# THE ROLE OF DELAWARE IN THE AMERICAN CORPORATE GOVERNANCE SYSTEM, AND SOME PRELIMINARY MUSINGS ON THE MELTDOWN'S IMPLICATIONS FOR CORPORATE LAW

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**Delaware Court of Chancery**

**Governance of the Modern Firm 2008**

**Molengraaff Institute for Private Law**
**Utrecht University**
**Utrecht, The Netherlands**
**13.45 – 14.15**
**December 13, 2008**

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This essay was prepared for delivery as a keynote speech at the Molengraaff Institute for Private Law's Governance of the Modern Firm conference on December 13, 2008. No attempt has been made to address the material events that have transpired since the conference. I am grateful for the help of Elane Boulden, Jonathan Hofer, and Neela Mookerjee in preparing this essay.

Ladies and Gentlemen, I am honored to have this opportunity to speak to this prestigious assembly of corporate governance experts, especially at such a distinguished university, in such a lovely city.

Although I do not speak Dutch, I can assure you that my sons learned the word "Cruyff" by the time they were three and can now confidently pull one off with either foot in tight traffic. For me, it is a thrill to be in the homeland of Cruyff, Neeskens, Rykaard, Van Basten, Overmars, Seedorf, and Van Nistelroy, and although this conference is quite interesting, I'm anxious for tomorrow night to come so I can go see a football match at Feyenoord.

But in exchange for that opportunity, I have to talk about a less exciting topic, which is the role that Delaware, and in particular its Court of Chancery, plays in corporate governance in the United States. Because this is a sophisticated audience, I will not spend all of my time outlining how our system of corporate law works, but I will do that as a foundational exercise.

But once that overview is out of the way, I want to make some brief observations, necessarily preliminary and tentative, about the current capital markets collapse and its implications for America's approach to corporate governance.

Most specifically, I want to emphasize that the current debacle underscores something those of us in Delaware always knew, which is that our approach to corporate law works best when our national government provides strong safety and soundness regulation that ensures that the national economy is not endangered by firm failures that pose a risk, not simply to their own equity investors, but, more systemically, to our economy as a whole. Our system of corporate law depends upon national regulation to limit the extent to which corporations can externalize costs, such as environmental damage, because corporate law itself does not address issues of that kind.

At its essence, American corporate law is a specialized contract law that ensures that directors and managers are faithful to the interests of their stockholders. To that end, corporate law does not condemn managers who take good faith risks to secure profits for corporations when those risks do not pan out. That is the essence of the so-called business judgment rule.

But, precisely because corporate law goads directors to create wealth for their stockholders, and gives stockholders increasingly potent tools to hold directors accountable for failing to produce profits, it creates a stimulus for risk-taking up to the bounds of positive law. If those bounds are too loose, risk-taking can get out of hand, causing the potential for firm failure. Likewise, if stockholders are not long-term investors focused on the sound, durable generation of wealth, but are short-term traders churning in and out of securities, they may tend to demand that corporate boards deliver unrealistically high profits. When those stockholders have the practical power to replace the board, managers may strike a suboptimal risk-reward balance, feeling that they need to be edgy in pursuit of the hyper-charged returns that activist, short-term investors demand. To the extent that is the case, the boundaries of positive law become even more important in ensuring that public corporations are operated in a fundamentally sound fashion that does not pose a potential for systemic risk.

With those preliminary thoughts in mind, I will turn first to a basic description of our system of law. After that, I will address the current financial markets debacle and some of its corporate law implications.

## The Delaware model of corporation law

But I start with the narrow and mundane: a basic description of Delaware's corporation law. Delaware's corporation law is not what, in a European context, might be called a broad-based company law. Aspects of company law like competition law, labor law, trade law, and requirements for the filing of regular disclosures to public investors, are not part of Delaware's corporation law. Instead, those matters are primarily governed at the national level by regulatory regimes originating in congressional enactments and administered through agencies of our federal government, like the Federal Trade Commission and the Securities and Exchange Commission.

Delaware corporation law governs only the internal affairs of the corporation. In that sense, our law is a specialized form of contract law that governs the relationship between corporate managers — i.e., the directors and officers — and the stockholders. Consistent with a contractarian vision, our statute is, by design, a broad enabling one that permits and facilitates company-specific procedures. In other words, our statute is different from what one might find in a civil law nation, which would be more likely to have a prescriptive corporation law chock full of mandatory terms specifying exactly how corporations must conduct their business.

By contrast, the Delaware approach to corporation law keeps statutory mandates to a minimum. And even some of the mandatory terms are subject to being overridden through charter and bylaw provisions. In particular, our law gives corporate planners tremendous power to use the charter — the equivalent of the corporate constitution — to vary otherwise mandatory terms. The charter, which is formally known as the certificate of incorporation, can only be amended upon a recommendation by the board of directors coupled with stockholder approval. Because the charter therefore reflects a contract that is agreed upon by both the managers and the stockholders, our statute permits that more specific manifestation of contractual assent to override most of the statutory default terms.

