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Topics in Corporate Finance

The Quality of Corporate Law and the Role of Corporate Law Judges

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in cooperation with

Universiteit van Amsterdam
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Edited by
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Preface

Introduction

This volume brings together a selection of the papers that were presented on 20 March 2006 at the OECD 'Exploratory Meeting on Corporate Governance Related Dispute Resolution', which took place at the Stockholm Center for Commercial Law and the papers delivered at the Netherlands Ministry of Economic Affairs' conference on 'Delaware Comes to the Netherlands' which took place on 18 April 2006 in The Hague. The Stockholm Exploratory Meeting brought together leading scholars from Europe, Asia and the US and experts from both OECD and non-OECD countries to focus on specialized courts and arbitration as alternative mechanisms for resolution of corporate governance related disputes. The conference in The Hague attracted leading scholars and judges from the State of Delaware and the Netherlands to make contributions and give comments on the quality of corporate law and the role of specialized courts in their respective jurisdictions. While the conferences were organized separately, the topic of corporate governance and dispute resolution in Europe and the United States was addressed by scholars participating in both conferences and consequently the editors decided to organize this volume around that theme. The editors also included a number of articles published elsewhere that address the question how corporate governance related enforcement mechanism could be re-directed in the future.

Issue Coverage and Overview of Papers

The chapters are divided into three categories: (1) the policy framework on corporate governance and dispute resolution; (2) the Delaware approach to corporate law and adjudication; and (3) the role of specialized courts in the Netherlands and Italy.

The chapters in Part 1 focus on why effective enforcement is a key variable in a corporate governance regime and what particular dispute resolution mechanisms may be able to enhance the quality of enforcement in certain circumstances. The article by Louis Bouchez and Alexander Karpf canvasses the variations in enforcement practices in OECD and non-OECD countries, showing that jurisdictions that enjoy a sufficient number of high quality judges that understand the issues at stake, and act with reasonable speed and accuracy can help make good corporate law. The cost and benefits of different dispute mechanisms are considered in light of how they contribute to effective dispute resolution. They show, for example, why management has good reasons to select arbitration and other voluntary methods of dispute resolution to litigate intra-corporate disputes. Finally, they provide a synthetic account of the OECD Stockholm meeting, focusing on the qualities and categories of dispute resolution mechanisms, the role of arbitration in settling corporate disputes, with special reference to innovations taking place such as class actions in arbitration, the trade-offs between specialized courts and arbitration, and a summary of the OECD questionnaire in which 15 categories of corporate dispute resolution were ranked by participants and an assessment of the results.

The article by Jaap Winter contrasts the system of regulation and enforcement in corporate and securities law in Europe and the US, showing that a key distinction is between regulation at the federal/union level and regulation at state/member state level, with the distribution of powers – at both levels – being very different in the EU and US. In EU, the European Treaty has a special provision designed to protect the interests of shareholders and creditors against a destructive race to the bottom. The result is a set of EC company law mandatory directives that are not particularly facilitating or management-friendly. Recent EU reform measures have attempted to address the shortcomings of this regulatory pattern by introducing legislation which facilitates more cross-border choice and increases the options of rules from which companies can choose.

A second set of articles in Part 2 examines carefully the main components of the Delaware approach to corporate law and adjudication. In their article, William W. Bratton and Joseph A. McCahery identify two stable equilibriums that characterize corporate federalism in the US: (1) state corporate law's enabling structure changed little over the 20th century; and (2) national corporate law regulation covers the securities markets and mandates transparency respecting firms with publicly traded securities while internal corporate affairs are left to the states. Bratton and McCahery then go on to show that in the evolving pattern of lawmaking, the federal system mandates while Delaware consistently favors self regulation. Their analysis suggests that: (1) federal intervention into internal affairs is inevitable because Delaware follows an evolutionary stable strategy that constrains its ability to respond to shocks that create national political demands; (2) national interventions are structured so as to leave the rent-driven state equilibrium undisturbed; (3) the cooperative federal strategy has come to respond to political demands on shareholder value; (4) the state equilibrium's second-best quality has no bearing on corporate federalism; and (5) the threat of federal intervention has sunk into the deep constitutional structure, leaving Delaware safe in the present context.

In his article, Justice Jack B. Jacobs explores the role of the Delaware Court of Chancery in resolving complex business disputes in a timely and effective manner. He shows that this was not always the case, arguing that only during the 20th century did the Court of Chancery develop the necessary degree of expertise in business and corporate law matters. Justice Jacobs considers the factors influencing this shift in policy, finding that the large number of publicly-listed companies were (and continue to be) incorporated in Delaware which seems to have account for the Court of Chancery becoming the most important court for resolving corporate governance disputes. He goes on to argue that the decisions of the Delaware Court of Chancery and Delaware Supreme Court are widely influential in shaping the development of American corporate governance practice, as reflected in the recent cases of *Hollinger International, Walt Disney Company* and *News Corporation.* Justice Jacobs juxtaposes the Delaware Court of Chancery's record in successfully resolving corporate disputes with the admirable record of the Netherlands Enterprise Chamber in successfully addressing intra-corporate conflicts.

