THE DELAWARE WAY: HOW WE DO CORPORATE LAW AND SOME OF THE NEW CHALLENGES WE (AND EUROPE) FACE

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ABSTRACT

In this article, originally addressed to the European Policy Forum, Vice Chancellor Strine provides an overview of Delaware's approach to corporate law and identifies some of the challenges that approach now faces. These challenges include: the potential threat to economic efficiency that might result if the federal government further expands its role in corporate governance; the difficulties presented by the increasing separation of capital from capital, i.e., the reality that more and more of the stock of operating corporations is held by institutional investors, whose interests are not entirely aligned with those of the individuals whose capital they control; and, finally, the pressures that globalization presents not only for the United States, but for all advanced liberal democracies, seeking to preserve the societal benefits obtained through the corporate form in their humane approach to capitalism while simultaneously seeking to include the developing nations in an international market for goods and services.

I. INTRODUCTION

Ladies and Gentlemen, I am honored to have this opportunity to speak to the European Policy Forum.

In the following moments, I intend to take some of the mystery out of Delaware's role in the governance of American public corporations. To accomplish that, I will describe for you the central principles that animate our corporate law. I will then explain a bit about how our corporate law is made. In particular, I will focus on an underappreciated fact about Delaware's small—indeed, some have called "pygmy-sized". Our petite territory is not coincidental to the supple and balanced nature of our corporate law; rather, our size is a useful force in maintaining our corporation law's contractarian nature. Indeed, it is arguable that the United States' system of federalism, which permits corporations to govern their internal affairs through the laws of a state of their choosing, has enabled the evolution of a "national corporate law—i.e., that of

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Delaware—that better facilitates wealth creation than would the type of corporation law that Congress would likely produce.

In the concluding minutes of this talk, I will tee up for the ensuing panel a few hot issues that have potentially large implications for the future of American-chartered corporations. Perhaps most relevantly to you, I finish with one issue—the challenge presented by the globalization of the world's product, services, and capital markets—that poses interesting questions for corporate and economic law makers in all the advanced liberal democracies. That broad issue, if unaddressed in an effective international fashion, threatens to cause nationally-chartered corporations to pursue, by economic necessity, business practices that are inimical to the principles of the very nations that gave them birth.

II. THE DELAWARE MODEL OF CORPORATION LAW

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, 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 (SEC).

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—the directors and officers—of corporations, 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 much different than one might find in a civil law nation, which would more likely have a prescriptive corporation law chock full of mandatory terms specifying exactly how corporations must conduct their business.

By contrast, the Delaware approach to corporate 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 recommendation by the board

of directors and with stockholder approval. Because the charter 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 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 benefitted 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

[1] DEL. CODE ANN. tit. 8, § 141(a) (2005).

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 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 Delaware's Court of Chancery and its Supreme Court comes in. Delaware's broad investiture of legal—i.e., statutory and contractual—authority in corporate management is policed by courts of equity, who review 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 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

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[2]The default rule under Delaware law is that all directors stand for election annually. By charter, a classified board system may be implemented whereby a third of the board is elected every year.

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 who 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.[3]

As this 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

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[3]Currently, much thought is being given in our law to providing a stronger incentive for boards to condition transactions with controlling stockholders on both: (1) negotiation and approval by a special committee of independent directors and (2) a majority of the minority vote. By replicating the process of a third party merger (i.e., the combination of an active, disinterested negotiating agent—the board—combined with ratification by the ultimate, disinterested principals—the stockholders), this combination of protections is a powerful one for minority stockholders. Because it shifts the authority over the transaction's procession to impartial managers and stockholders, there is increasing sentiment in favor of granting full business judgment rule deference when this transaction structure is employed. *See, e.g., In re* Cox Commc'ns, Inc. Shareholders Litig., 879 A.2d 604 (Del. Ch. 2005) (advocating this change).

more intensively when the court suspects that incumbents are taking actions that have the effect of preventing a fair election.

III. 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. As we shall later see, by historical happenstance, our English heritage plays an important continuing role in that ongoing process.

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 headquartered here, such as chemicals (you might have heard of that little company called DuPont), pharmaceuticals (Astra Zeneca's U.S. headquarters, e.g.), banking (like MBNA[4]), 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 fifty 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 five years, the North Carolina legislature

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[4]MBNA's sale to Bank of America was announced just this week in July 2005. Interestingly, MBNA, although headquartered in Delaware, is chartered in Maryland.