The Delaware statute is flexible in another way. It provides transactional planners with multiple routes to accomplish identical ends. Under the doctrine of independent legal significance, a board of directors is permitted to effect a transaction through whatever means it chooses in good faith. Thus, if one method would require a stockholder vote, and another would not, the board may choose the less complicated and more certain transactional method.

In emphasizing the enabling nature of the Delaware statute, it is important to make two related points. First, and too often ignored, is that efficiency and flexibility are values that do not just serve the interests of corporate managers; they are also vital to stockholders. It is rather obviously useful for stockholders to have the freedom to craft charter provisions that address their company-specific needs. But there is an even more important reason why stockholders are benefited by a broad, enabling statute.

The central idea of Delaware's approach to corporate law is the social utility of an active, engaged central management. That idea is expressed by our statute, which states the fundamental principle that the "business and affairs of the corporation are managed by or under the direction of a board of directors."[1] It is managerial ingenuity that creates stockholder wealth through the invention and exploitation of new products, the development and more efficient provision of services, and sound financial management. Delaware corporate law recognizes that reality by investing central management with wide discretion to make business decisions and a wide choice of means to effect those decisions. Those investments facilitate creativity and risk-taking. The so-called business judgment rule, which requires that the judiciary not second-guess business decisions made in good faith and with due care, even if they turn out badly, is also designed to protect the economic value served by centralized management. The rule does so by insulating managers from fear that pursuit of an attractive, but risky, business venture will leave them liable to the stockholders if the venture fails.

But Delaware's broad grant of power to management leads to a second point, which also deserves emphasis. Delaware corporate lawmakers recognize that managers can abuse their clout, and have therefore deployed means to prevent and remedy disloyalty. The statutory means are several, and include the requirement that stockholders meet annually to elect directors.[2] Although the analogy can be pushed too far, elections in the corporate republic have the same purpose as they do in real polities: they are designed to promote before-the-fact responsiveness and guarantee after-the-fact accountability to the electorate.

In the Delaware corporate republic, stockholders also get other ballot box opportunities that promote managerial fidelity. Our statute identifies certain transactions that may not be implemented by the directors without stockholder approval. These include sales of substantially all the assets of the corporation, mergers, and charter amendments. The requirement of stockholder approval permits stockholders to decide for themselves whether an important initiative of central management deserves support. The obvious goal is to provide, by the requirement of a stockholder vote, a before-the-fact incentive for management only to present transactions that management believes to be in the best interests of the corporation.

The other major check on managerial abuse is where the Delaware Court of Chancery and the Delaware Supreme Court, come in. Delaware's broad investiture of legal — i.e., statutory and contractual — authority in corporate management is policed by its court of equity, the Court of Chancery, which reviews claims by stockholders that corporate fiduciaries have breached their fiduciary duties of loyalty and care. The intensity of that review varies in a sensible way correlated with the probability that the managers' business decisions might have been impermissibly influenced by self-interest, rather than a proper concern for the corporation's interests.

For example, when a corporate board decides to approve next year's natural gas supply contract, and none of the directors has an ownership interest in any of the competitors bidding to be the supplier, there is virtually no chance that a stockholder would be able to prove a claim that the directors breached their fiduciary duties by striking a bad deal. Because there was no conflict of interest, the business judgment of the board is sacrosanct, unless, at the extreme, no person of rational mind could think the deal fair to the corporation.

But, assume a different scenario, when a board is responding to an unsolicited takeover bid. Assume further that the board is comprised of a majority of independent directors. Unlike the situation in certain European nations, including the United Kingdom, the directors of a Delaware corporation may thwart even an all-shares, all-cash bid if they believe that the offer is not in the best interests of the corporation and its stockholders. But, when the directors decide to take a defensive stance, our law scrutinizes their actions closely.

Under our law, the concern that the directors might be influenced by their desire to keep their positions, and to keep the company independent, justifies a tightened form of equitable review. Therefore, the court may overturn the defensive actions of the board if those actions are not reasonably proportionate to any threat the bid poses to proper corporate interests. In our jurisprudential lexicon, a "reasonableness" standard legitimates far more searching judicial scrutiny than exists under the business judgment rule. Yet, even here, our law does something that is consistent with the business judgment rule. In assessing the reasonableness of a board's defensive reactions to a takeover, we give more credit to a board that is comprised of a majority of independent directors.

Why? Because we intuit that the independent directors, although not immune from a desire to protect their positions, will be more likely than inside directors to impartially decide whether a bid is in the stockholders' best interest. The inside managers, in the ordinary course, have more at stake, both financially and reputationally. Therefore, our law encourages board processes that give a strong hand to the independent directors in responding to takeover bids and, even more generally, in handling M & A transactions, such as mergers of equals.

