to protect stockholder interests.

Notably, the Exchanges' more aggressive regulation of the internal affairs of their listed companies is not necessarily limited to the subject of compensation. An interesting NASDAQ proposal requires all

48 See Sarbanes-Oxley § 402, 15 U.S.C.A. § 78m(k) (West Supp. 2003) ("It shall be unlawful for any issuer . . . to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer . . ."").

49 See DEL. CODE ANN. tit. 8, § 143 (2001) (authorizing loans to employees and officers of a corporation whenever "in the judgment of the directors, such loan, guaranty or assistance may reasonably be expected to benefit the corporation").


51 See id. at 5-6 (discussing advancement of litigation costs as possibly implicating Sarbanes-Oxley's prohibition on personal loans); see also DEL. CODE ANN. tit. 8, § 145(e) (2001) (enabling corporations to advance litigation costs under certain conditions).

related party transactions to be "approved by the company's audit committee or a comparable body of the board of directors . . ." In contrast, Delaware law allows proof of fairness or stockholder ratification to substitute for the use of a special committee in validating an interested transaction. This protection of interested transactions that are either fair or shareholder-approved is an allowance not afforded under the NASDAQ proposal.

With these basic features of the 2002 Reforms in mind, we now turn to some of the implications they have for state corporate law.

II. ARE THE 2002 REFORMS A SHADOW CORPORATE LAW?

The most striking feature of the 2002 Reforms is a pervasive and general one: the extent to which they can be seen as a shadow corporation law that requires public company boards to comply with a very specific set of procedural prescriptions. This aspect of the Reforms represents a departure from the general spheres in which the three principal sources of corporate governance guidance in the American system have operated. Stated very roughly, the division between the two governmental authorities has given primary responsibility for fair disclosure and securities market regulation to the federal government, principally through the SEC. State law has retained the substantive regulation of corporate transactions and board conduct. The Exchanges have played a more mixed role, through listing requirements and rules of some diversity, but generally with non-burdensome effects. These include requirements for stockholder votes on certain transactions that do not require such approval under state law, and,

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53 NASDAQ Proposed Amendments, supra note 3, R. 4350(h).
54 DEL. CODE ANN. tit. 8, § 144(a)(2) (2001).
55 For recently released articles that express (in stronger terms) some of the same sentiments and concerns we raise here, the interested reader should consult the provocative and well-written articles by Stephen M. Bainbridge, A Critique of the NYSE's Director Independence Listing Standards, 30 SEC. REG. L.J. 370 (2002), and Simon Lorne, Sarbanes-Oxley: The Pernicious Beginnings of Usurpation?, WALL ST. LAW., Sept. 2002, at 1.
56 The NYSE has long required a stockholder vote on any transaction that would result in an increase in the listed company's outstanding shares by twenty percent or more. See LISTED COMPANY MANUAL, supra note 18, § 312.05(c) (explaining that shareholder approval is required "prior to the issuance of common stock, or of securities convertible into or exercisable for common stock . . ."). This requirement has often influenced the dynamics of mergers and acquisitions cases arising under Delaware corporate law. See, e.g., Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1146 (Del. 1989) (noting that under the NYSE rules, but not under Delaware corporate law, the shareholders of Time would have been required to approve the original Time-Warner merger agreement).
perhaps most notably, for audit committees comprised of independent directors.  

This division of responsibilities has never been marked by bright borders. To the contrary, many federal disclosure requirements have had the natural and (presumably) intended consequence of influencing boardroom practices. Similarly, the state law of fiduciary duties has been an important tool in evolving better disclosure practices, particularly in the context of mergers and acquisitions requiring a stockholder vote or tendering decision. The tug-and-pull among the various policy actors has occurred in a civil manner, manifesting a sincere concern for the creation of an overall system that functions fairly and efficiently and that avoids whipsawing corporate officials with contradictory or unworkable mandates from different sources of legitimate authority.

In several respects, however, the 2002 Reforms can be seen as different in kind from previous incursions across the rough borders of policy responsibility that have characterized the American system of corporate governance to date. The isolated provision of Sarbanes-Oxley that bans most loans from public corporations to their directors and officers is the most obvious example. By this method, Congress took upon itself responsibility for delimiting the range of permissible transactions that corporations chartered by state law could consummate. In itself, the mandate is relatively trivial, but its precedential significance may not be. What's next? A ban on going private transactions? Or on options-based compensation of executives? Or on interested transactions?

57 See LISTED COMPANY MANUAL, supra note 18, § 303.01(B)(2) ("Each audit committee shall consist of at least three directors, all of whom have no relationship to the company that may interfere with the exercise of their independence from management and the company . . . .").

58 At various times during the past century or so, the federal government and the Exchanges have considered a more full-bodied intrusion into the states' primary role in governing the internal relations of corporations. There is no doubt that federal statutes exist which vest in the federal government primary or coequal governance of corporate conduct that might seem to fall principally within the purview of state law—for example, regulation of the corporate proxy solicitation and ballot process. For a provocative and incisive examination of the interaction between the federal government and the states in corporate law policymaking, see Mark J. Roe, Delaware's Competition, 117 HARV. L. REV. 588 (2003).

59 As noted, the NASDAQ's proposed change to Rule 4350 requires all related party transactions to be approved by the company's audit committee or a comparable body of the board of directors. See NASDAQ Proposed Amendments, supra note 3, R. 4350(h) ("Each issuer shall conduct an appropriate review of all related party transactions on an ongoing basis . . . and all such transactions must be approved by the
The proposed Exchange Rule requiring a stockholder vote on equity compensation plans and plan amendments has a similar quality. Under this rule, shareholders must approve "all equity-compensation plans," other than exempt plans, and brokers may not vote on stock option plans without client instructions. What is the next class of transactions that the Exchanges believe should receive stockholder approval, irrespective of the fact that state law empowers directors to consummate them without such approval? In recent years, for example, there has been a great deal of controversy about whether stockholders may adopt a bylaw requiring a board of directors to dismantle a shareholder rights plan or a poison pill. Could the Exchanges (with SEC approval) preempt this state law debate by adopting listing rules requiring stockholder assent to a board's adoption of a pill in the first place and mandating a stockholder vote on a board's decision to block a bid through use of the pill in the heat of a takeover battle?

company's audit committee or comparable body of the board of directors . . . . "). This diminishes the range of options available to corporations under state law, which have typically also been able to use proof of fairness or a ratification by disinterested stockholders to validate an interested transaction. See DEL. CODE ANN. tit. 8, § 144 (2001) ("No contract or transaction between a corporation and 1 or more of its directors or officers . . . shall be void or voidable solely for this reason" if it is "approved in good faith by vote of the shareholders[,]" is "fair as to the corporation[,]" or is "authorize[d] . . . by the affirmative votes of a majority of the disinterested directors . . . .").

NYSE PROPOSED RULES, supra note 3, § 303A(8) (emphasis added).

61 These articles include John C. Coffee, Jr., The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?, 51 U. MIAMI L. REV. 605 (1997); Jeffrey N. Gordon, "Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett, 19 CARDOZO L. REV. 511 (1997); Lawrence A. Hamermesh, Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?, 73 TUL. L. REV. 409 (1998). As Professor Robert Thompson has commented, these examples raise two distinct, albeit related, issues. That is, the distinction between what board decisions stockholders must approve and what decisions stockholders may make themselves (e.g., through bylaws). For our purposes, this distinction is less important than the potential that these answers to traditionally state law questions may be dictated by the Exchanges or the federal government.

62 Sarbanes-Oxley lacks any specific section expressing an intention to expand the SEC's reach into corporate internal affairs through Stock Exchange listing requirements. As a result, the SEC's authority to command state-chartered corporations to comply with those aspects of the proposed Exchange Rules that require the formation of certain types of committees with particular members is unclear. An important decision predating Sarbanes-Oxley casts doubt on the ability of the SEC, through its oversight of Exchange Rules, to regulate the internal affairs of corporations.

In Business Roundtable v. SEC, 905 F.2d 406, 407 (D.C. Cir. 1990), the United States Court of Appeals for the District of Columbia Circuit held that the SEC did not have the statutory authority to promulgate a rule barring national securities exchanges and associations from listing stock of corporations which nullify, restrict, or disparately reduce per share voting rights of existing common stockholders. In so ruling, the
We have no reason to believe that the Exchanges will in fact enter the poison pill debate anytime soon. But this illustration does highlight the potential problems that could arise if the federal government and the Exchanges are not sensitive to the states' primary role in the formulation of substantive corporation law.65

Whether or not everyone is entirely happy with the resulting product, Delaware does have a carefully thought-out model of corporation law—one which corporations and their constituencies are free to choose or to abandon by going to another state. Delaware takes an enabling approach, which broadly empowers corporate boards acting in conformity with their fiduciary duties to cause their corporations to engage in virtually any lawful activity subject to compliance with relatively flexible statutory constraints.64

The statutory constraints on unilateral action that exist in the Delaware General Corporation Law have been chosen with some care. They are designed to protect stockholders in situations when the importance or nature of a transaction seems to require support from the corporate electorate to prevent abuse and fulfill the legitimate court held that the provision of the Exchange Act authorizing Exchange Rules had to be read as addressing certain specified congressional purposes, and not as, sub silentio, an intention to supplant state corporation laws. Id. at 415. Consistent with that holding, the D.C. Circuit found that "the Exchange Act cannot be understood to include regulation of an issue that is so far beyond matters of disclosure . . . and of the management and practices of self-regulatory organizations, and that is concededly a part of corporate governance traditionally left to the states." Id. at 408.

The court also rejected the SEC's claim that it had authority to promulgate the rule because the 1975 amendments to the Exchange Act gave the Commission the authority to "facilitate [the] establishment of a national market system for securities." Id. at 415 (quoting 15 U.S.C. § 78k-1(a)(2) (1994)). It refused to read into those words broad-sweeping authority for the SEC to supplant all state corporate law, stating that the SEC's "theory can easily federalize corporate law for all companies wishing access to the national capital markets. Yet nothing in the statute and legislative history suggests so broad a purpose." Id. The court's reasoning was largely grounded in the teaching of the United States Supreme Court, found in the landmark case of Santa Fe Industries v. Green, where the Court stated that corporations "are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation." 430 U.S. 462, 479 (1977) (emphasis added) (quoting Cort v. Ash, 422 U.S. 65, 84 (1975)).