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 fifty 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 only the 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.

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 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.

IV. THE ROLE OF DELAWARE'S ENGLISH HERITAGE

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 included 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 back-bone, general corporation law that enabled entrepreneurs freely to 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 many 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 action 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 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 demanded.

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 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 could 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 became 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 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.

Although the Delaware system is not perfect, the value it generates for the United States is considerable and would be difficult for the federal government to replicate. Unlike Congress, our legislature attends to the 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.[5]

Through this means, the United States realizes 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

[5]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.

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.

V. THE ROAD AHEAD: CHALLENGES FOR DELAWARE, GREAT AND EVEN GREATER

With that overview in mind, I will finish by highlighting a few emerging issues that pose challenges to Delaware's approach to corporation law, and even more broadly, to all the advanced liberal democracies that have chartered private corporations as instruments for creating wealth for their societies.

I will not pretend to give you a comprehensive description of any of the issues or of my views regarding them. An *amuse bouche*, or at most a *tapas*, rather than a heavy meal, is what I will serve up for you.

VI. WILL THE FEDERAL GOVERNMENT STAY IN ITS LANE?

The first of the issues I'll discuss is the federal regulatory authorities' and the stock exchanges' increasing imposition of specific mandates on American corporate boards. As I noted previously, the federal government's role in regulating corporate conduct towards investors has centered on demanding that public corporations give investors certified financial statements and other materially accurate periodic disclosures about their condition, and on providing remedies when those disclosures are materially inaccurate. The articulation and enforcement of the substantive duties owed by corporate managers to stockholders has largely been the province of state corporation law. And the U.S. Supreme Court has, through its jurisprudence, kept the federal judiciary out of the internal affairs of corporations.

After the first wave of corporate scandals involving, among others, Enron, the stock exchanges and Congress began to consider whether reforms at their level were advisable. For their part, the exchanges began considering extensive new listing standards that had the practical effect of mandating numerous board committees and specific duties that had to be staffed and carried out by independent directors. The exchanges had hoped that these new standards might head off the need for Congress to adopt onerous new mandates of its own, once the initial heat from the Enron debacle cooled. But after the exchanges were too far along to abandon their initiatives, the WorldCom mess floated to the surface of public and, therefore, congressional consciousness.

Soon, the sour scent of hypocrisy wafted from some important congressional chambers. Federal legislators who had played a leadership role in stymieing efforts at increasing the integrity of public accounting standards during the late Clinton years began to support rapid congressional action. Several of these legislators were no doubt hoping that their current drive for new federal regulation would cover for their prior efforts to hamper the SEC's initiatives to prevent improper overstatements of corporate earnings.

For others, the moment was one they had long been anticipating. These members of Congress genuinely desired a stronger federal role in corporate governance, and sensed an opening to advance their ideas.

What resulted was what might be fairly called an odd tasting "jumblaya" of ideas, which came to be known as Sarbanes-Oxley. That strange stew coupled sensible ideas—like the idea of a strengthened independent body to enforce genuinely meaningful accounting standards—with narrow provisions of dubious value—such as an outright ban on the making of loans to managers by public corporations. When combined with the new stock exchange rules, Sarbanes-Oxley had the effect of requiring corporate boards—and particularly independent directors—to spend a huge portion of their time fulfilling regulatory mandates. Characteristic of the bachelor's fridge of ingredients that make up the jumble, many of these mandates were unrelated to the core problems that gave rise to a legitimately perceived need for reform.

Those core problems primarily involved financial fraud, and the incentive systems that led gatekeepers like independent directors, public accountants, and corporate lawyers to fail to stop it, and, on occasion, sadly, even to actively facilitate accounting chicanery. Instead of a focused initiative addressing the financial integrity of publicly listed firms—which in fairness parts of Sarbanes-Oxley do speak to in useful ways that deserve credit—Congress and the exchanges generated an unwieldy set of mandates that have the perverse effect of impinging on the time that independent directors have to spend on monitoring their corporation's legal compliance.

For today, the issue to consider is what it might mean for the U.S. system if this sort of creeping intrusion continues. For all their costs, the new exchange rules and Sarbanes-Oxley are survivable, and, indeed, may be modestly beneficial, so long as the responsible regulators are flexible about giving boards leeway to implement the new mandates in a cost-effective manner.