In other words, we do not wish to maximize judicial rulings finding board actions unreasonable; we wish to provide an incentive for boards to use good processes that can be trusted to reduce the role of self-interest and promote a focus on what is in the best interests of the stockholders. Notably, the heightened scrutiny the directors face in this context does not work in isolation; the voting rights I earlier described often come into play in M & A deals, requiring directors to face not only heightened judicial scrutiny, but also the need to convince the stockholders to ratify their actions. This combined pressure has led, in general, to boards that are far more willing to consider unsolicited bids and to abandon friendly mergers if demonstrably preferable alternatives come along. As a result, most M & A battles are decided in boardrooms and not by judicial injunctions.

Delaware reserves the most intrusive form of scrutiny for actual conflict of interest transactions. These transactions occur when a fiduciary — a director, a manager, or a controlling stockholder — is on the other side of the deal from the corporation. When a conflict transaction is effected, the burden is on the proponents to demonstrate that the deal is entirely fair to the corporation. In the absence of such proof, the fiduciary interested in the transaction — i.e., the one on the other side of the deal — must disgorge any profits or pay whatever damages are necessary to make the corporation whole. The interested fiduciary must do that regardless of whether or not she acted with the intention to take unfair advantage of the corporation; in other words, even if she acted in utmost good faith.

Even here, however, Delaware tries to respect the business judgment of disinterested directors and stockholders. How? By invoking the protection of the business judgment rule if an interested transaction is approved by a majority of the independent directors or by a majority of the disinterested stockholders, after full disclosure. The idea, of course, is that the investment of ultimate power over the transaction in impartial directors or stockholders suffices to police the conflict. By this instrumental means, Delaware law can protect the resulting business decision without any loss of integrity, because the decision was made or ratified by persons whose interests were aligned with those of the corporation and its stockholders.

Consistent with the nuance that infuses our common law, Delaware is more suspicious when the fiduciary who is interested is a controlling stockholder. When that is so, there is an obvious fear that even putatively independent directors may owe or feel a more-than-wholesome allegiance to the interests of the controller, rather than to the corporation and its public stockholders. For that reason, when a controlling stockholder is on the other side of the deal from the corporation, our law has required that the transaction be reviewed for substantive fairness even if the transaction was negotiated by independent directors or approved by the minority stockholders. To encourage the use of these protections, however, when these protections are deployed, the burden of proving that the transaction is fair falls not on the controlling stockholder or the corporation, but on the stockholders who sue, who must show that the transaction is unfair.

As this necessarily surface level overview shows, Delaware's scrutiny of managerial conduct gets tighter the more we have rational reason to suspect that a conflict of interest exists. Similarly, because Delaware gives great deference to decisions made by the stockholders' elected representatives, our law is extremely vigilant about policing abuse of the director election process. The heightened scrutiny given to defensive actions is applied even more intensively when the court suspects that incumbents are taking actions that have the effect of preventing a fair election.

How Delaware makes corporate law and why we are well positioned to construct a fair and efficient corporation law

That brisk tour of our law leads to the next logical topic, which is how Delaware breathes life into its corporate law.

Delaware's statutory law is made, of course, by our elected legislature, subject to veto by our governor. Because of the special importance of our corporation law, amendments to the corporate code must pass with a super-majority vote. In practice, our legislature and governor defer in the making of statutory law to the corporate law council of the Delaware State Bar Association. That council consists of corporate lawyers of all kinds, not just the transactional lawyers who represent corporate managers, but also plaintiffs' lawyers who represent stockholder interests. The council is comprised entirely of Delawareans, but it regularly seeks out and receives national input from the only two constituencies involved in shaping Delaware's corporation law — corporate managers and stockholders.

I say they are the only two constituencies because that is what I mean. And that is where our small size comes in as, in my view, an important part of the story. Delaware is a state of fewer than one million residents. We have important industries like chemicals (you might have heard of that little company called DuPont), pharmaceuticals (e.g., Astra Zeneca's U.S. headquarters), banking, and agriculture (think chickens, corn, and soybeans). But, the corporate law industry is as important, or more important, than any of those industries. For a state of our size, the corporate franchise taxes and legal jobs that our corporate law advantage brings in are a substantial reason why Delaware is among the most prosperous of the 50 states.

For other states, the integrity of their corporation law is of far less moment than the fate of a particular corporation facing a takeover bid or a major claim for damages. From sea to shining sea, we have witnessed examples of this phenomenon. For example, when Wachovia bank faced a takeover battle within the last decade, the North Carolina legislature passed a bill changing the state's corporation law precisely in order to help its home-based Wachovia avoid accepting a hostile bid from SunTrust. The legislatures of Massachusetts and Ohio have acted similarly, intervening to make changes in their corporate codes to address specific corporate feuds that they believed threatened the independence of corporations headquartered in their states. For these state legislators, the jobs and collateral community benefits that would be lost if a home-state headquartered firm was taken over far outweighed any concern about having a responsible corporation law that facilitates long-term wealth creation. The political calculus for them was not difficult. Their states receive a trivial portion of their revenue from corporate franchise taxes or their equivalent. Indeed, even if Delaware's advantage was wholly dissipated and all of our corporation business was distributed over the 50 states, the other states would barely notice.