63 See Bainbridge, supra note 55, at 396-99 (arguing that the nation will suffer if substantive corporate law is federalized through the SEC and the Exchanges).
64 See Edward S. Rock, Saints and Sinners: How Does Delaware Corporate Law Work?, 44 UCLA L. REV. 1009, 1015 (1997) (recounting Samuel Arsht's statement that "[d]irectors of Delaware corporations can do anything they want, as long as it is not illegal, and as long as they act in good faith").
expectations of the investors. Thus, our law requires stockholder approval for important items such as charter amendments, increases in the corporation’s authorized shares, certain mergers, and a sale of substantially all of the corporation’s assets.

Enforcing these statutory safeguards is the common law of fiduciary duty. The preoccupation of that aspect of corporate law has been the deterrence and remediation of disloyal acts by fiduciaries who use their position of trust to extract private benefits at the expense of their corporations’ stockholders. The Delaware courts have deployed a variety of tools for that purpose, including the entire fairness standard of review for conflict transactions and the heightened Revlon and Unocal standards that are applied to certain director actions in the mergers and acquisitions context. Within the framework of fiduciary duty review, the Delaware courts have provided strong incentives for corporate boards to use procedures that are designed to protect public stockholders. For instance, our law gives great liability-insulating effect to majority-of-the-minority vote provisions and to the deployment of a special committee of independent directors. Indeed, it has long been the case that Delaware law provides a strong

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66 § 242(a)(3).
67 E.g., DEL. CODE ANN. tit. 8, § 251 (2001) (requiring that the board of directors submit a resolution approving an agreement of merger or consolidation to stockholders for a vote in many circumstances).
68 Id. § 271.
69 See, e.g., Weinberger v. UOP, Inc., 457 A.2d 701 passim (Del. 1983) (requiring fiduciaries who stand on both sides of a transaction to act according to the concept of entire fairness, which includes fair dealing and fair process); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) (“Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests.”).
70 See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182-84 (Del. 1986) (finding that when directors decide to sell the company, the court may review whether they have taken reasonable steps to fulfill their sole duty at that point: to maximize the share price).
71 See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (finding that directors must prove reasonable grounds for believing a threat to the corporation exists before taking defensive action and may only take action that is reasonable in relation to the threat posed).
72 For cases addressing the important litigation consequences of special committees and disinterested stockholder approval, see, e.g., Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1117-18 (Del. 1994); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985); Harbor Finance Partners v. Huizenga, 751 A.2d 879, 891, 900-01 (Del. Ch. 1999); In re General Motors Class H Shareholders Litigation, 794 A.2d 611, 617 (Del. Ch. 1999).
incentive for companies to comprise their boards with a majority of independent directors.\footnote{See, e.g., Aronson v. Lewis, 473 A.2d 805, 812-13 (Del. 1984) (holding that demand is excused in derivative actions if the plaintiff pleads facts compromising the independence of a majority of the board).}

What Delaware law has resisted, however, is the recitation (by statute or case law) of a detailed set of particular measures that boards must take, or of certain transactions that boards must avoid, if they are to act equitably and lawfully. This reticence is not inspired by any reluctance to hold boards accountable for improper action, as our case law is replete with examples that refute any assertion of that kind.\footnote{See, e.g., Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1988) (finding the board of directors to be "torpid, if not supine" in their actions requiring application of the entire fairness standard); Revlon, 506 A.2d at 185 (requiring directors to be concerned solely with maximizing shareholder wealth when the sale of a corporation becomes inevitable); Weinberger, 457 A.2d at 703 (finding a breach of fiduciary duty when necessary information was withheld from minority shareholders); Schnell v. Chris-Craft Indus., 285 A.2d 437, 439 (Del. 1971) (finding that the directors' action to advance the shareholders meeting was designed to unlawfully perpetuate themselves in office and generally reaffirming that an action which complies with a statute may be struck down if inequitable); Blasius Indus. v. Atlas Corp., 564 A.2d 651, 660-63 (Del. Ch. 1988) (requiring directors to provide a compelling justification when their actions interfere with the shareholder franchise); Sealy Mattress Co. v. Sealy, Inc., 532 A.2d 1324, 1341-42 (Del. Ch. 1987) (holding the board of directors liable for unfair exploitation of a minority stockholder in a merger).}

Rather, this cautious approach has rested on a belief that there must be room for creativity and innovation and that the law must accommodate the diversity that exists in corporate America. Restraints that might be useful and workable when applied to the largest fifty companies in America might be ill-suited to smaller public companies. The potency of fiduciary duty review, particularly under the entire fairness doctrine, and the statutory protections given to stockholders (e.g., appraisal rights) were seen as sufficient,\footnote{This statement subsumes the idea that Delaware's lawmakers and its judges adapt these protections to address new evolutions, such as the takeover boom of the last twenty-five years.} especially when coupled with a corporate election process that gave stockholders an annual opportunity to elect directors.

The Delaware system takes the electoral process seriously, and our courts have been vigilant about policing electoral abuse.\footnote{See Schnell, 285 A.2d at 439 ("The advancement by directors of the by-law date of a stockholder's meeting, for [the purpose of obstructing a proxy contest against management], may not be permitted to stand."); State of Wis. Inv. Bd. v. Peerless Sys. Corp., No. 17637, 2000 WL 1805376, at *7 (Del. Ch. Dec. 4, 2000) ("The right to vote one's shares is a fundamental aspect of stock ownership governed and protected by [Delaware law]."); Chesapeake Corp. v. Shore, 771 A.2d 293, 344-47 (Del. Ch. 2000).} One
natural outgrowth of our system’s view of corporate democracy has been a mindset on the part of Delaware policymakers that does not lightly deprive the stockholders’ chosen representatives of managerial authority. When the matter is debatable and no self-dealing exists, the decisions of elected boards have been respected. That is the essence of the business judgment rule.

From the perspective of Delaware and other states, the 2002 Reforms are somewhat problematic because they supplement our principles-based, substantive corporation laws with a variety of specific requirements that are not part of any overall system of corporate governance. This is not to say that the 2002 Reforms do not bespeak an overall philosophy of corporate governance; they do. That philosophy is based on the notion that strong and diligent oversight by independent directors who are required to focus on legal and accounting compliance will result in public companies behaving with integrity. Concomitantly, the 2002 Reforms reflect a belief in the behavior-influencing effect of process and disclosure—i.e., by requiring boards and officers to undertake certain tasks and to certify that they have done so (or to explain why they have not). Thus, the Reforms aim to encourage responsible conduct and to deter wrongdoing and imprudent risk-taking.

To two Delaware judges, these beliefs are almost as familiar as the Lord’s Prayer. What is not so familiar is the detail in which the 2002 Reforms prescribe the precise means by which directors and officers are to pursue certain ends. The Delaware approach has tended to create incentives for particular good governance practices, yet also recognizes that what generally works for most boards may not be the best method for some others. The fiduciary duty form of accountability is well-suited to this sort of flexibility because it is context-specific in application.

(invalidating a “supermajority bylaw” that would impede the exercise of the shareholder franchise); Blasius, 564 A.2d at 659 (“The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.”).

77 Academic and professional commentators have raised concerns about this aspect of the 2002 Reforms, as well as the large staff and advisor costs that will be required to implement them. See, e.g., Peter V. Letsou, Flaw and Folly, THEDEAL.COM (Oct. 9, 2002) (“[Sarbanes-Oxley] places squarely on public-company investors the costs of establishing a new bureaucracy (the Public Company Accounting Oversight Board) and of greatly expanding an existing one (the SEC)—even though there is little reason to believe these new and expanded bodies will be any better... than existing regulators.”), at http://www.thedeal.com/NASApp/cs/CS?pagename=TheDeal/TDDArticle/StandardArticle&bn=null&c=TDDArticle&cid=1034100864189.
But because the 2002 Reforms naturally take a more rule-based form, they come with the risk of codifying (by statute or contract) an array of procedures that, when implemented in their totality, might be less than optimal. For present purposes, we highlight two risks of the 2002 Reforms that seem to stand out. First, there is the hazard that corporate boards will have very little time to concentrate on core business issues given the various tasks and implementation deadlines mandated by the Reforms. Second, there is a danger that the 2002 Reforms may be too costly for smaller firms to implement efficiently. The intense focus of the 2002 Reforms on corporate compliance is both understandable and praiseworthy. What is a bit more questionable is the expansive reach of the Reforms and their attempt to spell out precisely the means through which each board will ensure the goal of legal compliance and accounting integrity.

By their own terms, the proposed NYSE Rules require several committees comprised entirely of independent directors with specific mandates. Once the independent directors have carried out (or at least “checked the box” on) all of their Reform-mandated duties—on the audit committee, on the nominating/corporate governance committee, and on the compensation committee—they may find it difficult to find time to ponder questions like: Does the company have a good strategic direction? If it does, how well is the company’s management doing in executing that strategy?

78 Taken as a whole, the 2002 Reforms impose a host of new obligations on listed companies which come due at various times of the year. By way of example, auditor independence requirements became effective in April 2003, subject to transition periods. See Memorandum from Patricia A. Vlahakis et al., Wachtell, Lipton, Rosen & Katz, Sarbanes-Oxley Act: Compliance Reminders (Feb. 7, 2003) (on file with authors) (indicating the timeframe for compliance with the various requirements of Sarbanes-Oxley). Failure to comply with the strict audit committee standards by this date could subject an issuer to delisting by the Exchanges, as discussed infra notes 87-88. Provisions requiring enhanced disclosure for non-GAAP financial measures and disclosure of earnings releases on Form 8-K became effective after March 28, 2003. Id. Various other disclosures must be included in annual reports for fiscal years ending on or after July 15, 2003 for most companies, such as Audit Committee “financial expert” disclosure and Code of Ethics disclosure. Id. Record retention requirements take effect on October 31, 2003. Id. With all of these compliance dates, and many more, contained within the Act, boards will likely feel great pressure to merely meet the baseline requirements, especially at smaller public corporations. One law firm’s compilation of the required tasks fills a chart spanning five pages and includes another page of proposed rules that still require final rulemaking before their deadlines are established. Id.