What will be more troubling is if the federal government continues to veer out of its traditional lane in the American corporate governance system. Whether Congress likes it or not—and in its heart of hearts Congress does secretly like it—Delaware has a well-thought out

perspective on corporation law. We do not tie down all boards with a prescriptive set of procedural mandates. We do not create a thousand boxes to check. Instead, we give managers broad flexibility to chart the course that they believe is best for their corporations, using the stockholder franchise and the potency of fiduciary duty review to ensure managerial fidelity.

I freely admit that Delaware's system of corporate law relies heavily on the federal government for its overall integrity. We need the federal government to vigorously enforce national laws mandating accurate and sound accounting of corporate health, and the routine disclosure of material information to stockholders. When the federal government plays that role well, and when Delaware enforces fiduciary duties expertly, investors are well served.

What investors do not need, however, is for the federal government to undercut the valuable space for innovation and flexibility that Delaware's approach to corporation law creates. Delaware's approach recognizes that what works for one corporation might not be optimal for another. This approach recognizes that boards might perform more effectively if they contain a mix of not only independent directors, but also of directors who might have industry-specific knowledge that would actually be useful in crafting a business strategy.

Already, the new federal reforms are making it difficult for boards to include a blend of inside and outside expertise, as the multiple tasks required of independent directors generates a need for more of them. Meanwhile, the labeling by the exchanges of any director having company affiliations as "non-independent" has led potential "outside, inside directors" to rethink whether continued board service makes sense for them personally. The emerging model is a board comprised of one insider—the CEO, who knows everything about the corporation and has a keen interest in its future—and ten independent directors selected precisely because they have no affiliation with, or any historical or current interest in, the corporation's business or its fate. That is an odd group to help develop a business strategy, and seems likely to function largely as a monitor, with strategy being left to be decided by the CEO and her subordinates outside of the board's presence.

The present rules are not so deeply planted as to prevent some rethinking of this new model, thus enabling the creation of boards that combine strong independent majorities with several inside directors who have the acumen and experience to help fashion an innovating and successful strategy, too. The risk I highlight is that even more so-called "federal reforms" could emerge with costs that far outweigh their protective benefits.

The goal of corporations, after all, is to create societal wealth. That means creating new products and services, and delivering them in efficient ways. Corporate governance is a means, not an end.

Going forward, Congress needs to be mindful of these considerations and avoid stifling the wealth-creating potential of corporations through costly mandates that not only do little to protect investors, but also distract boards from their fundamental duties to develop and oversee the implementation of an effective corporate strategy, to select excellent managers, and to monitor the corporation's compliance with its legal and ethical responsibilities.

VII. WHAT DOES IT MEAN TO BE A STOCKHOLDER?: THE RAPIDLY ACCELERATING "SEPARATION OF CAPITAL FROM CAPITAL"

Compounding these regulatory pressures is the next issue I'll highlight: what I call the "separation of capital from capital." This separation is well-developed in the United States and is rapidly emerging in Europe, as well. Those of us who are corporate law junkies are of course familiar with the phrase the "separation of capital from management," which encapsulates the key idea behind the public corporation. But, it has become increasingly common for individual investors to not directly own stock in operating corporations. They instead own shares in mutual or pension funds, which in turn own shares in the operating companies.

These institutional intermediaries have interests that are not perfectly aligned, to state it mildly, with those of their own stockholders. Mutual funds make money through fees, and do not have a profit motive to undertake efforts at shareholder activism at the operating company level. A mutual fund family knows that whatever benefits its activism generates for the operating company will not be exclusively or even primarily theirs, but will be spread among the operating company's diverse investor base, including the mutual fund's own industry competitors. For that reason, the huge institutions that manage an enormous amount of equity for many Americans—like Vanguard, Fidelity, and Barclay's—have been relatively docile stockholders in the United States.

In relative contrast, pension funds under the control of elected state officials and affiliated with labor unions have been more vociferous, but these institutions have their own agency costs. The agendas of these institutions have often seemed quixotic and not rationally designed to promote the long-term creation of wealth. These institutions focus almost obsessively on corporate takeover policy. Meanwhile, they were for too

long tolerant of accounting and disclosure practices that masked real corporate rot.

More recently, institutions of these kinds have been looking to increase the competitiveness of the corporate election system. They desire access to the company's proxy card in seeking votes and corporate reimbursement for their campaign expenses if their preferred candidates attain a substantial, but not winning, show of support from the electorate. But, many investors, and most managers, fear that these institutions have less-than-optimal incentives and expertise to select corporate directors who have the experience and wisdom to guide corporations towards sound business strategies.