But for us, a small state, it is vital that we remain the leader in corporation law. That leadership produces thousands of Delaware jobs and nearly a quarter of our state's budget revenues.

For that reason, our state will not tilt its corporation law to favor a corporation that happens to have its headquarters here. We cannot afford to do so. Even if the DuPont Company faced a hostile bid, we could not change the rules of the game to favor DuPont. The cost to our integrity and our ability to preserve our advantage in the corporation law field would be too high.

Because of that reality, corporation law in Delaware is influenced by the only two constituencies whose views are most important in determining where entities incorporate: managers and stockholders. Over time, the relative power of these constituencies has changed, and it is now fair to say that both groups have a lot of clout, and that Delaware corporate lawmakers seriously consider each group's perspective on all key issues. Given the increasing flow of capital from individual investors into institutional investors, this rough equality of voice is likely to be preserved, and may at some point tilt heavily towards stockholder interests. As an example of that clout and its influence on Delaware, Delaware adopted a statute responsive to institutional investor concerns about using a plurality rule in director elections. That statute authorized stockholders to adopt bylaws embracing majority voting that are not repealable by the directors.[3] Even more recently, our Supreme Court issued a decision making clear that stockholders had wide authority to adopt bylaws making it more accessible and affordable for stockholders to run a proxy contest.[4]

But, for now, the key takeaway point is that Delaware's financial self-interest in legal excellence leads to a productive dynamic for the creation and maintenance of an efficient and fair corporation law. That law is essentially a specialized body of contract law that governs the relations between the managers and stockholders of firms incorporated in Delaware. That is not to say that Delaware itself does not have laws protecting the environment, ensuring the fair treatment of workers, and guarding consumers against fraud. We do have such laws, but they only govern actual business operations that are conducted within our borders.

The corporation law itself does not address these issues. It only governs the internal affairs of the corporation. Within that domain, our law emphasizes that the goal of the corporation is to advance the interests of the stockholders. But we do not — by law — require boards to measure their success against the moment-to-moment impulses of the stock market. Rather, our law gives central management a strong hand to chart a course for the corporation that it believes will, in the end, produce the greatest increase in stockholder wealth. A good faith business judgment that does not maximize current payoffs to stockholders — such as a decision to grant pay increases to the workers, increase the corporation's involvement in charitable giving, or to sacrifice current dividend payments in order to make capital investments — will be respected if it is rationally related to a plan to enhance the corporation's long-term profitability.

Furthermore, our statutory corporation lawmaking process is not only careful, it is continuous. We do not look at the corporation law every five or ten or fifteen years as Congress might do with our national securities laws. Our corporation council meets regularly and the General Assembly makes modest adjustments at its instance annually to make sure our law remains as efficient as possible.

Because our statute is an enabling statute, the enforcement of the managers' fiduciary duties is arguably the most important check Delaware imposes on managerial abuse. When a stockholder believes a fiduciary breach has occurred, he can bring suit in the Delaware Court of Chancery, the court on which I am privileged to serve.

The Delaware Court of Chancery's original jurisdiction explicitly includes all the jurisdiction vested in the English Court of Chancery as of 1776. By happy historical evolution, the English Court of Chancery had jurisdiction over fiduciary relations, like those between executors and estates, and between trustees and trusts. The Delaware Court of Chancery kept that jurisdiction and other traditional equity jurisdiction, all of which involved exclusively civil as opposed to criminal law.

When Delaware moved beyond the specific legislative chartering of particular corporations and adopted a backbone, general corporation law that enabled entrepreneurs to freely create corporations, it was natural to vest jurisdiction over corporate law disputes in the Court of Chancery. Directors were thought to be a species of fiduciary.

Thus it was fitting for the court that enforced equitable duties to oversee suits against corporate directors.

Because Chancery did not use juries, other advantages flowed to corporate managers and stockholders. The Chancellor issued written decisions that, unlike a jury verdict, provided useful guidance for future analogous situations. Until shortly after World War II, Chancery had only one judge. Even if I assume that the raging internal debates that go on in my own head are characteristic of the inner ruminations of past Chancellors, it's fair to say that having a single judge promoted a certain consistency in application. And, because the Chancellor heard lots of business cases, he developed a good feel for business dynamics and fashioned commercially practical rulings.

Not only that, the Chancellor was often called on, as part of his equitable duties, to consider emergency applications for injunctions to stop actions that, if not enjoined, might cause irreparable injury. Injunction rulings must be issued with dispatch in order to serve their intended purpose.