79 See Bainbridge, supra note 55, at 394 (expressing concern that the NYSE has “strap[ped] all listed companies into a single model of corporate governance.”).
Finding the time to think about issues of this kind may be even harder for smaller public companies that may not be able to afford extra staff or a host of outside advisors simply to ensure implementation of the 2002 Reforms' mandates. Likewise, these companies may have more difficulty finding independent directors at an affordable price. These time demands and cost pressures on smaller public companies could lead to an increase in going-private transactions, or to much lower net profitability, as increased advisor and staff costs eat into cash flow. Even at the largest of companies, it will be a challenge for boards to organize themselves in an efficient manner that leaves adequate time for the deep consideration of key business issues and that does not overly diminish the corporations' coffers.\footnote{Even well-meaning efforts by the SEC to create flexibility under the new Act surface this challenge. For example, the SEC has given companies flexibility to have required reports by attorneys or accountants go to a Qualified Legal Compliance Committee (QLCC), rather than to the chief legal counsel or the chief executive officer of the company. Press Release, SEC Adopts Attorney Conduct Rule, \textit{supra} note 47. But this QLCC must include a member of the audit committee and two other independent directors. \textit{Id.} This "flexibility" actually takes away the ability of a board to create a separate legal compliance committee comprised of independent directors to address legal compliance matters that do not related to financial or disclosure issues. Given the substantial new burdens on audit committees and the far-flung compliance obligations of some big companies, separate committees might make business sense, not only in terms of allocating scarce director resources, but also in terms of expertise (i.e., the director who is an expert at accounting might be clueless about CERCLA or Title VII). As now proposed, however, some very lucky independent director will get to serve on both the audit and legal compliance committees.}

III. SPILLOVER EFFECTS: STATE COURTS WILL SOON FACE FIDUCIARY DUTY CASES PREMISED ON THE 2002 REFORMS

Because public companies, as a practical matter, cannot opt out of the 2002 Reforms, their mandates can be seen as reducing the overall flexibility of the American system of corporate governance. Although our state has a strong market position, it still faces competition from other sources of corporate law, a factor which some scholars believe has contributed to a better product.\footnote{See, e.g., ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 148 (1993) (arguing that state competition over corporate codes has created a "race to the top"); Ralph K. Winter, Jr., \textit{State Law, Shareholder Protection, and the Theory of the Corporation}, 6 J. LEGAL STUD. 251, 256 (1977) (postulating the original claim that competition among states to attract corporations results in a "race to the top").} It can be argued, we suppose, that this type of governance choice could be made available through competing Exchange requirements. We find this a bit doubtful. Furthermore, the congressional process is not designed to produce
annual updates, such as have characterized state corporate law, at least in Delaware. Nor are the Exchanges likely to gin up the energy for an annual review of their listing requirements.

As a result, corporate America is likely to have to live with the 2002 Reforms for some time. Because the Reforms address boardroom practices traditionally governed by state law but do not, in themselves, constitute a comprehensive body of substantive corporation law, the Reforms will inevitably begin to influence state law adjudication. One of the important factors supporting this intuition is that Congress and the Exchanges did not supply forums for the resolution of implementation disputes at the instance of stockholders.

Unlike Delaware, for instance, the Exchanges do not have a judicial tribunal that regularly applies corporate governance requirements to real-world disputes through a fair process that results in written decisions, which, in turn, provide feedback to policymakers that stimulates later amendments to the rules. In addition, the Exchanges have only a very blunt tool to use to ensure compliance: the threat of delisting or suspending trading in a company’s stock. Delisting

82 Listed Company Manual, supra note 18, § 801.00 ("[S]ecurities admitted to the list may be suspended from dealings or removed from the list at any time."). Under the proposed regulations, the NYSE would also wield the power of issuing a “public reprimand letter to any listed company that violates an NYSE listing standard.” NYSE Proposed Rules, supra note 3, § 303A(13); NYSE Report, supra note 3, at 24. If such a public reprimand fails to move a listed company toward compliance, then the NYSE is left with only two blunt remedies—delisting or suspending trading. Indeed, Delaware judges are sure to hear from the plaintiffs’ bar that the significance of a public reprimand is that a company’s board of directors is “risking delisting.” In any case, NYSE Chairman Dick Grasso said in public speeches (e.g., as one of the authors heard him state at Duke University’s Director’s Education Institute in October 2002) that the NYSE will move to delist noncompliant companies for any material violation. See Kimberly Sweet, Firms’ Disgrace Spur “Sweeping Reforms,” Herald-Sun (Durham, N.C.), Oct. 22, 2002, at A1 (summarizing Grasso’s speech, which stated that the NYSE would act to hold corporations accountable for their transgressions).

It is also true, of course, that the SEC may potentially enforce the listing standards of the Exchanges. The Exchange Act provides that the SEC can bring an action for violations of, or to command compliance with, the rules of a self-regulatory organization if the organization is unable or unwilling to take appropriate action, or if the action is “otherwise necessary or appropriate in the public interest or for the protection of investors.” 15 U.S.C. § 78u(f) (2000). In addition, the SEC has recently proposed a rule that would require the Exchanges to prohibit the listing of securities by issuers that do not comply with Sarbanes-Oxley’s audit committee requirements. Proposed Audit Committee Standards, supra note 22, at 2638. This proposed rule puts teeth in section 301 of Sarbanes-Oxley.

As previously discussed, see supra note 62, the extent of the SEC’s authority to act under this authority is, at the very least, uncertain when the Exchange Rule to be enforced addresses the internal affairs of corporations.
or suspending trading does not punish just the directors who are responsible for the failures (as fiduciary duty review does); they also punish the stockholders themselves. Therefore, delisting or suspending trading are likely to be viewed as unsatisfactory remedies from the point of view of stockholders. And, under preexisting law, stockholders have generally been denied the ability to enforce Exchange Rules by way of a private right of action under the Exchange Act. Sarbanes-Oxley contains no provision suggesting that Congress intends for stockholder-plaintiffs to now be permitted to press such claims.

In fact, Sarbanes-Oxley itself does not, with certain limited exceptions, create new causes of action for stockholders. Rather, as a general matter, the provisions of Sarbanes-Oxley are to be codified in the Exchange Act and will be enforced exclusively by the SEC or by federal criminal authorities. The inadequacy of delisting as a remedy

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83 As a general matter, stockholders attempting to assert a right of action under the Exchange Act based on a violation of Exchange Rules have been denied standing to sue. For example, in Walck v. American Stock Exchange, Inc., 687 F.2d 778, 784-86 (3d Cir. 1982), the court noted that Congress expressly created a private right of action in sections 9(e), 16(b) and 18 of the Exchange Act, but did not create a private right of action in section 6. In its decision, the court stated:

The clear implication of the legislative history is that Congress has carefully studied and "balanced" the competing considerations and enacted the statutory schema that in its view would best serve its various goals of promoting transactional efficiency, fair dealing, and investor protection, and of limiting expensive and ineffective federal intervention. We cannot infer in the face of all this evidence that Congress nonetheless authorized by implication authority in the federal courts to intervene in the self-regulatory system at the instance of an injured investor and grant redress in the form of a monetary award against an exchange, conditioned on its failure to enforce its own rules, for the purpose of coercing or encouraging enforcement . . . . We therefore conclude that application of the Cort v. Ash standards demonstrates a clear congressional intent not to create a private damages remedy in § 6.

Id. at 786 (citations omitted).

84 The statute's language states that:

A violation by any person of this Act, any rule or regulation of the Commission issued under this Act, or any rule of the Board shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 (15 U.S.C. § 78a et seq.) or the rules and regulations issued thereunder, consistent with the provisions of this Act, and any such person shall be subject to the same penalties, and to the same extent, as for a violation of that Act or such rules or regulations.

Sarbanes-Oxley § 3(b)(1), 15 U.S.C.A. § 7202 (West Supp. 2003). One firm interprets this provision to mean that:

Except in the case of recovery of profits from prohibited sales during a blackout period and suits by "whistleblowers," [Sarbanes-Oxley] does not expressly create new private rights of action for civil liability for violations of the Act. However, the Act potentially impacts existing private rights of action under the 1934 [Exchange] Act by: (1) lengthening the general statute of limitations
and the absence of a clear path for aggrieved shareholders to press claims themselves in the federal courts under the 2002 Reforms may, therefore, generate new types of state corporate law cases. In our experience, it is unlikely that stockholder-plaintiffs will be content to leave enforcement of the 2002 Reforms entirely to the SEC and the Exchanges. Rather, if history is any guide, the active corporate plaintiffs' bar will be creative and aggressive in deploying the Reforms as a tool in shareholder litigation under state law.85

After all, unlike the 2002 Reforms, state corporate laws come with a full-service commitment to enforcement at the behest of stockholders who file well-pleaded allegations of breach.86 State courts are applicable to private securities fraud actions to the earlier of two years after discovery of the facts constituting the violation or five years after the violation; and (2) expanding reporting and disclosure requirements which could potentially expand the range of actions that can be alleged to give rise to private suits under Sections 10(b) and 18 of the 1934 [Exchange] Act and SEC Rule 10b-5.


85 In our experience, the effective adjudication of corporate law disputes requires a great deal of direct involvement by the trial judge. The factual records in such cases are often large and make for demanding reading. Moreover, many of these matters are time-sensitive and involve the application of complex legal doctrines to the evidence in a very short timeframe—a reality that limits the capacity of judges to delegate very much of the work to law clerks.