The purpose is not to single this class of institutional investors out for undue criticism. By comparison to the mutual funds, these institutions were at least not inert.

To address institutional inertia, the U.S. Department of Labor, which governs pension funds for many purposes, now requires institutional investors who manage pension money to vote their shares in an informed manner. And the SEC is now forcing mutual funds to disclose how they vote. But these are not panaceas leading to rational voting behavior.

Many institutional investors have, as I mentioned, little desire to do any thinking of their own, particularly about investments that they often hold for nanoseconds.[6] Into this opportunistic breach has stepped an organization called Institutional Shareholders Services (ISS), which provides institutions with recommendations as to how to vote on corporate governance issues. Following ISS constitutes a form of insurance against regulatory criticism, and results in ISS having a large sway in the affairs of American corporations.

Moreover, powerful CEOs come on bended knee to Rockville, Maryland, where ISS resides, to persuade the managers of ISS of the merits of their views about issues like proposed mergers, executive compensation, and poison pills. They do so because the CEOs recognize that some institutional investors will simply follow ISS's advice rather than do any thinking of their own. ISS has been so successful that it now has a California rival, Glass Lewis.

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[6]In a private conversation, the managers of a large mutual and pension fund complex confessed that, even in funds that were invested relatively equally in Compaq and Hewlett-Packard, they voted on the controversial merger between those companies as follows: they voted the Compaq shares for the merger because the premium Hewlett-Packard was paying was attractive. But, they voted the Hewlett Packard shares against the merger because they thought the combination would not create good value in the long run. For a diversified investor represented by this complex, who therefore indirectly held relatively equal positions in both companies, this form of "thinking" is, to put it mildly, not financially savvy.

Institutional investors now hold over half the stock in most American corporations. They are duty bound to vote it. But they often have interests that diverge from those of a hypothetical investor who has entrusted his capital to an operating firm in exchange for shares.

As a result, we face a world in which stockholders of operating companies are both more active and more conflicted. Those institutions most inclined to help set the corporate governance agenda—public and union affiliated pension funds—are probably least suited to evaluate what ideas make the most business sense. Those institutions better positioned to act on sound business logic—mutual funds—are the least inclined to be active stockholders. Mutual funds have a profit motive to be torpid, and also have business reasons to not upset corporate managers, even if upsetting managers is best for their own clients. Most frustratingly, those mutual funds whose stockholders have the most to gain from an overall increase in corporate integrity—index funds—are often the ones with the most interest in avoiding activism, in order to keep their management fees down.

Not only that, but institutional investors face incentives that can lead them to act in a way that is bad in the long-run for a particular operating company whose shares they hold if that act would benefit their overall portfolio. If a takeover bid for a healthy operating company involves only a twenty-five percent premium, instead of a forty percent premium, an institution whose overall portfolio for the quarter is suffering will often be willing to accept a low-ball bid rather than supporting the board's demand for independence until a full-priced bid comes along. Why? Because the profits from the underpriced bid will help mask the overall weakness of the portfolio's performance in the quarter. Likewise, when considering between alternative strategic stock-for-stock merger bids for a target, institutions are often more focused on which offers the highest immediate premium, rather than on which combination is more likely to produce stockholder wealth in the long run.

Short-term thinking of that kind should come as no surprise to any of you who own an actively managed mutual fund. Just what does it mean to be an investor when mutual fund portfolio turns over 300% or more of its holdings in a year? Is that rational? And what sort of monitoring does such an "investor" perform and to what end?

An increasingly popular form of investment fund is putting even more confounding pressure on corporations. So-called "hedge funds" now sometimes hold voting rights in corporations in which they hold net short positions. Rather than having an incentive to vote their shares in the manner that will increase the value of those corporations, these hedge funds

often have an economic incentive to vote in a manner that will impair corporate value.

These and other related factors are making it difficult for corporate law makers to avoid a fundamental look at the system. Questions of the following kind are surfacing: Should mutual fund boards face the same kind of fiduciary duty review that operating boards do? And just precisely what are the duties that institutional investors owe to their beneficiaries? Must they be intelligent and active monitors of the operating companies in which they invest? What mechanisms should, or feasibly can, be implemented to prevent the casting of votes designed to injure, rather than help, the corporation? Are there means by which the influence of long-term stockholders with a demonstrated commitment to particular operating firms can be enhanced, while the ability of transient, short-term profit seekers to disrupt sound corporate planning is limited?