The capacity and willingness of Chancery judges to act with speed fit well with the business community's needs. In many instances, once a transaction is completed, there is no way for the judiciary to, as we are wont to say in Delaware, "unscramble the eggs," leaving the parties who effected it in danger of facing a huge damages suit. Therefore, it is often the case that the proponents and opponents of certain corporate action agree on one thing, which is that they would like to get an up-front ruling on whether the transaction should be preliminarily enjoined. Chancery judges were well-equipped by disposition and training to provide such answers with the alacrity that modern commerce demands.

In fact, as a matter of judicial culture, Chancery developed a deep commitment to the timely resolution of disputes, however big or small, and whether expedited or not. As a result, corporate constituencies knew that they would receive well-written, practical, and timely decisions from Chancery. If they did not like those decisions, they could appeal directly to the court with the final say, the Delaware Supreme Court, an appellate court that took business cases equally seriously, and that also has historically had a very practical bent.

Although there were the occasional controversial decisions, all-in-all the system produced predictable, efficient results that balanced the needs of managers for flexibility and consistency with those of stockholders in policing self-dealing and managerial sloth.

The small size of Delaware was again not coincidental to these results. Because our state is small, we can devote a Chancellor, and now four Vice Chancellors as well, substantially to the expert resolution of corporation law cases and other exclusively civil matters. Because corporation law is materially important to our state, the Chancery and Supreme Court judges who handle corporate cases take them very seriously and are motivated to produce a law that fairly balances the interests of managers and stockholders. Each generation of corporate law judges truly feels invested with a sacred trust, and behaves accordingly.

And, because most corporate cases involve corporations that are chartered, but not headquartered, in Delaware, our courts are not subject to hometown bias. To put a point on that, in most takeover battles filed in our court, one Delaware corporation headquartered somewhere else is seeking to take over another Delaware corporation headquartered elsewhere, not atypically because that second Delaware corporation has signed up a friendly merger agreement with yet a third Delaware corporation also headquartered outside of Delaware.

The use of a specialized court that issues written rulings has other advantages. By its very nature, equitable review is situationally-specific and proceeds in the common law fashion. The case at hand is decided and the law is thereby evolved incrementally. Although that can lead to what some scholars like to call indeterminancy — i.e., some residual uncertainty — it also allows space for the judiciary to pull back in future cases if a prior decision turns out, in the wake of experience, to have been unwise. And the overall body of case law coherently fills in a map that guides transactional and corporate governance advisors in charting a course for their clients that is relatively risk free. The speed with which our judiciary works also enables corporate constituencies to get answers about emerging issues with the speed required by the business world. When novel issues arise, they are addressed with dispatch, as is exemplified by Chancery decisions earlier this year that upheld the ability of stockholders to make proposals at annual meetings, in the face of arguments that company bylaws barred them from doing so.[5]

Although the Delaware system is not perfect, the value it generates for the U.S. is considerable and would be difficult for the federal government to replicate. Unlike Congress, our legislature attends to its corporation law every year and does so thoughtfully. Unlike what would be the case in Congress, our corporation law is solely focused on the relations between stockholders and managers, and is not heavily influenced by other constituencies. And unlike the federal judiciary, consisting of over one thousand judges, ten Delaware Chancellors and Supreme Court Justices devote a considerable amount of time to fashioning sensible, fair corporate law decisions in a timely way. Also unlike the federal judiciary, the Delaware judiciary is, by the state's Constitution, evenly balanced between the major political parties, resulting in a centrist group of jurists committed to the sound and faithful application of the law.[6]

Through this means, the United States achieves the benefits of a virtual national company law, but more efficiently. Even for firms not chartered in Delaware, the teachings of Delaware courts are likely to be more important than their own state's law, as a practical matter. Delaware law is, in essence, American corporation law for most purposes. The balanced approach it embraces facilitates managerial innovation and creativity, while preventing managerial self-dealing and entrenchment.

Some observations on the current capital markets meltdown and its relationship to and implications for Delaware corporate law

Wait a minute, pal. That's what you may be asking yourself. Does this bald-headed dude read the news? Take a look outside, it's ugly, you may be thinking.

Put more nicely, does the current meltdown suggest that there is something fundamentally broken about Delaware's approach to corporate law? What does it say about our system of corporate governance that firms like AIG, Citigroup, Merrill Lynch, and Lehman Brothers have failed? How did this come about after all the enhanced duties placed on boards by Sarbanes-Oxley and the Exchange Rules in the wake of the Enron and WorldCom debacles? Where were the boards? These are all are rational questions, and deserve careful study, not in a hasty rush to judgment, but in a deliberate manner.