As we understand it, the federal courts already face a stiff challenge in addressing their already formidable caseloads. Indeed, Chief Justice Rehnquist has regularly noted that the federal courts are overworked and has encouraged reforms (e.g., measures to diminish diversity suits) to reduce, rather than increase, their caseloads. See generally WILLIAM REHNQUIST, U.S. SUPREME COURT, 2002 YEAR-END REPORT OF THE FEDERAL JUDICIARY, at http://www.supremecourtus.gov/publicinfo/year-end/2002 year-endreport.html (last modified Jan. 2, 2003); Milo Geyelin & Arthur S. Hayes, Chief Justice Rehnquist Warns About Swamped Federal Courts, WALL ST. J., Jan. 2, 1992, at 14. In view of that reality, it seems unlikely that the federal courts are well-positioned to absorb the burden of adjudicating corporate governance disputes now handled by state courts.

86 Some would note that Delaware courts do not provide a forum to enforce the fiduciary duty of care, leaving a gap for others to fill. See, e.g., Edward B. Rock & Michael L. Wachter, Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation, 149 U. PA. L. REV. 1619, 1664-65 (2001) (stating that Delaware courts "rarely see cases and almost never [impose] liability" for breaches of the duty of care). This is, at best, partially true. Although it is the case that Delaware corporations can adopt charter provisions that immunize directors from damages liability for due care violations, see DEL. CODE ANN. tit. 8, § 102(b)(7) (2001), this does not preclude courts from enjoining transactions resulting from grossly negligent board action. More importantly, many exculpatory charter provisions were adopted at mature public companies with support from sophisticated and activist institutional investors. As Professors Edward Rock and Michael Wachter have noted:
expected to, and do, resolve all disputes under their codes, including suits alleging fiduciary misconduct by corporate directors and officers. Indeed, in the recent past, the Delaware courts have entertained claims touching on Exchange Rules. For example, our courts have

In the wake of section 102(b)(7), Delaware corporations quickly amended their certificates of incorporation, and thereby immunized directors from liability under Van Gorkom. These amendments were overwhelmingly approved by shareholders at a time when shareholding was already concentrated in the hands of institutions, and at the beginning of the rise of institutional investor activism. In the years since, as institutional investors have become increasingly active, there has been no pressure on firms to re-amend their charters to expose their directors to monetary liability for negligent breaches of the duty of care. This is strong evidence that a judicially enforced duty of care is not in the shareholders' interests. At the very least, intelligent and sophisticated shareholders do not think it is in their interests.

Edward Rock & Michael Wachter, Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants, 96 NW. U. L. REV. 651, 659-60 (2002); see also E. Norman Veasey, The Role of Corporate Litigation in the Twenty-First Century, 25 DEL. J. CORP. L. 131, 147 (2000) ("The strongest support for the principle of self-governance came in the form of the liability limiting charter provisions that were first authorized in 102(b)(7) of the Delaware General Corporation Law. Similar provisions have been enacted in forty-three states and ... routinely approved when presented to shareholders as charter amendments." (citations omitted)). If the federal government wishes to deprive investors of the right to provide such protection, it must consider whether that intrusion on private ordering makes principled sense, especially because it will tend to discourage board service.

One Delaware case illustrates the limited utility of Exchange Rules to plaintiffs' lawyers as a direct route to obtaining relief. In Lennane v. Ask Computer Systems, Inc., No. 11744, 1990 WL 154150, at *6 (Del. Ch. Oct. 11, 1990), former-Chancellor Allen held that stockholder-plaintiffs were third-party beneficiaries of their corporation's listing agreement and, therefore, had standing to enforce the agreement as a matter of contract law. He held that this was so because third party rights are a function of contract and federal regulation of the securities exchanges does not interfere with these rights. See id. ("I decide the current motion on the assumption that the federal regulation of securities exchanges does not itself preclude a shareholder from enforcing terms of a listing agreement intended to benefit shareholders. I assume also that shareholders are third party beneficiaries of ... the terms of a securities listing agreement."). But the right to sue that Chancellor Allen recognized was of dubious value, because he observed that a stockholder's only remedy for a breach of the listing agreement as a contract was the same as that available to the direct party to the listing agreement, the Exchange—i.e., delisting:

What third party rights are created by a contract is obviously a function of the contract itself. Here the parties to the listing agreement have negotiated the remedy for breach of the terms of the agreement: delisting. It seems plain to me that the NASD itself could not specifically enforce by court order its shareholder voting by-law. Rather the remedy for its breach appears to be limited to delisting of the offending corporation's securities ... If this is the case, as I now believe, then it should be apparent that others—even if they be intended beneficiaries—can have no greater rights.

Id.
held that plaintiffs stated a claim for breach of fiduciary duty when directors were alleged to have delisted the company's stock in order to further an inequitable purpose. For that reason, those of us who serve on state courts may be among the first to hear shareholder grievances based on the requirements of the 2002 Reforms.

One form that these cases may take could involve claims that directors are breaching their fiduciary duties by not complying with the 2002 Reforms. The plaintiffs' arguments will likely come in two varieties. The most straightforward will be that Delaware's common law ought to embrace the substance of a feature of the Reforms (e.g., the Reforms' definition of independent director or the Reforms' requirement for independent director approval of certain transactions). The more indirect route will be an allegation that directors breach their fiduciary duties by exposing the corporation (and, therefore, its stockholders) to an injurious sanction (e.g., delisting) by not adhering to the Reforms.

88 A corporation's directors have the power to cause a corporation to withdraw its listing and registration with securities exchanges in their proper exercise of business judgment. See, e.g., Hamilton v. Nozko, No. 13014, 1994 WL 413299, at *6 (Del Ch. July 26, 1994) ("Delaware law... recognizes the power of the issuing corporation's directors, in a proper exercise of their business judgment, to cause the corporation to [withdraw its securities listing] even if, as an incidental matter, the delisting and deregistration might adversely impact the market for the corporation's securities."); Lennane, 1990 WL 154150, at *6 ("[T]he corporation may voluntarily delist its securities at any time."). But when the power is exercised for an inequitable purpose, the fiduciary analysis becomes interesting. In Hamilton, the court of chancery found that stockholder-plaintiffs stated a claim for breach of fiduciary duty because they alleged that the delisting, which eliminated the market for their stock and forced them to convey their stock at an unfair price, was undertaken for self-interested purposes. 1994 WL 413299, at *18-21. Similarly, in Seagraves v. Urstadt Property Co., No. 10307, 1989 WL 17918 (Del. Ch. Dec. 4, 1989), the plaintiff-stockholders were able to withstand a motion to dismiss because they properly alleged a claim for unfair dealing in relation to the wrongful delisting of their stock. Id. at *4. Because the delisting was allegedly part of a scheme to lower the market price of the company's stock so the company could force a cash-out merger at an unfair price, the court found that this inequitable purpose could form the basis for a breach of fiduciary duty claim. Id.

In another case, defendant directors threatened to delist the shares of the company's stock if a self-tender offer for the company's preferred stock proposed by the company's president did not succeed. Eisenberg v. Chi. Milwaukee Corp., 537 A.2d 1051, 1061-62 (Del. Ch. 1987). This threat was held to be coercive of a stockholder's decision whether to tender. Id. at 1061-62. The court held that when a corporation goes beyond simply informing the stockholders of the possibility of delisting and deregistration, and instead threatens that it "intends to request" a delisting of its shares, such a disclosure "tips the balance and impels the Court to find that the Offer, even if benignly motivated, operates in an inequitably coercive manner." Id. at 1062.
There will be some legitimate pressure on state courts to respond with a measure of receptivity to these arguments. After all, there is something to be said for harmonizing state standards with the 2002 Reforms when that can be achieved fairly and efficiently. And why, plaintiffs' lawyers will ask, shouldn't state courts require directors to ensure that their companies do not run afoul of the Exchanges, when that is necessary to guarantee listing of the company's shares? Is there a fiduciary duty to avoid this kind of harsh penalty? Or, relatedly, to make sure that the corporation doesn't engage in a transaction that violates Sarbanes-Oxley?

Through arguments of this kind, state courts may soon find themselves immersed in the implementation of the 2002 Reforms, even though their own state laws are not directly implicated. In this process, the gravitational effect of the Reforms' existence will nudge state judges to align their own state corporate systems to avoid whipsawing corporate directors with incompatible dictates. At the same time, this process will generate opportunities for state judges to deepen the dialogue with policymakers at the Exchanges and in the federal government. In particular, the resolution of actual disputes may shed light on the utility of the 2002 Reforms and reveal whether they are compatible, in their present form, with the enabling systems of corporate law that are employed by Delaware and most other states.

In the remaining parts of this Article, we examine a few specific subjects that provide good examples of how the 2002 Reforms may require adaptive responses by the states that may reflect pressure back on the sources of the Reforms to modify their initial scope and shape.

IV. HARMONIC CONVERGENCE OR TRAIN WRECK?: THE 2002 REFORMS' DEFINITION OF AN INDEPENDENT DIRECTOR

The 2002 Reforms contain a relatively pristine definition of independent director—one that builds on the best practice recommendations of many shareholder activists. Although this definition is not in all respects identical to preexisting state law, the concerns the definition seeks to address are ones that state law has always considered important. The common law of corporations is suspicious of directors who hold managerial positions or who are beholden to management

89 *Cf.* Eisenberg, 537 A.2d at 1062 (finding actionable coercion when a board threatened to seek delisting if a transaction was not approved).

90 *Cf.* DEL. CODE ANN. tit. 8, § 102(b)(7)(ii) (2001) (denying exculpation for acts or omissions involving a knowing violation of law).
for consulting contracts or other valuable things. Although the degree of scrutiny of such ties has long been a subject of some controversy, the legitimacy of concerns about such ties is universally acknowledged.

In one important way, the 2002 Reforms are likely to simplify state law adjudication. By way of example, consider the common question of demand excusal in a typical case involving a transaction between the corporation and its Chairman and CEO. By requiring a majority of independent directors without compromising ties to management or the corporation, the 2002 Reforms make it more likely that Delaware courts will not have to make as many difficult categorical judgments about particular directors at the pleading or injunctive stages of cases. For the most part, it should be the case that satisfaction of the new Exchange Rule independence standards will enable a director, at least as a prima facie matter, to be labeled as "independent."