I have grave doubt that corporate law alone can engender greater rationality. Without tax and other policy changes designed to reform the incentives of these institutions and to check their agency costs, it is unlikely their behavior will change. For example, most of us think the market's preoccupation with quarter-to-quarter profits is stupid. Anyone who is honest will admit that this obsession contributed to wrongdoing at corporations like Enron and HealthSouth. But, as presently constituted, the institutions who most shape the market's movements and focus are not designed with the goal of patient, fundamentally sound wealth creation in mind. These institutions respond to, and thus behave in ways that further fuel, short-term pressures for immediate payoffs. Meanwhile, these institutions suffer little—compared to their clients, corporate workers, and society as a whole—if that myopia contributes to corporate debacles, which have deep roots in hypersensitivity to the production of so-called "accounting profits." The divergence in interests between institutions, particularly mutual funds, and their stockholders (i.e., individual investors) is likely to become even starker. As more and more "mom and pops" (individual investors) are forced to depend on equity investments as a means to finance a secure retirement, the chasm between the institutions' incentives to focus on the very short-term and their typical stockholders' need and desire for responsible, durable portfolio growth will widen further.

That said, corporate law bears its share of responsibility. It must continue to provide space for well-intentioned boards to conceive and execute long-term strategies. Where it can, corporate law should facilitate a greater voice for true long-term investors, willing to put patient capital at risk in pursuit of plans to produce wealth, not through accounting gimmickry, but through the provision of new products and services.

In Europe, the phenomena I have described are probably in a somewhat more nascent state, but seem to be evolving rapidly in the same directions we have experienced. But watch out—the outbursts of institutional investor pressure your companies now occasionally face are likely to become more commonplace than unusual.

VIII. BEYOND STOCKHOLDERS AND MANAGERS— THE CHALLENGE OF GLOBALIZATION: CAN THE BLESSINGS OF A HUMANE CAPITALIST SYSTEM BE PRESERVED WHILE SPREADING PROSPERITY TO THE DEVELOPING WORLD?

As I close, I want to widen the lens even further. In Delaware, those who know me recognize that corporation law is not my primary public passion. Rather, what primarily animates my commitment to public service, now as a Vice Chancellor and even more directly in my prior role as Counsel and Policy Director to Delaware Governor Thomas R. Carper,[7] is the continued worthiness of the liberal vision of a just society.[8] That vision, as I understand it, recognizes the need for a large sphere of life that is immunized from government intrusion. Importantly, for present purposes, that sphere includes the realm of commerce, which should largely be free to be conducted through the voluntary operation of markets.

The liberal vision is not an irrationally rosey one, that pretends that the unfettered pursuit of private advantage inevitably leads to optimal outcomes. Instead, that practical, realistic vision recognizes that there is no such thing as a free market in the state of nature, and that the unrestrained operation of markets does not maximize either societal wealth or happiness. Without appropriate regulation by the citizenry's duly elected representatives, the least ethical of businessmen will trash the environment, exploit workers, and steal from investors—thereby creating inexorable pressures for others to follow suit in order to survive. Just as the existence of government without a larger realm of private ordering leads to tyranny and oppression, so does private ordering without restraint lead to poverty, sharp class inequalities, and poor stewardship of our natural resources.

Much of what is most admirable about Europe, Canada, Japan, and the United States—what we might call the advanced, liberal

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[7]Governor Carper is now a U.S. Senator.

[8]I risk the term liberal, trusting that those capable of reading thus far are also capable of differentiating between the actual western tradition of liberalism and the caricature of the term drawn by some for electoral purposes (an unfortunate practice that, of course, is also used as to other appellations, like the term conservative). I use the term in a wholly non-partisan and descriptive sense as describing a broader philosophy embraced by most in the mainstream in the United States and Europe.

democracies[9]—rests in the balance we have struck between the need to allow market forces to operate with due freedom so as to generate innovation and wealth, with a commitment to protecting other, even more important, human values. We all went through a phase of economic development when smokestacks and open pipes fouled the air and water, when workers were grossly underpaid and overworked, when we exploited children for labor, and when there was no protection for those, who by misfortune or market cycles, found themselves unable to provide a dignified living for themselves. Despite our cultural diversity, all of our societies eventually came to the consensus view that those conditions had to be ameliorated through appropriate government action. To move to a more sustainable and humane capitalist model, our societies have, among other things, protected workers by guaranteeing their right to form unions, to be paid minimum wages, and to have reasonable working hours; by banning child labor; and by requiring that they be afforded safe working environments. To include the many in the blessings of prosperity, our societies have provided assistance to the unemployed, the working poor, the disabled, and the elderly. To protect the planet we are fortunate to inhabit, environmental laws were adopted to ensure that we can breathe clean air, swim in and drink clean water, and honor our duty to the other species that inhabit our planet.