I will not pretend that there is not just cause for anger. There is, but not by everyone in the same measure. In that regard, I think it is fair to say that the direct investors in these failed corporations — who were largely institutional investors — are in a far less sympathetic position than ordinary American workers or end-user investors who have their money in the markets through institutional investor intermediaries. These direct investors, after all, were in a position to use their influence to orient our system of corporate governance toward an emphasis on safety and soundness, and to sound the warning on firms that were undertaking business strategies that involved too much leverage. But what one largely heard in the years before this year's debacle were calls for public companies to take on more leverage and to run on a private equity-like model, so as to deliver higher immediate returns to investors.

This is not to say that all investors haven't taken it on the chin. By and large, they have.

Rather, it is to emphasize that the current debacle does not have at its core a story about evil managers wishing to secure private benefits at the expense of the stockholders. Although the meltdown is too widespread for no unlawful activity to have occurred, the larger story is not one of managerial self-dealing. Rather, the story is one of the avid pursuit of CORPORATE PROFIT by means that turned out to be overly risky.

In other words, at least from reports in the press, a lot of smart folks hoping to have their corporations make money made investment and other business decisions that did not turn out well. Put in corporate law terms, that is a description of the kind of conduct that the business judgment rule is designed to keep courts from second-guessing.

Does this mean that boards and managers performed ideally? No, almost certainly they did not. Large questions remain to be answered about whether managers and directors knew the magnitude of the risks they were taking, even in the most basic sense of understanding how large their investments in certain securities were as a percentage of the firm's capital, and what the firm's overall leverage was. It seems likely that many firms were investing in securities that they did not understand and were purchasing insurance (in the form of credit default swaps) from sellers without resources to back up the protection promised. Should these venerable firms have gone into this type of investing at all, much less in such a substantial manner? Was the reward really worth the risk?

But questions of these kinds are not ones that courts in the United States traditionally answer. They are at the core of running a business, and when managers are not taking action in conflict with the corporation, the business judgment rule instructs the court to keep its hands off. Of course, in recent decades an enforceable duty of care has emerged, but when that duty is enforceable by way of money damages, stockholders are required to show that the directors acted with gross negligence, a difficult burden.

Moreover, most corporations, with the assent of their stockholders, have completely immunized their directors from monetary liability for breaches of the duty of care.

This raises the related question of which, if any, source of law anger should be directed at. The answer to this question is, in my view, relatively clear and does not involve concern over basic principles of corporate law. Regardless of the depth of the current debacle, I do not see the basic business judgment rule changing, and for good reason. Courts are not well equipped to accurately second-guess disinterested business decisions like these, and subjecting directors to damages verdicts on the basis of accusations of negligence is likely to drive good directors from service.

Although I have no doubt that the disaster of the moment will lead to a large amount of litigation, it is hard for me to grasp the social utility of holding hundreds, if not thousands, of directors, officers, and top managers personally liable for having made errors in judgment that did not involve an attempt to injure their corporations. And, although there are many policy ideas on the table, fortunately no one in any position of responsibility in the United States has sought to go in that direction. Undoubtedly, that is because they recognize that risk-taking is vital to the wealth-creating function of corporations, and that punishing mistakes as if they were crimes would not only be morally problematic, but reduce, over time, societal wealth. Before-the-fact prudential regulation is the optimal way to address the problem of business activity that poses systemic risk or generates externalities, not post-hoc litigation.

That is, what the current debacle again underscores is the fundamentally different roles played by corporate law and by regulatory law in the American system of corporate governance. Corporate law is a specialized contract law designed to address the relationship between stockholders and managers of particular firms. It is not designed to protect society as a whole. Instead, what protects society is regulatory law.

That is the body of law that determines what corporations can lawfully do, and sets specific rules for certain corporations (such as banks and insurance companies) whose health is considered of public importance. For example, it is not corporate law that prohibits corporations from polluting waterways in the United States, it is regulatory law at the national and state law. More pertinently to the current situation, federal law addresses the capital requirements for banks and pervasively regulates the sale of mortgages to the public. In that regard, it is notable that many of the large investment banks were exempt from the strong prudential regulation applied to commercial banks, on the grounds that their solvency and activities were not of systemic concern. I think we now know that not to have been the case.

Safety and soundness regulation to protect the public interest in the continued health of the banking industry and the availability of adequate capital has never been a function of corporate law per se. That sort of regulation has been undertaken through specific legislation authorizing legislation at the national and state level. The same is true for regulation of the insurance industry, with most of the regulation in that case occurring at the state level.

Precisely because profit-seeking incentives can lead specific firms to overreach and undertake too much risk, regulatory law acts as a critical complement to corporate law itself. Regulatory law addresses systemic risks threatening the public interest.

Regulatory law addresses the externalities that corporate profit-seeking imposes on third parties and society as a whole. Corporate law reinforces regulatory law, at least in Delaware, by requiring that corporations only undertake LAWFUL ACTIONS for LAWFUL PURPOSES.

But within the boundaries set by law, corporate law expects that directors will be responsive to stockholders' desires for profits. That is because corporate law is an accountability mechanism of a capitalist society; a mechanism that largely exists to make sure that directors are faithful to the stockholders' best interests.