In his article, John L. Reed focuses on the role played by 102(b)(7) of the Delaware Corporate Law, which permits firms to include in their certificates of incorporation provisions that curb or limit liability of their directors for breach of fiduciary duty, in cases involving claims of misconduct by directors. Having examined the history and background of section 102(b)(7) in respect of waste and disclosure claims, Reed shows that acts or omissions 'not in good faith' are unprotected by a corporation's exculpation provisions. This leads Reed to interpret the meaning of the 'good faith' standard under recent Delaware case law, which he suggests cannot be generally defined but is determined by reference to context. He suggests that the general point that the 'definition of "good faith" is necessarily broad and flexible, acting as a component of loyalty, while also implicated in certain duty of care violations.' Finally, he reviews both the Delaware case law dealing with the abdication of duty and lack of oversight in non- §102 (b) (7) and non-Delaware case law, finding that the courts are moving in the direction of greater accountability for directors in the oversight of their companies and the duty of good faith is likely to play an increasing significant role.

A third set of articles addresses respectively the company law jurisprudence of the Dutch Supreme Court, the function of Enterprise Chamber in the Netherlands and the role of Milanese corporate law judges in Italy. In his article, Levinus Timmerman examines the role of 'contextualism' in judicial decision-making, which, unlike the use of other doctrinal instruments, ensures that judgments are made based on the circumstances of a case. This leads Timmerman to argue that the Netherlands Supreme Court will often rely on contextualism when resolving corporate law conflicts. Timmerman goes on to explain how the principles of reasonableness and fairness, which are embedded in Dutch company law (Book 2, sections 8-9 of the Civil Code), play a key role in stimulating the use of contextualism by the courts. This can be seen, for instance, in respect of the Dutch Supreme Court decisions which take into account all relevant considerations when deciding cases implicating section 9 regarding the liability of board members. Timmerman then goes on to trace the importance of the Dutch inquiry procedure, which allows shareholders holding 10% of the nominal capital of a company with a means to enforce fiduciary duties, to investigate cases of mismanagement. While the inquiry proceeding does not deal with the liability of directors, the result of an investigation may lead to: (1) the suspension of annulment of board resolutions; (2) suspension or dismissal of board members; and (3) the temporary appointment of new board members. Decisions of the Enterprise Board are subject to review by the Dutch Supreme Court. Interestingly, the Dutch Supreme Court has found that some of the decisions of the Enterprise Board involving takeover defenses insufficiently contextual and have applied a proportionality test similar to that developed in Delaware case law.[1]

Maarten Kroeze explores the similarities between Delaware and the Netherlands, focusing on the fundamental role that specialized courts play in the development of corporate governance in their respective jurisdictions. Kroeze identifies the advantages of specialized courts, including their ability to: (1) resolve conflicts more efficiently and effectively; (2) pro-

1 See *Revlon, Inc v. MacAndrews & Forbes Holding Inc.,* 506 A.2d 173 (Del. 1986).

mote accuracy and predictability; (3) devote more time to individual matters; (4) determine more effectively the key issues of the case; (5) reduce the case load of general courts; and (6) yield a higher number of settlements than general courts. Conversely, there have been criticisms targeted at specialized courts, including the charges that they are: (1) immunized from new ideas and hence less responsive to change; (2) encourage lawyers to become narrow specialists making them less effective before general courts; (3) adversely influenced by organized interests; and (4) given more judicial resources at the expense of other areas of the law. Turning to the Dutch Enterprise Chamber, Kroeze argues that its success is largely due to the ability of professional judges and lay people to review written documents and defenses, conduct hearings in a speedy and effective manner and deliver timely decisions. Moreover, he points to the consistency of the decisions of the Enterprise Chamber which, notwithstanding their commercial importance, are made taking into account all relevant considerations. It seems that the Enterprise Chamber is comprised of a well-organized, highly professional group of justices and professionals that are committed to high quality results. Like the Delaware Court of Chancery, the Enterprise Chamber is less interested in formal or technical matters, focusing directly on the pivotal issues necessary to decide a matter. Finally, he concludes that despite the criticisms made against the Enterprise Chamber, the benefits of the Netherlands specialized court clearly outweigh the costs.

In his article, Marius W. Josephus Jitta take a different approach to evaluating the performance of the Enterprise Chamber. Having reviewed the role of the Enterprise Chamber and the inquiry proceeding, he goes on to evaluate the effectiveness of the court in resolving complex corporate disputes. To this end, Josephus Jitta examines recent case law of the Enterprise Chamber from *EVC* to *Begemann,* which involved alleged claims by minority shareholders against management actions made by a listed company to their detriment. Very few of these applications actually led to a hearing (due to withdrawal, settlement talks, etc). Josephus Jitta goes on to note that this sample is fairly representative of the applications for an inquiry, noting that few companies have the time or inclination to endure the three stages of an inquiry proceeding. Indeed, he argues that in the cases where the Enterprise Chamber has, for example, ordered the appointment of an independent member to the supervisory or management board of a company, as a means to resolve specific issues and devise remedies, the associated risks and costs to a firm with respect to such interventions may be disproportionately high, particularly if the market context is especially fluid as in the case of *Versatel.* Finally, he makes some more general points about the potential risks that the Enterprise Chamber may face in the future. This leads Josephus Jitta to suggest that the enhanced jurisdictional scope and resulting increased case load may eventually force the Court to review its composition and the number of applications accepted.