If these measures fall short of the ideal, they have, over time, helped produce societies that, by any human measure, are remarkably decent. The many, and not the few, enjoy comfortable lives. There is a great deal of personal freedom and liberty.

But these achievements are now under threat. Many of those protections were adopted with the expectation that our domestically chartered corporations would largely compete with each other. Or, at most, that our home chartered corporations would compete with corporations in other nations operating under similar, humanitarian restraints. This did not necessarily mean that some nations, such as Japan, would not emerge with substantial comparative advantages.

But the gap was not so large, or so we hoped, that it would cause us to abandon our evolved standards. If we worked smarter, we could, or so we said, keep the high-margin, high-skilled work, and still maintain our impressive standards of living. But the hopeful notion that, through skills development alone, we will not sacrifice the social and economic progress our societies have made is now less obviously sound.

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[9] I do not mean to slight Australia, New Zealand, South Korea, or other nations that have earned this moniker. The nations cited are illustrative of what I ardently hope will be an ever-growing club.

As the nations of the developing world legitimately struggle to attain the same level of success as the liberal nations, they are putting pressure on our own standards of living. And when a nation whose government combines many of the predatory qualities of both mercantilism and communism—think China—sets out to dominate our markets, even the most efficient manager amongst us has reason to fear.

No matter how ingenious the manager or however productive the worker, it is virtually impossible to compete against workers who are paid pitiful wages, who work in factories that are not required to meet responsible environmental standards, and whose products (on top of those advantages) are deeply subsidized by their governments. And these workers are not just making low-end, simple products. They are making high value-added products using complicated manufacturing processes.

Recently, I read an article touting how wage inflation in China has increased wages at some factories to nearly $150 per month. Somehow, I didn't find that at all comforting. When I told that to a group of high-powered lawyers and investment bankers, they told me that U.S. and European workers simply needed to acquire better skills so as to be able to hold jobs that couldn't be exported into low wage nations. But, the blitheness of this response is belied by the fact that many X-rays taken in the United States are now read abroad by physicians who are paid a mere fraction of what American doctors make. As I speak, high rises in India are filled with Indian lawyers writing legal briefs and performing other legal work for American corporations at a pittance of what an American lawyer would charge. DuPont, my state's flagship science-based company, is moving research jobs to India, China, and Russia. For better ideas and to better serve customers abroad who need specific applied research tailored to their needs? To some degree. For cheaper access to high-powered brains? To be sure.

I raise the issue of globalization and its ramifications for the liberal experiment because it is a topic that should unite the United States and Europe. Neither of us can tackle it in isolation, or, indeed, without working with Canada, Japan, South Korea, and others to formulate a responsible path forward.

How, you might ask, does this relate to corporation law? Well, let me return to first principles. Our nations did not charter corporations to benefit solely investors. We chartered corporations for the interests of our societies as a whole.

The corporations our nations now charter increasingly face competition that plays by rules of the game that we, as a result of our enlightenment, no longer tolerate domestically—e.g., rules that tolerate manufacturers who pay substandard wages and immunize them from the

need to protect the environment or their workers' safety. In the face of this pressure, corporations chartered in our lands are increasingly choosing to move jobs from places that require protections of these kinds to places that do not. More and more, our corporations lack any sense of commitment to their nations of origin.

In this respect, American corporations are probably on the leading edge of being emotionally and ethically untethered from their home nation.

America's sharper focus on the best interests of stockholders helps explain this. If the way to become more profitable is to shift production from an environmentally sound plant paying relatively low wages in the United States to an unsafe plant, paying extremely low wages in China, American corporate boards will increasingly support that decision on the grounds that it is in the stockholders' best interest. If their companies want to sell to Wal-Mart, they might have no choice other than to do so.