In my view, the current troubles do not provide any basis for confusing the basic division of responsibility between corporate law and regulatory law. Instead, this meltdown reinforces the reality that profit-seeking can result in systemically dangerous consequences for society if regulatory law is too weak.

This is not to say that within corporate law itself, there is not reason to consider what can be done better. A few areas for consideration follow.

First, this is yet another market crash largely attributable to responsiveness to the stock market itself. Unlike the last crash, fraud does not seem to be at the core, but a desire to generate high returns to please a demanding stockholder base does. Boards are more and more responsive to stockholder demands for profit maximization, as is evidenced by phenomenan like outsourcing, reductions in force, increased receptiveness to acquisition proposals, larger stock buy back programs and increased dividends, much higher corporate leverage, the reduction or elimination in corporate defenses like classified boards and poison pills, and the much more frequent replacement of CEOs. The indisputable reality is that institutional investors have huge clout, they are using it, and directors are responsive. One key method of responsiveness is to put in place an aggressive plan for profit maximization designed to please an aggressive marketplace.

This is an environment in which the marginal trader has a profound influence and in which the voices that are the loudest are the ones that often have the most short-term horizon. Although the efficient capital markets hypothesis teaches that an active trading strategy is unlikely to beat the market over time, most of the activist institutions engage in trading strategies that involve substantial turnover. They seek rates of return that are extremely high, and that seem to be unrealistic and unsustainable.

When corporate boards face pressures to meet activists' demands or a proxy fight, boards may not question profitable activity that smacks of gimmickry and that involves risk as much as they otherwise would. Indeed, keeping up with the "Goldmans" may have inspired some firms involved in more staid business, that was unexciting to the institutional investor community, to get involved in more complex and risky activities, not for any improper reason, but to generate rates of returns comparable to their competitors.

The voice of impatient capital is loud and unceasing. The voice of patient capital is gentle and quiet, and too often, silent. To wit, the investment vehicles for the most rational of end-user investors — index funds — are virtually silent in the debate about corporate governance. Even though most end-user investors care about long-term performance and sound growth, their interests are poorly represented by the investment funds who actually own and vote shares in public companies. Until the voting citizens of the corporate republic — institutional investors — are themselves held accountable for the generation of durable wealth and focus their activism on that objective, it is likely that public company boards will face continued demands from institutional investors to take excessive risk.

The conflicts of interest that flow from the "separation of ownership from ownership" are profound and beyond the scope of the time I have today. But the overall turnover rate of stocks — which has risen to 320 per cent[7] — says it all. Stocks in public companies are increasingly not owned in any genuine sense, they are rented. But the pressures that renters generate on boards have consequences for long-term investors of patient capital. If we are to ensure that the corporate polity is one that is responsible for the generation of wealth on a durable basis through fundamentally sound economic activity, and not gimmicks, we cannot ignore the need to ensure that institutional investors are held accountable for acting in a way more consistent with their end-user investors' interests.

Second, this meltdown highlights the reality that just making boards work more hours, doesn't make them work more effectively. When the story is completely written, I think it will not be the case that the failed companies had boards that did not put in a large number of hours on company business. But it must be understood that those boards are different in composition than they used to be. Because of tighter independence rules, most of the directors are completely independent of the corporation. As a result, many of the directors lack any industry-specific experience or knowledge. Long gone are the days when the corporation's lender or key supplier might be on a board. These directors might have had some conflicting interests, but they also brought a concern for the long-term solvency of the corporation that was real and a knowledge of the corporation that is difficult for independent directors to match. In that regard, it is also clear that American corporate directors — in contrast to their predecessors of decades past — now have a clear focus on one constituency, the equity holders, and that is the constituency most interested in aggressive risk-taking.

Not only that, American boards of directors have been asked to address an ever-increasing check list of specific mandates, mandates that are dictated by stock exchange rules and Sarbanes-Oxley. Many of these are well intentioned, no doubt, but leave directors with scarce time to think about the big picture. Illustrative of this reality is the fact that one of the firms that melted down had created a committee called "Governance, Nominating and Risk Oversight,"[8] no doubt in an effort to have a single committee meet several requirements of the exchanges. In practical terms, that meant that a committee that had to figure out how the corporation should respond to stockholder proposals on poison pills, majority voting, and so forth, was also charged with addressing issues of fundamental risk.

Even the part of Sarbanes-Oxley that addressed core accounting — § 404 — seems not to have had the intended effect. A down and dirty look at the § 404 disclosures of the failed firms reveals that none disclosed material risks around credit default swaps, subprime mortgages, or mortgage backed securities. That may be because § 404, by its own terms, focuses on controls for financial reporting, rather than issues of fundamental economic risk.