Luca Enriques considers the effectiveness of the Milan Tribunal, Italy's most specialized court in corporate law matters, by reviewing a sample of its recent decisions. Enriques argues that a judge's quality can be evaluated in terms of: (1) their level of deference to insiders; (2) their ability to focus on the key underlying issues before them; (3) the degree of formalism in their decisions; and (4) the concern they have for the effect of their decisions on other corporate actors. In evaluating the quality of Italian corporate law judges, Enriques sampled 123 judgments published by the Milan Tribunal between 1986 and 2000 involving actions: (1) brought according to Article 2388 of the Italian Civil Code to nullify shareholder resolutions that a shareholder has not voted for, if they violate the law or the corporation's bylaws; (2) shareholders challenging board of director resolutions; (3) liability suits lodged by the corporation against the directors outside bankruptcy; (4) individual shareholder liability suits brought against directors; and (5) suits brought according to Article 2409 brought against companies for granting approval of false annual accounts. In reviewing these cases, he found: (1) the Milan Tribunal issued a disproportionately high number of favorable rulings in favor of insiders; (2) the substantive dispute is not often revealed or taken into account by the court; (3) decisions of the court reflect a degree of formalistic reasoning; and (4) judges are not particularly concerned with the effects of their decisions, as there is no established doctrine of *stare decisis* in Italian law. Enriques then turns to suggest that an evaluation of competing corporate law regimes would probably lead to similar results. Against this background, he suggests that policymakers should focus on a number of law on the books reforms, including a revision of corporate law provisions making it easier for minority shareholders to challenge self-interested transactions, forcing courts to address the rights and wrongs in each case. Finally, his analysis suggests that it might be desirable for corporate law judges to be assigned to work exclusively in the area and receive specialized training.

The chapters in this collection offer a variety of insights on the need for effective enforcement for a well-functioning corporate governance system. As such, we hope that the papers published in this volume will improve our understanding of corporate governance dispute resolution mechanisms.

Louis Bouchez
Marco Knubben
Joseph A. McCahery
Levinus Timmerman

August 2006

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Prologue

Opening Speech: Ministry of Economic Affairs Conference: 'Delaware Comes to the Netherlands'

Ladies and Gentleman,

Welcome to this conference dedicated to the Delaware Model of Company Law. A special welcome to our American guests, the judges of the Delaware Chancery Court. In recent years officials of the State of Delaware have been quite busy spreading the Delaware success story across the world. But this is one of the first times the judges of the Delaware Chancery Court have come to the Netherlands. We're very happy to have you here.

The conference is entitled, 'Delaware comes to the Netherlands'. This reminds me that about 400 years ago the Netherlands came to Delaware. The first European settlement in Delaware was founded in 1631, near the present town of Lewes. Its name was Zwaanendael, Dutch for Swansdale. The population of Zwaanendael consisted of 30 colonists from Hoorn, a town 90 kilometers to the north of The Hague.

To think that the Dutch were the first Europeans to reside in Delaware makes me proud about our common heritage. Rightly, the website of the State of Delaware carries the motto: 'It's good being first'. Personally, I agree. But I doubt if my fellow-countrymen from Hoorn were of the same opinion. Because within a year their settlement was raised by Indians and burned.

The Delaware Story

The Delaware motto, 'It's good being first', of course refers to the fact that Delaware was the first state to ratify the American Constitution in 1787. But by now the same motto could apply to your legal system. For the fifth year in row, the Delaware legal system topped the annual survey of the US Chamber of Commerce. Delaware's courts have a reputation of fairness and efficiency.

This contributes greatly to the attraction of Delaware as a location for doing business. More than half a million companies are legally registered in Delaware. And this goes for more than 50% of the companies listed on the New York Stock Exchange and NASDAQ. This means that Delaware has almost as many companies as people.

Delaware's attractive legal climate also has a positive effect on the state's economy. Growth rates are above the US average and unemployment is below the average.

No wonder the world is interested in the Delaware story. This includes the Netherlands in general and the Minister of Trade in particular. I already understood that having the best corporate legal system did not happen by accident. It was the result of a strategic choice of the Delaware government for servicing business. And years of hard work to put this choice to practice. This focus and determination has made Delaware the favored gateway to the US marketplace.

The Netherlands Story

For its part, the Netherlands regards itself as the 'Gateway to Europe'. Like Delaware, the Netherlands is strategically situated on the coast, on the estuary of major rivers close to large population centers. We have Rotterdam, the world's largest port. We have Schipol, the continent's third largest airport. And we have the most important internet node, the Amsterdam Internet Exchange. From the Netherlands you can easily reach 450 million customers across a unified European continent with a single market for products, and, in due course, services too.

We don't just have an excellent infrastructure, but we also have a well-educated multilingual labor force. Our universities rank among the best in the world. We have high-tech industrial corporations like AkzoNobel, ASML, Unilever and Shell.

According to the Economist Intelligence Unit, the Netherlands is the second best business area of Europe. So it's logical that many multinationals have based their European operations in the Netherlands. Among them are some 1,600 US firms. All in all, this makes the Netherlands, like Delaware, a small country with a big economic impact.

While the world has rightly looked up at what is known as the American Dream, my country has a compelling dream of its own. The Dutch Dream revolves around creativity, our liberal environment and the way we have integrated ourselves into the infrastructure of Europe and the wider world. This combination has allowed us to carve out a unique place in the world of business. We've established a culture in which creativity can flourish. Be it by the hand of Rembrandt, Van Gogh, Philips or Heineken.