In twenty years, when these companies have little domestic production left, the obvious question will arise as to why they need a U.S. CEO, U.S. lawyers, U.S. investment bankers, or even a U.S. charter. Already, many of the leading brand names in the United States are owned by non-U.S. firms. That is no doubt true in Europe, as well. As more and more corporations lose their special ties to particular nations and communities—through shifts in their regions of production and multiple mergers—the practicability of the advanced liberal democracies to demand that the corporations they have chartered adhere to evolved standards of corporate responsibility may wither.

The big picture economic returns in the United States over the last few decades already show cause for alarm. Returns to capital and CEOs have grown enormously, a reality reflected in the growing percentage of American wealth held by the wealthiest one percent of our nation's populace. Meanwhile, median family income has grown in a trifling way, and has probably fallen on a per worker basis, when the huge increase in two wage-earner households is considered. Overall, economic inequality is growing.

In this more than slightly digressive, some might say Fezziwiggian manner, I therefore pose the final big question which I commend for your consideration. That is this: Can the liberal democracies combine together to create a rational economic structure that protects our hard-fought achievements, while facilitating the increasing inclusion of other nations in our markets? I have no doubt that none of our nations will be better off operating behind closed economic walls—I am no protectionist—but I also

have little doubt that it is not in our best interests to sacrifice our humanitarian principles in the pursuit of cheap consumer goods.[10]

Working together, we have some chance of all going forward at the same time. Will the liberal democracies forge a path that simultaneously permits their citizenry to continue to enjoy the blessings of an enlightened approach to capitalism and that affords the developing world the chance to substantially increase its wealth? Or will we resign ourselves to the notion that the progress we seemed to have made must be abandoned in order to facilitate the flow of goods from wherever they can be most cheaply made?

What current sacrifices are we prepared to make to secure the prosperity of all of our children? Are the liberal democracies (particularly, the United States) prepared to reduce our use of the world's resources by operating more efficiently, in exchange for the enforcement of real labor and environmental standards that enable our workers to remain competitive, while being paid good wages?[11] Are we willing to relent on our protectionist ways in areas like agriculture, in order to facilitate the adoption of more enlightened standards by our trading partners? Should there be escalating tiers of trading blocks, access to the markets of which requires a progressively more rigorous adherence to enlightened labor and environmental standards? Are there other, non-protectionist means by which the advanced liberal democracies can exert concerted leverage to spread the bedrock labor and environmental standards we all have independently determined are a necessary component of a humane capitalist economy to the nations that want access to our markets?[12]

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[10]As a matter of history, it is of course true that so-called "free trade" has never existed. A truly "free" trade zone among the advanced liberal democracies would be the hugest in human history. I, personally, favor an ever-widening realm for free trade, but recognize that there are other important values at stake. We should aim for us all to go forward with the sunny optimism of a Reagan, but also with the vision of Franklin Roosevelt, who combined Reagan's high hopes for human progress with a keen understanding of the necessary role for regulation in a capitalist system, and the need for international cooperation in shaping a better future.

[11] The United States and Europe must lead by example. Our societies obviously went through periods when we callously disregarded the rights of labor and the integrity of the environment. We therefore must help the developing world make the same progress we did but with fewer externalities. In the case of the environment, for example, it is not clear that the earth can suffer the same degree of environmental spoilage (on a per capita basis) from the emerging nations as the United States and Europe committed in the nineteenth and twentieth centuries.

[12]The precise domestic and international means by which the advanced, liberal democracies should address the globalization of the world economy are obviously matters of great complexity and legitimate debate, and are beyond the scope of this address. The only core contention I advance here is the evident reality that the advanced, liberal democracies cannot address these phenomena effectively in isolation and that effective international collaboration on these issues of obvious concern to our societies is essential. Relatedly, I also venture the notion that our own experiences in developing capitalist systems that correct for market externalities and spread prosperity a bit more evenly should not be forgotten as we expand the world trading community.

These are the real fundamental issues on which the vibrancy of the liberal vision's future rests.

Never has the human race had more capacity to shape a prosperous future working together. And no person of sound mind can, in my judgment, believe that we have a rational alternative to doing so. We can have diverse approaches to handling the relationships between corporations and their stockholders—i.e., to corporation law as it is narrowly conceived in Delaware. But our corporations cannot serve the societal purposes for which they were originally chartered unless the liberal democracies collectively take a truly international approach to ensuring that the provision of decent, middle class wages and the responsible treatment of the environment are not death knells for corporate profitability. Just as we should globalize the world's economy in order to spread prosperity as widely as possible, so too must we globalize those policies that reflect our best ideals.