And given the stock exchange mandates for independent nominating, compensation, and corporate governance committees, many boards continue to vest one board committee — the audit committee — with soup-to-nuts responsibility for all areas of legal compliance, accounting compliance, and risk management.[9] Three members of the board are therefore confronted with an overwhelming and impossible scope of responsibilities. Audit committee members are working harder than ever, but are destined to miss something when they are asked to cover so much territory.

This observation is not a new one coming from me. It is a consistent one dating back from before the Enron debacle.[10] But the current crisis again suggests the need to look at ways to help boards and managers. [11] What can we do to reduce unnecessary mandates so that they have time to address fundamental issues of strategy and risk more effectively?

In the wake of the last meltdown, stockholder activism again reverted to a focus on takeover defenses, executive compensation, and related issues like majority voting. What did not occur was an emphasis on holding boards accountable for managing risk and preserving, not just generating, value. If we are going to ask boards and managers to do more in response to this debacle, what else of less value can we take off their plates? Some ideas for consideration ought to include reducing some of the committee mandates of the stock exchange rules — particularly for boards that wish to create a risk management committee separate from audit — and perhaps going to a system of twice a year, rather than quarterly reporting.

But more fundamentally, the looming issue remains that of better aligning the overall system of corporate governance, so that stockholders — in the form of institutional investors — and managers are all focused on the durable creation of wealth through the corporate sale of high quality products and services. To do that, policy makers will have to grapple with the agency problem they have been ducking for decades now — the question of how to make institutional investors accountable to their end-user investors — end-user investors who care about the same thing an enlightened government should — which is the ability of public corporations to increase wealth in a sustainable manner. There are a myriad of ways to tackle that challenge if there is the political will. How to do that is a subject for another day, but I will leave you with this thought. Until the investors of public companies who vote shares and influence boards make the prudent, long-term growth of profit through sound economic activity the chief focus of their activism, their activism will put corporate managers under pressure to generate unrealistic returns, and to strike a suboptimal balance between risk and reward. Perhaps it is time to stop ignoring this aspect of the problem and start doing something about it.

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[1] 8 *Del. C.* § 141(a).

[2] The default rule under Delaware law is that all directors stand for election annually. A classified board system whereby a third of the board is elected every year may be implemented by charter. Classified boards are diminishing at a rapid clip, as boards respond to stockholder demands for their elimination.

[3] 8 *Del. C.* § 216 ("A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors.").

[4] *See CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008).

[5] *See Jana Master Fund, Ltd. v. CNET Networks, Inc.*, 954 A.2d 335 (Del. Ch. 2008); *Levitt Corp. v. Office Depot, Inc.*, 2008 WL 1724244 (Del. Ch. Apr. 14, 2008).

[6] Moreover, for the past thirty years, Delaware governors have employed a bipartisan judicial nominating commission comprised of distinguished lawyers and laypersons to screen nominees for fitness.

[7] Platt 2008, p. 52; Bogle 2009, p. 3. In contrast, during the 1950s stocks turned over at 25-30 per cent. *Id.* Even during 1929, in the midst of one of the most speculative markets in history, stocks turned over at only 145 per cent. *Id*. By the beginning of this decade stock turnover on the New York Stock Exchange was already close to, and on occasion, even over 100 per cent per annum. NYSE Overview Statistics. And, turnover on the New York Stock Exchange continues to increase. Annualized turnover on the New York Stock Exchange for December 2008 was 138%, compared to 123% in December 2007 and 118% in December 2006. NYSE Euronext.

[8] The firm is Freddie Mac.

[9] According to a recent law firm memorandum, "less than five of the one hundred largest U.S. companies by market capitalization maintain a board committee dedicated to risk management." Lipton et al. 2008, p. 14. Instead, "most boards delegate oversight of risk management to the audit committee, which is consistent with the NYSE rule that requires the audit committee to discuss policies with respect to risk assessment and risk management." *Id.*

[10] In previous writings, I advocated a more rational approach to legal compliance and risk management, which spread the work more evenly. *See* Strine 2007, pp. 8-9 (noting that the modern board of directors "is less equipped than it used to be to provide strategic advice" and "is preoccupied with the completion of a long list of legal mandates"); Strine 2003, p. 7 ("Does it make sense to heap a ton of duties on three members of the board, leaving them with responsibilities that demand close to a full-time effort to accomplish?"); Strine 2004, p. 27 (observing that audit committees are too often given a wide range of responsibilities some of which will necessarily be out of the directors' experiences). I also encouraged directors to focus on cash flows generated by activities that smacked of gimmickry and to ensure that the underlying transactions were actually reliable and sound. Strine 2004, p. 28 (noting that being asked to approve a transaction with no actual economic value should be a warning sign to directors).

[11] Other commentators have made similar recommendations in response to the current crisis. *See* Lipton et al. 2008, p. 14 ("[T]he scope and complexity of risk management may make it desirable to consider creating a dedicated risk management committee or subcommittee.").