Corporate Governance in the Netherlands

This is something else that did not come automatically. It took and will continue to require a lot of hard work. For example, we need corporate law that sets clear boundaries but at the same time gives companies great scope to excel. High-quality corporate governance and good, flexible corporate law are extremely important ingredients of an attractive business climate and for innovation in the Netherlands.

We've come a long way already. For listed companies we have the Tabaksblat Code. After one year of formal operation we can see that companies are adhering to the code. This is due to the fact that we did not adopt a 'one size fits all' approach. Instead of restrictive frameworks, we opted for a code that works according to the 'comply or explain' principle. Companies may deviate from the provisions of the code, provided that they give good reasons for doing so. This is crucially important when you have different companies operating in different markets at a different stage of development.

The Dutch government wants to avoid a situation where companies start to avoid risks because of the burdens of rules and regulations. Taking risks is inherent in doing business. It is precisely now that the innovative capability of companies is hugely important.

The improved corporate governance among listed companies has not gone unnoticed internationally. Various international surveys – including one conducted by Governance Metrics International – revealed a substantial rise in the rating of Dutch corporate governance. Indeed, we now top the league in continental Europe.

Company Law in the Netherlands

But good corporate governance for just listed companies is not enough. Therefore, we're working hard on a complete overhaul of corporate law and on making laws governing private limited companies more flexible. After all, a good business climate requires a good infrastructure for companies.

My objective is to strip away as far as possible the mandatory, statutory provisions covering our existing legal forms of enterprises. Instead, I want to make them as flexible as possible and conducive to enterprises. This will allow entrepreneurs to do what they do best and what they like doing: business.

You could say we're going to create a kind of menu of different legal forms of enterprises. A listed company will obviously be subject to 'stricter' rules than the bakery on the street corner. The big difference will be that enterprises will have greater freedom than in the past to pick the legal form best suited to them.

Efficient Judiciary

I referred to the quality of corporate governance and corporate law. But there is, of course, more to the story. An efficient judiciary can influence the quality of the legal environment in which firms operate and improve corporate governance accordingly, as the case of Delaware so brilliantly illustrates. For example, judges that have a reputation for honest and effectiveness are necessary for an effective corporate law system.

Yet, honest and efficiency may not be enough since a good legal system also requires access to justice for minority shareholders. Moreover, a coherent and well-developed case law is needed in the area of fiduciary duties to ensure to foster investor confidence.

Against this background, the Dutch Enterprise Chamber is a specialized court that has over the last 35 years resolved sophisticated infra-corporate disputes with much expertise and skill. Moreover, the Enterprise Chamber, like the Delaware Courts, has created a more investor-friendly environment by application of judicial standards and principles. The quality of the Enterprise Chamber, along with the recent reforms of Dutch company law, have led to increased optimism about the Netherlands among institutional investors.

Conclusion

Ladies and gentlemen,

This brings me to the end of my talk. Years ago, Delaware began amending its corporate law and establishing a fast and efficient legal procedure. This is why we asked this delegation to share their experiences with us.

Like Delaware, the Netherlands is committed to strengthening its business climate and making the country an attractive place to set up in business. We're doing this by improving our corporate law. It will make us more attractive, also in legal terms, as the 'Gateway to Europe' -not only for companies from other parts of the world.

I wish you all a very enlightening and interesting day. And I hope that in the near future Delaware and the Netherlands will share not only a history, but also a vision of corporate law.

Karien van Gennip
18 April 2006
Minister of Foreign Trade, Ministry of Economic Affairs
The Netherlands

PART I: POLICY FRAMEWORK

1 The OECD's Work on Corporate Governance and Dispute Resolution Mechanisms

Louis Bouchez and Alexander Karpf[1]

Corporate governance is fairly new as a public policy area, and experience with how to best design, implement and evaluate the regulatory framework is still limited. This also applies to corporate governance related dispute resolution. Corporate governance related dispute resolution covers those disputes that involve shareholders on the one hand, and the various company organs – typically the board and the executive management – on the other hand. Policymakers should consider what market participants request from dispute resolution mechanisms. Moreover, policymakers need information about the available range of different dispute resolution mechanisms, their respective pros and cons, and how they can complement each other in serving market participants. There is a demand from policymakers for a perspective on rules and practices, for them to understand the relative costs and benefits of different policy options, as well as to identify, assess, promote or re-direct existing policies in the field of corporate governance related dispute resolution.

This paper reports on the OECD's work in the field of corporate governance and dispute resolution. Part I describes the background to the OECD's work on corporate governance and dispute resolution and Part II contains the synthesis note of a recent expert meeting which focused on specialized courts and arbitration as alternative mechanisms for resolution of corporate governance related disputes.