It would be Panglossian to believe, however, that the 2002 Reforms will answer all such questions. Notably, the Exchange Rules continue to permit an "independent director" who is not on the audit committee to enter consulting or other arrangements with the company so long as the other independent directors conclude the arrangements are not material. Quite obviously, the Exchanges contemplate that board votes excusing such economic arrangements as inconsequential are likely to be rare, if they occur at all. Nonetheless, there remains some play in the joints. On balance, however, the frown that the 2002 Reforms cast at independence-compromising familial, personal, and financial ties comports with Delaware's view of best practice and will reduce the scope for litigable controversy about director status.

This does not mean that state law will (or should) bend completely to the 2002 Reforms' articulation of the independent director

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91 See, e.g., Rales v. Blasband, 634 A.2d 927, 936-37 (Del. 1993) (analyzing the independence of two directors "in light of their employment with entities affiliated with [management/inside directors]"); Orman v. Cullman, 794 A.2d 5, 24 (Del. Ch. 2002) (finding that the disinterest of two directors was potentially compromised when one director stood to lose substantial consulting fees and the other owned a company that stood to gain in fees if the challenged transaction closed); see also supra note 13 (summarizing Delaware's treatment of the effect of consulting contracts to independent directors).

92 See supra Part I.B (discussing the qualifications of an "independent director" under Sarbanes-Oxley and the proposed Exchange Rules).

93 NYSE PROPOSED RULES, supra note 3, § 303A(2)(a); NYSE REPORT, supra note 3, at 7; NASDAQ Proposed Amendments, supra note 3, R. 4200(a)(15).
concept. One of the disadvantages of the common law—its slow evolution and sensitivity to context—also has offsetting benefits. Under the evolutionary common law approach, hard definitions emerge only after multiple tests and remain subject to alteration. The Reforms exemplify the nearly opposite characteristics of legislative reform, by displaying both the impressive scope of rapid change that can be achieved in that manner and the potential costs of a system-wide imposition of ideas that have not been proven bug-free. In at least a couple of areas, the common law of corporations must pause before fully yielding to the 2002 Reforms' treatment of the independent director concept. We discuss these situations next.

A. Is Ownership by Directors a Good Thing?

One feature of the 2002 Reforms' definition of an independent director clashes with Delaware's view of best practice. The Reforms' definition appears to be grounded in a belief that the attribute viewed by Delaware law and many academic commentators as a positive thing—ownership or affiliation with the owner of a significant, but not controlling, block of company stock—casts doubt on a director's independence. What many have seen as the best evidence of a good faith incentive to monitor—a real equity stake in the corporation, or, as Ross Perot would say, "skin in the game"—is instead a taint that, at

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94 For a sampling of cases in which the Delaware courts found that the directors' ownership of significant amounts of stock tended to align their interests with the other stockholders, see Unitrin, Inc. v. American General Corp., 651 A.2d 1361, 1379 (Del. 1995); In re Pennaco Energy, Inc., 787 A.2d 691, 709 (Del. Ch. 2001); In re IXC Communications, Inc. v. Cincinnati Bell, Inc., No. 17324, 1999 WL 1009174, at *6 (Del. Ch. Oct. 27, 1999). See also R. Franklin Balotti et al., Equity Ownership and the Duty of Care: Convergence, Revolution, or Evolution?, 55 Bus. Law. 661, 692 (2000) ("[B]y increasing the equity holdings of board members, the result should be improved corporate performance."); Sanjai Bhagat et al., Director Ownership, Corporate Performance, and Management Turnover, 54 Bus. Law. 885, 913-17 (1999) (finding "a significant correlation between the amount of stock owned by individual outside directors and firm performance"); Charles M. Elson, Executive Compensation—A Broad-Based Solution, 34 B.C. L. Rev. 937, 981-83 (arguing that when directors own stock, "their interests and thinking [are realigned] with those of the shareholders," making them capable of more effectively bargaining with management on issues such as management compensation); J. Travis Laster, Exorcising the Omnipresent Specter: The Impact of Substantial Equity Ownership by Outside Directors on Unocal Analysis, 55 Bus. Law. 109, 126-34 (stating that the likely result of having directors with "substantial equity holdings" is "an increase in the overall quality of director decision making"). We emphasize that in using the work "stock," we mean actual stock holdings, not options.
best, can be explained away, freeing a stockholder-director to be an "independent director" for some, but not all, purposes.95

This is the necessary implication of a fair reading of the 2002 Reforms, starting with Sarbanes-Oxley itself. For purposes of service on the audit committee, a director is deemed independent by Sarbanes-Oxley only if he is not an "affiliated person" of the company or one of its subsidiaries.96 Even under the SEC’s proposed, looser definition of the term than existed previously under the Exchange Act,97 a director who owns, or is affiliated with any stockholder who owns, ten percent or more of the company’s shares could be deemed an affiliated

95 Recent evidence regarding the positive effect on corporate performance (as measured by stock price) of having relatively long-term owners who held significant but non-controlling blocks of stock is inconclusive. See generally Sanjai Bhagat et al., Relational Investing and Firm Performance, 27 J. Fin. Res. (forthcoming 2004) (explaining that the first large-scale test of the hypothesis that relational investing affects corporate performance provided a mixed answer). Notably, this study did not involve an examination of whether corporations whose boards contain representatives of such long-term owners perform better; it only involved whether having such owners as stockholders had any measurable effect on share price. Id. at 11-12. The study also does not focus on another factor, which is more difficult to measure—whether the presence of such owners has any positive effect in improving corporate integrity and compliance. A positive effect of this kind might not do much to increase stock price in any particular period, but might be wealth-creating over the longer term.

The study, however, does deepen the dilemma faced by advocates for stronger monitoring by long-term institutional holders, because the authors of the study found institutions tended to hold short-term positions, a reality in part exemplified by the authors’ core definition of a relational investor as one that holds a significant position for at least four years. Id. at 9-10. Of course, this is but one of many factors that perceptive scholars have identified as limiting the ability and, as important, the incentives for institutional investors to actively monitor their portfolio companies. See generally Bernard S. Black, Agents Watching Agents: The Promise of Institutional Investor Voice, 39 UCLA L. Rev. 811 (1992); Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520 (1990); Bernard S. Black, The Value of Institutional Investor Monitoring: The Empirical Evidence, 39 UCLA L. Rev. 895 (1992); John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277 (1991); Jill E. Fisch, Relationship Investing: Will it Happen? Will it Work?, 55 Ohio St. L.J. 1009 (1994).


97 See Proposed Audit Committee Standards, supra note 22, at 2641 (“For purposes of the proposed rule, we propose to define the terms ‘affiliate’ and ‘affiliated person’ consistent with our other definitions of these terms under the securities laws, such as in Exchange Act Rule 12b-2 and Securities Act Rule 144, with an additional safe harbor.”). The SEC sought input relating to this safe harbor by asking the following questions: “Is the proposed definition of ‘affiliated person’ for non-investment companies appropriate? Is the proposed safe harbor from the definition of affiliated person appropriate? Should it include fewer or more persons?” Id. at 2642; see also Exchange Act § 3(a)(19), 15 U.S.C. § 79b(a)(11)(A) (2000) (using the lower five percent threshold to define “affiliated person”).
person and therefore be ineligible to serve as a voting member of the audit committee.\textsuperscript{98}

In effect, this means that a venture capital firm that owns fifteen percent of a public company and does not participate in management is disqualified from having a representative on the audit committee. Ditto for a leveraged buyout firm with twenty-four percent of a company's equity, but no managerial role. As a result, these investors—who have a strong incentive to monitor managerial rent-seeking at the expense of the firm—are disabled from participating in the committee primarily charged with ensuring the financial integrity of the firm.

It is true that Sarbanes-Oxley does not contain any overarching definition of independent director, and, therefore, leaves directors affiliated with large stockholders free to serve as independent directors in other capacities, subject only to Exchange Rule and state law constraints. But the Exchange Rule provisions of the 2002 Reforms do not lift the shadow cast over owner-directors by Sarbanes-Oxley. Admittedly, as a general matter, the NYSE's definition of independence does not preclude a major but non-controlling stockholder from being considered an independent director. In intellectual harmony with Sarbanes-Oxley, however, the original NYSE Report recommended that directors affiliated with a stockholder holding more than twenty percent of the company's shares could not serve as a voting member on the audit committee.\textsuperscript{99} NASDAQ took a similar view and continues to adhere to this requirement for audit committee members.\textsuperscript{100} The NYSE proposal was ultimately abandoned in view of the outright ban on participation by such stockholders contained within Sarbanes-Oxley. Nonetheless, both the original NYSE proposal and the still-live NASDAQ one betray a suspicion of owner-directors and doubts about whether it is possible to distinguish between a substantial owner who does not exercise and reap private benefits of control (such as salaries and management fees) from those who do.

In fairness, the twenty percent threshold each Exchange embraced can be seen as an attempt to allow some flexibility for owner-directors

\textsuperscript{98} See Proposed Audit Committee Standards, \textit{supra} note 22, at 2641 (defining the proposed audit committee member independent requirements); \textit{see also} Exchange Act, § 3(a)(19), 15 U.S.C. § 79b(a)(11)(A) (2000) (incorporating the lower five percent threshold of the Investment Company Act of 1940 § (2)(a)(3) to define an "affiliated person").

\textsuperscript{99} \textit{NYSE PROPOSED RULES}, \textit{supra} note 3, § 303A(6) cmt. n.6; \textit{NYSE REPORT}, \textit{supra} note 3, at 11.

\textsuperscript{100} \textit{NASDAQ Proposed Amendments}, \textit{supra} note 3, R. 4350(d)(3)(a).
while setting a limit above which suspicions about control should predominate. Even when their proposal is read in this manner, the Exchanges have cast a shadow over directors affiliated with blockholders. For example, the NYSE Report’s acknowledgement that a director affiliated with a non-controlling stockholder owning twenty percent or more of the company’s shares can be independent for non-audit committee purposes is expressed in a most begrudging way: a statement that such an affiliation should not be a per se bar to an independence finding. This phraseology is perhaps not troublesome if taken literally, but its spirit seems broader. And there can be no doubt it will be read that way by the plaintiffs’ bar.