1.1 Part I - General Considerations

1.1.1 *Introduction*

When the OECD Principles of Corporate Governance were revised in 2004, a new chapter on the structure and quality of the regulatory framework was added. An important reason for introducing this chapter was to stress the need for effective enforcement, which increasingly is seen as an important element for a well-functioning corporate governance system. A crucial prerequisite for successful civil enforcement is the availability of efficient mechanisms for dispute resolution, be it through the regular court system, specialized courts, mediation, panel rulings or arbitration. (Administrative enforcement, in particular, by securities regulators, and criminal enforcement are also important elements of enforcement in the

1 The views expressed in this paper are those of the authors and do not necessarily represent the opinions of the OECD or its Member countries. The authors would like to thank the participants in the Exploratory Meeting on Resolution of Corporate Governance Related Disputes, organised by the OECD and the Stockholm Center for Commercial Law, on 20 March 2006 in Stockholm, for their time and expertise which has proven a substantial source of information for this paper. Special thanks are due to Mats Isaksson, Head, Corporate Affairs Division OECD and Professor Joseph McCahery, Professor of Corporate Governance and Innovation University of Amsterdam, Amsterdam Center for Law and Economics, for their useful comments on earlier versions of this paper and Mr. Gunnar Nord and Mr. Robert Ohlsson, both partners with Företagsjuridik Nord & Co, Stockholm, for their helpful suggestions.

area of corporate governance, but usually less so in the field of dispute resolution.) The preferred form of dispute resolution will depend on a variety of factors, including the character of the dispute, the parties involved and the importance that the parties attach to issues such as speed, cost and transparency.

1.1.2 Civil Enforcement – Context

Participants in the debate on corporate governance generally agree that enforcement is a crucial component of good corporate governance. Research on the external factors conductive to good governance (implementation, policy approach, enforcement culture, quality of courts) is growing fast worldwide. There are substantial variations in enforcement practices and the rules designed to enforce governance measures across countries. Effectiveness in enforcement tends to vary depending on: (1) ownership structure; (2) management entrenchment; (3) legal infrastructure. There are a number of challenges in evaluating the enforcement and dispute resolution environment:

a) A well developed corporate governance system does not necessarily ensure effective enforcement;
b) There may be a number of regulatory institutions necessary to ensure effective enforcement; and
c) An effective enforcement regime needs to facilitate civil actions by shareholders, supported by an adequate legal infrastructure that supplies sufficient incentives for parties to bring civil actions.

In relation to enforcement the OECD Principles state that

> 'The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.'

The annotations to this principle point out that,

> ' …a distinction can usefully be made between ex-ante and expost shareholder rights. Ex-ante rights are, for example, preemptive rights and qualified majorities for certain decisions. Ex-post rights allow the seeking of redress once rights have been violated. In jurisdictions where the enforcement of the legal and regulatory framework is weak, some countries have found it desirable to strengthen the ex-ante rights of shareholders such as by low share ownership thresholds for placing items on the agenda of the shareholders meeting or by requiring a supermajority of shareholders for certain important decisions.
>
> One of the ways in which shareholders can enforce their rights is to be able to initiate legal and administrative proceedings

> against management and board members. Experience has shown that an important determinant of the degree to which shareholder rights are protected is whether effective methods exist to obtain redress for grievances at a reasonable cost and without excessive delay. The confidence of minority investors is enhanced when the legal system provides mechanisms for minority shareholders to bring lawsuits when they have reasonable grounds to believe that their rights have been violated. The provision of such enforcement mechanisms is a key responsibility of legislators and regulators.'
>
> 'There is some risk that a legal system, which enables any investor to challenge corporate activity in the courts, can become prone to excessive litigation. [...] In the end, a balance must be struck between allowing investors to seek remedies for infringement of ownership rights and avoiding excessive litigation. Many countries have found that alternative adjudication procedures, such as administrative hearings or arbitration procedures organised by the securities regulators or other regulatory bodies, are an efficient method for dispute settlement, at least at the first instance level.'

The discussion about effective enforcement and efficient means of dispute resolution has been particularly prominent in the Regional Corporate Governance Roundtables that the OECD organizes around the world with the support of the World Bank Group and the Global Corporate Governance Forum. The prime task of the Regional Roundtables is to raise awareness, provide an exchange of experiences and to formulate concrete policy recommendations for reform. Based on these discussions it appears that regarding civil enforcement in non-OECD countries there is a particular need to address some key institutional weaknesses, i.e.:

a) an insufficient number of judges,
b) a judiciary lacking the necessary skills, and
c) the need for more expeditious decision taking by judges.

In order to accomplish effective law enforcement, the deterrence function of reputational damage for board members and senior management through media coverage is recognized by policymakers to be important. Therefore, and apart from arbitration, specialized courts or mediation, the role of the media also needs to be considered in this context. Through their extensive coverage of law suits brought against management and boards over the past few years, the media in many countries have proven to be very powerful in exercising their deterrence function.

1.1.3 Civil Enforcement – Costs and Benefits

While enforcement can occur via criminal enforcement, administrative enforcement (including regulatory action) or by civil enforcement, the quality of enforcement will depend largely on certain common factors, such as the level of political will, the resources available to prosecute cases, the (level of) incentives and the quality of the legal infrastructure. These different enforcement mechanisms have their respective costs and benefits. When policymakers consider different enforcement mechanisms, a distinction can be made between five main types of costs:

a) policy design costs,
b) policy implementation costs,
c) enforcement costs,
d) compliance costs, and
e) disclosure costs.

Regarding the benefits of enforcement mechanisms, a number of factors have to be considered by policymakers in their analysis, such as speed, quality, transparency or predictability.