In this regard, the 2002 Reforms motivate us to ask: have the Reforms cut off the most promising new source of independent directors to animate the best practice model now required of corporate America? By their plain terms, the 2002 Reforms evince a distrust of directors affiliated with holders of significant but non-controlling blocks of company stock. They disable the ability of directors affiliated with venture capitalists and certain institutional investors to serve on audit committees, and make them suspect if they are chosen to fill other board roles usually reserved for independent directors. This incentive system is contrary to much good thinking in academia and in Delaware decisional law, both of which have taken the view that independent directors who have a substantial stake as common stockholders in the company’s success are better motivated to diligently and faithfully oversee management.

A natural source of talent exists within the ranks of America’s institutional investor community, which controls a large portion of this country’s equity holdings. To date, there has been a reluctance on the part of many institutional investors and many money management firms to “walk the walk” of good corporate governance. Although these firms “talk the talk” and regularly advocate better board-room practices, and although they stress their status as “long-term stockholders,” they in fact provide few representatives to serve as directors on public company boards. Warren Buffett remains

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101 See NYSE PROPOSED RULES, supra note 3, § 303A(2)(a) cmt. ("[T]he Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding."); NYSE REPORT, supra note 3, at 8 ("We do not view ownership, or affiliation with the owner, of a less than controlling amount of stock as a per se bar to an independence finding.").

102 For a good summary of both the case law and the academic literature, see R. Franklin Balotti et al., supra note 94.
a relatively lonely example of a money manager willing to stand and be counted as a fiduciary.

Furthermore, most Americans participate in the stock market indirectly via money managers—a reality that is unlikely to change. One of the central problems of corporate law has always been how to create a system whereby diffuse stockholders feel comfortable entrusting their capital to centralized management. The emergence of a class of institutions (pension funds, mutual fund managers, venture capitalists, etc.) who act as a centralizing force between the ultimate source of capital (individuals) and the corporations that employ it has consequences for our system. If the appropriate incentives are created, representatives of many of these intermediate aggregators of capital are well-positioned to increase investor confidence in the market because these aggregators can act as more effective stockholder-monitors than individual investors. The full potential of these institutions, however, will not be realized if the system creates—rather than seeks to aggressively knock down—barriers to their responsible participation as independent directors. Indeed, by sidelining representatives of these institutions that hold about half of the stock of America's large public companies, our society will be benching a large

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103 Although it is beyond the scope of this Article, this topic warrants careful consideration by groups like the Council of Institutional Investors. Implemented with care, an industry-wide commitment to board service could be beneficial, efficient, and useful in overcoming “free-rider” incentives. If these institutions are truly long-term holders, they, like Buffett, should be willing to have representatives serve on a responsible number of boards. This would actually increase the real-world experiences of these money managers (perhaps increasing their effectiveness as stock-pickers) and improve the overall monitoring capacity of the system (a more generalized good for investors). Federal and state law barriers to responsible participation of this kind should be studied and removed, but as distinguished scholars have noted, these barriers are not so formidable as to present a real barrier to institutions seeking to play a more full-bodied role in the nomination and election of directors. See Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 STAN. L. REV. 863, 905 (1991) (arguing that, under existing legal rules, institutional investors could work together to identify qualified independent directors who would be nominated with the specific charge of being independent of management and accountable for advancing shareholder interests). To the extent the reader perceives that we are somewhat dubious of the system's ability to create after-the-fact "owners" out of new independent directors with no previous equity stake, the reader is not wrong. Indeed, the methods by which such "stakes" are created—stock option grants or stock purchases—often generate controversy themselves.

pool of talent and, arguably, one whose members have the healthiest incentive to be good directors.

Regrettably, this incentive for institutional representatives to avoid direct responsibility through service on corporate boards may well come as welcome news to even the most aggressive activists in the institutional ranks. Many of these institutions are reluctant to have their representatives serve. They see such service as costly, liability-generating, and flexibility-reducing. Why, they ask, would we serve on a board when that could limit our fund’s ability to dump the company’s stock?

Their narrow frame of reference should, if anything, be enlarged, not given validation. The clients of institutions holding diverse portfolios of enormous size have an interest in the integrity of the overall system. To the extent that the institutional investor community

("[Financial institutions own nearly 50% of the equity securities listed on the [NYSE] and account for approximately 75% of the daily trading volume on the NYSE. The ownership and trading percentages are equally high for securities listed on [the NASDAQ]."") (footnotes omitted)); Jayne E. Zanglein, From Wall Street Walk to Wall Street Talk: The Changing Face of Corporate Governance, 11 DePaul Bus. L.J. 43, 45 (1998) ("Collectively, all institutional investors, including pension funds, control about sixty percent of the stock of the one thousand largest U.S. public corporations." (citation omitted)).

For example, consider the reluctance of mutual funds to disclose even the policies and procedures they follow when voting proxies related to the portfolio securities they hold and the votes they cast. Cf. Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564 (Feb. 7, 2003) (to be codified at 17 C.F.R. pts. 239, 249, 270, 274) (amending portions of the Securities Act, the Exchange Act, and the Investment Company Act to require disclosure about how registered management investment companies vote proxies regarding their portfolio securities). Rather than supporting the new SEC rule, the mutual funds largely mounted a solid wall of resistance to it, claiming that it did not benefit stockholders and that it was too costly for the funds to implement. See, e.g., id. at 6568 (noting that “many commentators, including a large number of fund industry participants, strongly opposed any requirement for a fund to provide disclosure of its actual proxy votes cast.”); Ira Carnahan, Fund Companies Fight Disclosure, FORBES.COM (Dec. 11, 2002), at http://www.forbes.com/2002/12/11/cz_ic_1211belsway_print.html (discussing the resistance of “big fund companies such as the Vanguard Group and Fidelity Investments, as well as the Investment Company Institute, the mutual fund trade group” to the new SEC proxy voting disclosure rule); Press Release, Matthew P. Fink, President, Investment Company Institute, ICI Statement on SEC Proxy Vote Disclosure Rule (Jan. 23, 2003), at http://www.ici.org/issues/corp/arc-reg/03_news_proxy_final.html (expressing the Investment Company Institute’s objections to the new SEC rule because it “overreaches, and is more likely to harm than help fund shareholders” and “will produce no additional benefits while encouraging the politicization of mutual fund portfolio management”).

One of the (rightfully) most respected business leaders in America is mutual fund innovator John Bogle. In recent speeches emphasizing the need for reform and increased activism by institutional investors, Bogle embraces many of our premises.
First, he makes the obvious point that institutional holders in general, and mutual funds in particular, are by a large margin the predominant holders of stock in our economy. See John C. Bogle, After The Fall: What Lies Ahead for Capitalism and the Financial Markets?, Address at the University of Missouri (Oct. 22, 2002) [hereinafter Bogle, After the Fall] (noting that there are approximately 9000 funds with assets exceeding $5.5 trillion), available at http://www.vanguard.com/bogle_site/sp20021022.html; John C. Bogle, Just When We Need It Most... Is Corporate Governance Letting Us Down?, Remarks to the New York Society of Security Analysts (Feb. 14, 2002) [hereinafter Bogle, Just When We Need It Most] (remarking that stock ownership is concentrated in mutual funds), available at http://www.vanguard.com/bogle_site/sp20020214.html.

Second, Bogle's creed as an investment advisor is that investors cannot expect to beat the market average and that, in the long run, investors do not succeed by short-term trading moves, but through investments in good companies that pay off over time. Indeed, because Bogle believes that investors cannot beat the market over time, he is the leading advocate for investing in indexed portfolios that reflect broad market segments (e.g., the S&P 500). Therefore, it is logical to assume, as his emphasis on corporate governance indicates, that he believes that the integrity of the capital markets as a whole is critical to investor well-being. See Bogle, After the Fall, supra (encouraging investors to let themselves be idealistic and to play a role in corporate governance); Bogle, Just When We Need It Most, supra (emphasizing the important failures in corporate governance that contributed to the recent stock market decline and stating that "[i]t seems self-evident that the financial strength of our citizen-investors, our securities markets, and indeed our nation will be well-served by a return to full disclosure, sound financial statements, and corporate integrity"). Without active involvement by stockholders as owners of stock, directors cannot be relied upon as a sufficient safeguard. See id. ("If we can't rely on the directors to govern, who can we rely on? Why the stockholders!").

Third, he concedes that the mutual fund industry and other institutional investors have been less than ideally active stockholders. He seeks to create a "Federation of Long-Term Investors" to correct this problem. See Bogle, After the Fall, supra (observing that investors "remain ill-served by the passive governance policies of most funds"); John C. Bogle, Memorandum to: Financial Intermediaries Re: How We Can Profit From the Experience of Corporate America, Remarks to the Annual Conference of the American Life Insurance Council (Oct. 14, 2002) [hereinafter Bogle, Memorandum to Financial Intermediaries] ("We [the mutual fund industry] have failed to recognize that ownership entails not only rights but responsibilities, and as a result have failed to act as good corporate citizens."), available at http://www.vanguard.com/bogle_site/sp20021014.html.

Fourth, Bogle believes that institutional investors have the wherewithal to be powerfully influential stockholders, if they choose to do so. See Bogle, Just When We Need It Most, supra (proposing that fund managers work together to influence corporate decision making). Finally, Bogle argues that mutual funds can cut their costs in many ways that would be more beneficial to investors, which would free up some funds to use toward increased stockholder activism. See Bogle, After the Fall, supra (arguing that only a small portion of management fees is actually used on fund management).