As regards civil enforcement, different dispute resolution mechanisms have also their own typical costs and benefits. For example, in voluntary dispute resolution mechanisms such as arbitration or mediation the state does not bear surveillance nor investigation costs, only the policy design and implementation costs, and to a limited extent enforcement costs. For companies there are in particular compliance and disclosure costs.

1.1.4 Arbitration of Company Law Disputes

In 2003 the OECD, together with the United Nations Commission on International Trade Law (UNCITRAL) and the International Chamber of Commerce (ICC), organized two exploratory meetings in Vienna and Paris on arbitration of company law disputes. The meeting in Vienna focused on arbitration as a specific civil enforcement option. The conclusions can be summarized in five points:

a) arbitration of company law disputes is commonplace in many jurisdictions;
b) procedural and technical requirements can represent a trap for the unwary;
c) notwithstanding a clear trend favoring arbitration of company law disputes, its acceptance varies across countries;
d) arbitration of company law disputes involving publicly traded companies faces many more hurdles than arbitration of company law disputes involving privately held companies; and
e) notwithstanding the legal, policy and practical difficulties, a nascent trend supports wider use of arbitration of company law disputes, involving public companies and their shareholders.

The Vienna meeting also noted that the consensual/contractual basis for arbitration may require that a potentially very large and geographically dispersed group of shareholders would have to give binding consent. This group must also receive sufficient notice when the arbitration begins. Typically, shareholders in markets with a well developed, effective and reliable court system therefore prefer to litigate company-law disputes in courts rather than demand private arbitration. For company directors, the position is usually the opposite; the company directors would prefer to arbitrate. This preference on the part of company managers for arbitration can result in consent procedures that may be considered unconscionable because they: (i) are coercive; (ii) represent contracts of adhesion; and/or (iii) entail costs and inconvenience for retail investors or consumers that effectively deny them access to a dispute-resolution mechanism. In markets where the judicial system is less advanced or reliable, on the other hand, shareholders may prefer arbitration proceedings to national courts for reasons of capacity, competence and even-handedness. In such event, it may be sufficient for the company to commit itself to arbitration unilaterally, while providing shareholders with the option of choosing court adjudication.

But arbitration of company law disputes is not only a matter for the parties immediately involved. It can also be seen as a public policy matter where some commentators would argue that traditional judicial enforcement has an intrinsic value. Since it is unlikely that all shareholders in a widely held listed company will join an arbitration proceeding, questions also may arise about the legality of awards, particularly injunctive orders which affect non-parties.

Finally, on a practical level, there may be questions about the adequacy of arbitration for complex cases and the incentives of the plaintiffs' attorneys to pursue claims before an arbitration tribunal.

1.1.5 Beyond Arbitration – Specialized Courts

Research has concluded that also other 'alternative' dispute resolution mechanisms than arbitration can be effective and, as set out above, that arbitration sometimes can have certain disadvantages. Therefore in considering the different policy options for corporate governance and dispute resolution it may be fruitful to extend the analysis beyond arbitration. In particular the role of specialized company (or business) courts could be considered as a means of establishing a well functioning corporate governance system. Also in an era with a growing amount of national corporate governance codes it will be important to understand the remit, role and judicial powers of various 'committees', 'panels' and 'chambers' monitoring interpretation and compliance with these codes.

1.1.6 Directions for Future Work

The OECD's future work on corporate governance and dispute resolution focuses on how various forms of dispute resolution can complement each other in contributing to effective redress and enforcement. The objective is to make an 'inventory' that identifies the merits of various approaches to dispute resolution in corporate governance related disputes. Such an inventory could usefully be complemented by commentaries about applications and practical experiences. The inventory was one of the topics discussed during the recently organized expert meeting on corporate governance related dispute resolution, a summary of which is included in Part II.

1.2 Part II - Exploratory Meeting on Resolution of Corporate Governance Related Disputes Stockholm, 20 March 2006 – Synthesis Note

1.2.1 *Introduction*

On 20 March 2006 the OECD together with the Stockholm Center for Commercial Law, and with the support of the Government of Japan, organized the 'Exploratory Meeting on Corporate Governance Related Dispute Resolution'. The meeting brought together 25 experts from around the world, representing both OECD and non-OECD countries, public and private sector, as well as (non-governmental) international organisations. The meeting was organized to explore the policy options, including the trade-offs, for policymakers in non-OECD countries who will have to design a dispute resolution framework for corporate governance related disputes in listed companies. Identifying and comparing the merits of different dispute resolution options in the areas of company law and corporate governance beyond the traditional mainstream judiciary system is one way of doing this. The need for non-traditional (or specialized) means of dispute resolution and interpretation has also announced itself with the emergence of various types of corporate governance codes, whose 'ownership' and enforcement may sometimes be unclear. Fundamental questions regarding these sources of corporate governance regulation remains: what happens if they are being breached by market parties? Is (or should) there (be) a body that takes care thereof? What judicial redress do shareholders have in such case? The meeting focused on two alternative mechanisms, i.e. (i) specialized courts, and (ii) arbitration.

One of the reasons why the topic has become more important today is the rise of shareholder activism. In particular institutional shareholders are now common all over the world; often they represent individuals whose pensions and savings amongst others depend on structural corporate governance reforms. That is the reason why there is a need to consider the regulatory framework regarding this topic. In the search for better regulation, rather than more regulation, the prevailing question from an economic perspective should be who should bear the costs. From a legal perspective other considerations may play a role.