If all these premises are correct, the case for participation on boards by money managers seems to have some logical force behind it. And if, as John Coffee commented to us, it may be more feasible for institutions to identify director candidates to put up for election so as to avoid concerns about securities liability, then some variant of the idea presented by Professors Ronald and Kraakman could be implemented instead by the institutions. See Gilson & Kraakman, supra note 103, at 905 (arguing
steps up to the plate as a whole, it can contribute a useful supply of talented directors without placing an enormous stress on itself. By sharing the load through an industry-wide commitment to service, the institutional investor community could greatly improve the monitoring capacity of corporate boards, to the overall benefit of their clients as investors in diversified portfolios of stock. Unfortunately, the 2002 Reforms do not challenge market intermediaries to accept greater responsibility but, instead, provide them with another excuse to leave the actual hard work of governing corporations to others.

B. Label with Care: The Dangers of Careless Use of the 2002 Reforms’ Definition of Independent Directors

The 2002 Reforms’ tightening of the definitional standards for independent directors will exert leverage on Delaware and other state courts in a less obvious, but quite important, way. The momentum in favor of the independent director concept has, at times, led courts to be less than careful about terminology and about separating out a director’s status for purposes of articulating the appropriate standard of review to apply to a transaction from the distinct question of whether that director in fact breached his fiduciary duties in a manner that subjects him to monetary liability. Not only that, many corporate decisions involve a court’s examination of whether a particular transaction should be enjoined or rescinded, and do not involve claims for monetary damages against specific directors. The rhetoric used in such decisions is situation-specific and is of doubtful utility when extended to decisions requiring a director-by-director determination of culpability.

that institutions should identify, nominate, and elect professional directors responsive and accountable to stockholders, not management). The electoral reform discussed infra Part V would also tend to make such activism more affordable.

If institutions do not take up this cause, then the reality is that boards will be dominated by independent directors who, by the 2002 Reforms’ definition, will have little personal stake in the corporation, and by dint of institutional passivity, will have few ties of loyalty to the electorate. Whether this is a good reality is a question that can be debated another day, but reality it will be.

As Professors Gilson and Kraakman note, “[t]he surest way to increase the value of an indexed stock portfolio is to increase the value of all of the companies in the portfolio.” Gilson & Kraakman, supra note 103, at 867. To do this, Gilson and Kraakman suggest that the indexed institutional investors should seek a corporate governance system that will improve the monitoring of management system-wide. Id.

See, e.g., Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362 (Del. 1993) (containing a section heading entitled “When a Director’s Duty of Independence is Breached for Purposes of Rebutting the Rule”).
Stated more concretely, labels like independent director are important but must be utilized responsibly. For example, it makes perfect sense at the pleading stage to examine whether, based on the pleaded facts, a majority of the relevant board is capable of acting independently on a demand that the corporation bring suit against a senior officer. In that situation, a first-blush look at independence is an efficient way to make reasoned demand excusal decisions. Likewise, when one of the directors is “interested” in a transaction, a consideration of whether the other directors have ties to him that might render it difficult for them to act impartially on the transaction is a rational step to determining the appropriate level of judicial scrutiny to apply to the transaction.

It is problematic, however, if these prima facie labels are given weight in the determination of whether particular directors are subject to monetary liability. Remembering the difference between the concepts of an “interested” director and of an “independent” director is vital. Fundamentally, a director is “interested” in a transaction when he possesses a personal financial stake that is adverse to the interests of the company and its stockholders.\textsuperscript{109} In a case of that kind, the interested director is always at risk that the standard of review might, for various reasons, be the test of entire fairness. In that circumstance, the interested director must be prepared to remedy any injury to the corporation (through rescission or damages) in the event that the transaction was not accomplished on the same terms as a properly negotiated, arm’s-length deal.\textsuperscript{110}

The independence concept addresses a subtly different concern, which is that directors who lack a personal self-interest might be beholden (financially or personally) to someone who is interested, and

\textsuperscript{109} Del. Code Ann. tit. 8, § 144 (2001). By statute, an “interest” exists when a director also serves as an officer or director of a party (such as a controlling stockholder) that has a conflicting interest. Id. This part of the statutory definition is closer to the evolving concept of independence. Because of the likelihood of parent company indemnification for such directors in cases involving alleged unfair dealing with a subsidiary, the categorical label may not be as important for these directors and there may be policy reasons justifying the stronger “interested” designation.

\textsuperscript{110} Delaware’s exculpation statute expressly recognizes this, in particular by denying exculpation whenever a director has received an improper personal benefit, and more generally by denying exculpation for loyalty violations. Id. § 102(b)(7). As a matter of long-standing doctrine, when an interested transaction is deemed unfair, the interested director is deemed to have breached his duty of loyalty. See, e.g., In re The Limited, Inc. S’holders Litig., No. 17148, 2002 WL 537692, at *7 (Del. Ch. Mar. 27, 2002) (refusing to dismiss a claim that six interested directors breached their duties of loyalty because the interested transactions appeared unfair).
therefore be incapable of ensuring that any transaction with the interested party is fair to the corporation. Simply because a director possesses ties to an interested director, thus causing the court to presumptively consider the director non-independent, does not mean that the director in fact acted improperly. A finding that a director is not, by reason of personal or financial relationships, independent does not equate to a finding of breach of fiduciary duty.

To the contrary, when the personal liability of corporate directors is at issue, a further individualized finding is required as to each director. In that process, the court is required to determine whether the director acted with the requisite level of culpability to justify a damage award. In most cases, this will entail an examination of whether the director acted in a manner that is outside the exculpatory protection of the corporation’s certificate of incorporation by breaching the duty of loyalty. This exercise necessarily requires the court to consider factors bearing on the director’s partiality, but not as an end in themselves. Instead, such factors are relevant to, but not dispositive of, the court’s determination of whether the director acted with the necessary state of mind (e.g., with an absence of good faith) to justify the imposition of damages, irrespective of whether the director is insulated for damages for negligence. A director with potentially compromising ties to an interested director might have discharged his duties with entire fidelity. And a director with no suspicious connections to an interested director might be found to have consciously abdicated his responsibilities, thereby having acted in bad faith.

A related but distinct issue also exists. Under the 2002 Reforms, the status of “independent director” is generally imposed in a blanket manner that is not transaction-specific. This labeling could have an unfair effect if extended into the litigation context without appropriate sensitivity. There may well be situations in which the CEO of a company is entirely capable of acting “independently” on an issue because his management status (and presumed desire to keep it) has no bearing at all on his incentives.

After the 2002 Reforms, it will be even more important for courts to bear these realities in mind and not to allow the necessarily nuanced and fact-driven consideration of whether particular human beings must pay damages to be replaced by an overly simple inquiry into status. Otherwise, well-qualified people may be dissuaded from serving on boards, to the resulting detriment of stockholders.

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111 § 102(b)(7)(ii).
V. THE DIRECTOR ELECTION PROCESS: 
THE FORGOTTEN ELEMENT TO REFORM?

Another related issue provoked by the 2002 Reforms is whether or not it is time for state and federal policymakers to examine the management-biased corporate election system. After the 2002 Reforms, it is unquestionable that Delaware, the Exchanges, and the federal government each have policies that express the belief that genuinely independent directors who owe their allegiances entirely to the corporation and its stockholders are valuable to investors. In particular, the proposed NYSE Rule that demands that the nominating process be exclusively the province of independent directors reflects this view.112

If this philosophy is so central to our system of corporate governance, one can rightly ask why the current incumbent-biased corporate election process should be perpetuated. As of now, incumbent slates are able to spend their companies' money in an almost unlimited way in order to get themselves reelected.113 As a practical matter, this renders the corporate election process an irrelevancy, unless a takeover proposal is on the table and a bidder is willing to fund an insurgent slate. The aberrational cases in which shareholder activists have actually mounted proxy contests tend to prove the incumbent bias of the system, rather than cast doubt on it.114

Although it would seem to promise more expense than protection to investors to create incentives for lively electoral disputes on an annual basis, it is equally questionable whether the current balance is optimal. Even with the advent of independent nominating committees, there will remain the danger that incumbent slates will become overly comfortable in their positions and that even putatively independent directors will become less than ideally sensitive to stockholder input. A balance of the efficient deployment of corporate resources (i.e., costs) against the utility of a genuinely open election

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112 NYSE PROPOSED RULES, supra note 3, § 303A(4)(a) cmt.; see also NYSE REPORT, supra note 3, at 9 ("Placing this responsibility in the hands of an independent nominating . . . committee can enhance the independence and quality of nominees.")

113 See, e.g., Hibbert v. Hollywood Park, Inc., 457 A.2d 339, 345 (Del. 1983) (holding that the "management group . . . was entitled to use corporate funds to present its position" in a proxy election).

process that generates increased accountability might be reflected in a biennial or triennial system of elections that requires equal access to the proxy machinery between incumbents and insurgents with significant (e.g., five or ten percent) nominating support.

Through this means, Delaware could invigorate its system of corporate democracy without undue cost and create a more secure foundation for the 2002 Reforms. The very fact that an open process is created would influence independent directors to be more responsive on an ongoing basis and to consult with key stockholder constituencies in shaping the management slate. Put differently, by facilitating fair contests, the new rules of the game will cut down on the need for them.

This is, of course, not a novel proposal. Its implementation would also require a sensitive corresponding reaction by the SEC, to enable disaggregated investors to communicate in a non-burdensome manner in the electoral process. Reform along these lines needs to be carefully thought out, of course. The reality that thoughtful deliberation on this front is warranted cannot obscure an equally apparent reality: the rhetorical analogy of our system of corporate governance to republican democracy will ring hollow so long as the corporate election process is so tilted toward the self-perpetuation of incumbent directors.