In the morning sessions first the topic of specialized courts was introduced by representatives from two jurisdictions having successful specialized enterprise courts, i.e. Delaware with its Chancery Court and the Netherlands with its Enterprise Chamber. Subsequently arbitration as a means of resolving corporate governance related disputes was discussed by representatives from the international organizations setting the standards and framework on this specific topic, i.e. UNCITRAL and the ICC. Participants engaged in a true debate on the pros and cons of both specialized courts and arbitration, but also discussed alternatives beyond the two mechanisms. They explored for example the role of mediation and moreover the media in corporate governance related dispute resolution.

1.2.2 *Session 1: Setting the scope of the topic; Corporate Governance and Dispute Resolution – a Public Policy Perspective*

Background

The conference program was originally designed as a response to the OECD's Regional Corporate Governance Roundtables (which bring together (mostly) non-OECD countries) that underscored the central role of enforcement in corporate governance. Participants in Roundtable discussions have emphasized that although much has been achieved in raising awareness and in putting in place improved rules and procedures, real progress remains frustrated by poor regulatory and judicial enforcement.

Beyond Arbitration

Research has concluded that also other dispute resolution methods than arbitration can be effective and that arbitration sometimes can have certain disadvantages, in particular the fact that arbitration is contractual in nature. Arbitration in company law disputes therefore requires parties to the arbitration to have signed up for arbitration in advance. This also explains why disputes involving joint venture agreements and closed companies are more suitable for arbitration than those involving listed companies. Therefore in considering the different policy options for corporate governance and alternative dispute resolution it may be fruitful to include, but not limit, the analysis to arbitration. In particular the role of specialized company (or business) courts should be considered as a means of establishing a well functioning corporate governance system. Also in an era with a growing amount of national corporate governance codes it will be important to understand the remit, role and judicial powers of various 'committees', 'panels' and 'chambers' monitoring interpretation and compliance with these codes.

Categories of Disputes and Qualities of Dispute Resolution Mechanisms

Dispute resolution in corporate governance is an element of corporate governance enforcement and thus fits in the 2004 OECD Principles. The focus of the meeting has been on corporate governance related disputes between shareholders on the one side and other corporate bodies (e.g. boards) and stakeholders (including creditors) on the other side.

Issues discussed included the spectrum of judicial redress possibilities, the categories of disputes as well as the qualities of the dispute resolution mechanism sought for in case of corporate governance related disputes. Further issues include the costs versus benefits consideration, the problem of lawmakers also being law enforcers and the fact that a corporate governance *problem* is not the same as a corporate governance *dispute*. In order to assess the wide variety of possible alternatives presenters and discussants were invited from different legal traditions (Anglo-Saxon versus civil law) and different jurisdictions, both from OECD and non-OECD countries, as well as from different international institutions.

1.2.3 *Session II: Corporate Governance and Dispute Resolution - the role of specialized courts in settling corporate governance disputes*

The Chancery Court of Delaware

The first presentation was about the role of specialized courts in resolving corporate governance disputes in the United States and the European Union and primarily dealt with three issues: (i) the historical experience of the Delaware Chancery Court in dealing with corporate governance related issues and the wide impact of its decisions within the US and beyond, (ii) developments within the EU regarding specialized courts, and (iii) the possible lessons to be learned by EU policymakers from the Delaware and Netherlands' experiences with specialized courts. The presentation also addressed some of the recent high profile decisions, such as the Disney case and the Hollinger case. As a concluding remark it was stressed that the ability to make quick decisions and to to express its reasoning in appellate quality opinions are the key qualities of the Delaware Chancery Court. The two reasons why it can do so are: (a) its limited jurisdiction leads to a relative lower case load than other courts, and (b) the culture or 'esprit de corps' of opining in an expedited manner.

The Netherlands' Enterprise Chamber (Ondernemingskamer)

Subsequently the role and functioning of the Netherlands' equivalent of the Delaware Chancery Court, i.e. the Enterprise Chamber, was discussed. Three questions were dealt with, (i) which corporate governance cases are assigned to the Enterprise Chamber?, (ii) why has the Enterprise Chamber become so popular?, and (iii) how did the Enterprise Chamber help develop the Dutch corporate governance policy framework? The presentation underlined the reasons for the success of the Enterprise Chamber (such as expedience and less formalism), however, also reference was made to the threat that specialization of courts may seclude them from society and developments in other areas of law.

Observations

In immediate response to the two presentations participants raised several relevant considerations. Experiences from Russia and Ukraine show that procedural rules still often prevail. The judiciary still works very formalistic. Although there is a tendency to specialization within courts, there is not yet a focus on corporate governance related disputes in either Russia or Ukraine, but indeed a related topic such as tax is now specifically being focused on by courts. In relation thereto it was mentioned that there is a risk for transition economies when focusing on specialized courts since this may shift attention away from other, probably bigger, problems such as corruption. Also within such transition economies special interest groups may have too big an influence on specialized judges which may increase the threat of corruption. Moreover it was mentioned that transition economies have to address the question of what to spend their limited resources on. Therefore there will be a need to further explain the incentives for, and benefits of, setting up specialized courts. A comment was also made on Japan where some district courts allot certain types of cases to specialized divisions within the courts, which might be an example of *de facto* specialized courts as opposed to statutory specialized courts. Moreover it was stated that transition economies will likely have some difficulty in justifying a separate specialized court to deal with corporate governance disputes; however, these countries might benefit from the establishment of a commercial division of the general courts in the major commercial centers. Such special division could timely handle commercial matters important to that locality including corporate governance disputes.