To grasp why this is so, it is useful to consider the delicate subject of executive compensation. As we have explained, the American system of corporate governance involves a dialogue among the federal...
and state governments and the Exchanges, who each act on the basis of input from various interested constituencies. Policymakers at the state level must listen in this process, as well as speak. For example, it can be argued fairly that Delaware's common law did not react quickly or aggressively enough to changes in compensation practices during the last two decades, changes that were so substantial quantitatively that they required a qualitatively more intense form of judicial review, through, for example, a reinvigorated application of the concept of waste. In the past, the Delaware courts had generally taken a hands-off approach to executive compensation based on the assumption that this was a matter of business judgment, which could also be factored into the electorate's voting decisions. Before the last twenty years, the overall level of executive compensation did not seem to reflect any major defect in this policy choice. Empirical evidence of the huge Argentina-like inflation in executive compensation in more recent decades creates greater doubt. \[17\]

It will not surprise legal scholars that Delaware's common law was perhaps slower than ideal in adapting to the new realities, which seem to many to cry out for a deeper and more skeptical judicial inquiry. The common law accretes knowledge, but not always at an optimal pace. The 2002 Reforms contain measures reflecting a policy judgment that the constraints of state law on executive compensation are, in themselves, inadequate to protect investors against abusive compensation practices. State law policymakers—including judges shaping the common law—will undoubtedly be responsive to this expression of concern and may use it as an opportunity to reflect more deeply on whether their own policies need adaptation to better protect stockholders.

In that process, a familiar policy question might arise: is it preferable to react to a potential need for greater restraints on executive compensation by tightening judicial review, or by increasing the ability of stockholders to displace directors who do not set responsible levels of pay? A potent electoral check on director conduct dampens the need for increased judicial intervention and encourages the resolution of corporate disputes within the corporate family.

\[17\] Cf. Jerry Useem, The Winner-Steal-All Society, AM. PROSPECT, Oct. 21, 2002, at 13 (“The statistics are simply too obscene: In 1999, the average chief executive earned 419 times more than his or her coworkers, up from 25 times in 1981, while the 10 highest-paid executives have seen their income soar an astonishing 4300 percent between 1981 and 2000.”).
VI. WITH A REDUCTION IN OFFICER-DIRECTORS FROM THE 2002 REFORMS, THE DELAWARE COURTS MAY NEED NEW TOOLS TO HOLD KEY OFFICERS ACCOUNTABLE

One likely consequence of the 2002 Reforms is a further diminution in the already shrinking ranks of management directors who serve on the boards of public companies.118 Given the unmistakable message that independent directors are preferred, it will become increasingly unlikely that even the three managers most critical to governing a firm on a day-to-day basis will be on the board.119 But it is doubtful that this overall decline in board service by top managers will correspond with any genuine reduction in the importance of key executives to the management of public companies.

For Delaware, the trend toward boards comprised entirely of independent directors (with the exception of the CEO) has a subtle consequence. Many of our fiduciary duty cases involve claims of self-dealing against top managers who also happen to be directors. Under Delaware law, officers, as well as directors, owe fiduciary duties to the firm. As a practical matter, however, most of our case law has focused on the fiduciary duties of corporate directors because boards have tended to include those key executives in a position to extract private rents from the firm at the expense of the stockholders. Our law has made it clear, moreover, that a director who exploits the company in his capacity as an officer or an employee is subject to the same strictures as if his wrongdoing occurred in the boardroom. That is, there is no safe harbor for a director to argue that his malfeasance was


119 Notwithstanding the widespread pro-independent director drum beat, there is some empirical evidence that suggests that the proportion of independent directors on a board is inversely correlated to firm performance. See, e.g., Sanjai Bhagat & Bernard Black, The Non-Correlation Between Board Independence and Long-Term Firm Performance, 27 J. CORP. L. 231, 263 (2002) ("We find a reasonably strong inverse correlation between firm performance in the recent past and board independence. However, there is no evidence that greater board independence leads to improved firm performance ... [These results] do not support the conventional wisdom favoring the monitoring board, with a high degree of board independence." (emphasis added)); see also Bhagat & Black, supra note 28, at 944-49 (finding evidence that suggests "a possible negative correlation between supermajority-independent boards and firm performance" and suggesting "that it may be valuable for boards to include at least a moderate number of inside directors"). We do not enter this debate, but do note our belief that the 2002 Reforms will likely result in a reduction of inside participation and deepen the trend toward a model involving the CEO as the only inside director.
committed in his capacity as an officer or employee, rather than as a director.120

A practical problem exists, however, for Delaware's ability to hold key officers accountable for a breach of fiduciary duty when they are not also members of the board of directors. That difficulty is the court's ability to exercise personal jurisdiction over the officer, whose allegedly wrongful actions against the corporation will, in most instances, have occurred outside Delaware. Absent some act within Delaware itself that can be charged to the officer, our general "long-arm" service of process statute is insufficient.121

What is lacking in Delaware law is a key executive counterpart to our director service statute. After Shaffer v. Heitner,122 our state adopted title 10, section 3114 of the Delaware Code, which states that every person who accepts a directorship of a Delaware corporation consents to service of process in Delaware for purposes of defending an action brought against him in his official corporate capacity. In the past year, several of the most prominent of the corporate scandals have involved (apparently) serious breaches of fiduciary duty by corporate officers and executives who were not directors.123 Given that the 2002 Reforms will increase the trend toward fewer management directors, it would make sense for Delaware to adopt a new subsection of section 3114 designed to cover top executives. This provision could be modeled on section 3114 and simply state that top executives of Delaware companies consent to service of process in Delaware for claims brought against them in their official capacities as an officer or employee.124

120 See, e.g., Hoover Indus., Inc. v. Chase, No. 9276, 1988 WL 73758, at *2 (Del. Ch. July 13, 1988) (rejecting management director defendant's argument that his actions were taken in his capacity as an officer and not a director and therefore section 3114(a) did not authorize service of process).
121 See DEL. CODE ANN. tit. 10, § 3104 (2001) (generally requiring an act within Delaware or an effect within Delaware as a geographic fact, rather than as a matter of metaphysical theory, in the absence of a continuing presence by the defendant in Delaware); HMG/Courtland Props. v. Gray, 729 A.2d 300, 306 (Del. Ch. 1999) (holding that section 3104 "provides a basis for serving non-resident defendants who 'through an agent' engage in specified forum-directed activities").
123 E.g., Enron.
124 Simultaneously, section 3114 should be amended to make clear that a director consents to service of process for any claim brought against him involving a breach of duty against the company, whether as a director, officer, employee, or in a comparable position at a controlled subsidiary. Although our courts have generally rejected "Three Faces Of Eve" defenses by fiduciary defendants, e.g., Grace Brothers v. Uniholding Corp., No. 17612, 2000 WL 982401 (Del. Ch. July 12, 2000), statutory clarity would
This change would not increase the standard of liability that now applies to corporate officers and employees. But it would increase the ability of stockholder-plaintiffs to hold these key corporate decision-makers accountable for failing to comply with their fiduciary duties. It remains the case that the stockholders of Delaware companies are widely dispersed and that the effects on them of breaches of duty track their locations, not that of the company’s headquarters. The corporate contract—the certificate of incorporation—that selects a state of incorporation reflects a choice to have Delaware law govern the internal relations of the firm. This should include a promise by Delaware to make its courts available as a forum for the resolution of fiduciary duty claims against top executives who have voluntarily chosen to accept a position of trust in a Delaware corporation.

To bolster this modest reform, section 3114 could also be amended to clarify that any person who aids and abets a breach of fiduciary duty against a Delaware corporation is subject to jurisdiction in Delaware so long as Delaware’s exercise of jurisdiction is consistent with federal constitutional standards of due process. Again, the reality is that the injury to a Delaware corporation and its stockholders does not track the company’s headquarters. In order to be found liable for aiding and abetting, a defendant must have consciously assisted a breach of fiduciary duty. So long as the Delaware courts are satisfied that the fundamental fairness concerns of the federal due process test are satisfied, they should not have to trifle with the application of a long-arm statute designed for other purposes (namely, tort and contract cases).

reduce needless litigation expense and send a clearer policy message about the seriousness with which we regard fiduciary compliance.

This proposal was inspired in part by a provocative and incisive article written by Professors Thompson and Sale and by extensive discussion with Professor Thompson. See Robert B. Thompson & Hillary A. Sale, Securities Fraud as Corporate Governance: Reflections Upon Federalism, 56 VAND. L. REV. 859, 868-72 (2002) (noting that Delaware’s intense focus on director accountability is inadequate to address the important issue of officer misconduct and has ceded core state law concerns to the federal government, which regulates officer conduct through disclosure regulation, some aspects of which have the intended effect of encouraging care and loyalty by officers).

Undoubtedly, questions of scope will arise. These can be resolved by conservatism in the first instance, by focusing on chief executive officers, presidents, chief operating officers, chief financial officers, chief technology officers, treasurers, general counsel, controllers, secretaries, and executive vice presidents. The SEC also has regulations under the Exchange Act that define key executives for certain purposes which could serve as a starting point for Delaware. See, for example, Exchange Act Rule 3b-7 (defining “executive officer”), 17 C.F.R. § 240.3b-7 (2003), and Rule 16a-1 (defining “officer”), id. § 240.16a-1.
VII. CONCLUSION

This is a challenging and interesting time for policymakers involved in shaping the American corporate governance system. Like many ambitious policy initiatives, the 2002 Reforms have a destabilizing character, which, as we have shown, calls into question the relationship among the federal government, the Stock Exchanges, and the states in shaping our overall system of corporate law. In this Article, we have identified some aspects of the 2002 Reforms that generate creative friction with state corporate law and its regulatory domain. In our view, however, the destabilizing effects of the Reforms should not be greeted by state policymakers with despair. Instead, they should be welcomed as an invitation for the states to join as full partners in the creative process of reform.

By doing their part to ensure that the 2002 Reforms are sensibly implemented and that state law complements to the Reforms are considered, the states will maximize the likelihood that the Reforms can increase the integrity of corporate America without undue cost. By considering additional initiatives of their own and by showing that the states take corporate responsibility seriously, state policymakers will shape a political environment in which modest adjustments to the 2002 Reforms can be more feasibly accomplished, when necessary, in the best interests of investors in public companies.

This does not, of course, mean that state policymakers should yield supinely to whatever measures are proposed by the federal government and the Stock Exchanges. Rather, it means that the states must be full and active participants in the ongoing dialogue about improving our system of corporate law. To the extent that states play this role and serve as a source of creative and responsible reform themselves when action is warranted, the traditional division of responsibility that has, on balance, served investors and the general public well to date should remain largely intact.