1.2.4 Session III: Corporate Governance and Dispute Resolution – the role of arbitration in settling corporate governance disputes

UNCITRAL

The role of United Nations Commission on International Trade Law (UNCITRAL) in the area of arbitration was the next topic of a presentation. UNCITRAL is well known for the model arbitration law and standards it develops in different areas of law. Active participation of the private sector is characteristic of the work of UNCITRAL. Standards developed by UNCITRAL are non-binding.

In itself it is not clear whether corporate governance fits in the mandate of UNCITRAL. If UNCITRAL would embark on a corporate governance effort on dispute resolution, its previous work should be considered, in particular the 1958 New York Convention and the 1961 European Arbitration Convention. Moreover the 1976 Arbitration Rules have proven to be useful since a number of arbitration centers around the world function on the basis of these rules.

The specific challenge with corporate governance related disputes is the question of arbitrability. Why are such disputes often not readily arbitrable? The Model Law might need to be amended (in order to broaden its scope) to facilitate the specific needs for corporate governance related dispute resolution. UNCITRAL may wish to play a more important role on corporate governance by developing guidance on this topic for its member countries.

ICC International Court of Arbitration

The ICC International Court of Arbitration subsequently first addressed the issue of why parties are interested in private dispute resolution instead of genuine courts. Some of the arguments include: (i) impartiality and neutrality; (ii) speed; although arbitration tends to become more lengthy, the limited number of instances before a final opinion is granted, remains a strong advantage; (iii) costs (control over fees); (iv) confidentiality; (v) flexibility of proceedings (in particular the informality and scope); and (vi) the opportunity for parties to appoint the arbitrators. The enforcement of arbitration awards often remains a challenge.

The ICC is a not for profit organization set up to promote international trade. Over the past five years 20% of company law related disputes settled within the ICC context concerned corporate governance related disputes. Example cases include (i) valuation of shares; (ii) disputes between shareholders; (iii) remuneration of boards; (iv) bankruptcy related disputes; (v) shareholder participation in decision making processes; and (vi) takeovers.

Alternatives to arbitration may be: (i) specialized dispute boards, (ii) expert appointments, or (iii) alternative dispute resolution such as pre-arbitration referee decisions. In the end arbitration leads to a binding decision as opposed to some of the aforementioned alternatives. It should be noted that there is also a distinction between institutional and *ad hoc* arbitration. Institutional arbitration is perceived as giving parties more guarantees, in particular in the field of confidential treatment of disclosed information. Fraudulent schemes are in general easier to detect in institutional arbitration than in *ad hoc* arbitration. In each form transparency of proceedings is of the essence.

Finally, the issue of multiparty arbitration was addressed. This has shown still to be a challenge: how to arbitrate in case of multiple parties; in this context reference was made to the recent adoption of arbitration by Shell in its articles of association as the exclusive dispute resolution mechanism. It was mentioned that in cases such as the Shell example one will also have to deal with how various jurisdictions treat articles of association of a company; is it a binding compact only on incorporators or is it binding on all original plus any new shareholders by transfer of title? Or is there another treatment in a particular jurisdiction.

Observations

Participants noted that arbitrability of corporate governance related disputes remains the key challenge. In particular to obtain an arbitration agreement in case of a corporate governance related dispute seems to be difficult. It appears that for example either in Japan or East-Asia no corporate governance related dispute, or notable one, at least, has until now been decided upon by arbitration. Indeed arbitration may only succeed in case parties already agreed thereto prior to the rise of a corporate governance dispute. In practice this prior agreement still remains a problem; also because of poor drafting of arbitration clauses, as experience from the Stockholm Arbitration Center has shown.

Recently some interesting concepts in the field of arbitration have been developed. In the US the concept of class action in arbitration is now introduced; moreover interim measures during the arbitration proceedings are also being developed by the ICC in order to make the arbitration process more attractive. In general it should be noted that although arbitration is rapid, it is not rapid enough at the outset of a case; in courts judges are ready to start proceedings while in arbitration the proceedings leading to the actual arbitration often take a lot of time. Arbitration institutes should acknowledge this issue and find a solution. In this context reference was made to the Canadian example where some courts are designed to specifically facilitate rapid decision making by the judiciary.

On a fundamental note it was mentioned that in particular developing countries should address the issue of arbitrability in their statute in order to secure that arbitration indeed is permitted as a means of private dispute resolution.

In relation to the procedural difficulties accompanying arbitration reference was made to mediation as a potential alternative. It was stated that although the average length of ICC arbitration is about two years, mediation until now has proven to be in (the ICC) practice a very complex process. Also in particular share valuation is becoming more often a topic submitted to binding expert advice as alternative to arbitration.

In conclusion it was stated that the issue of arbitrability of corporate governance related disputes should be a topic for UNCITRAL to elaborate on.

1.2.5 Session IV: Specialized Courts or Arbitration? Trade-offs for the Resolution of Corporate Governance Related Disputes

Background
This session dealt with the trade-offs between specialized courts and arbitration for the resolution of corporate governance related disputes. What would be the most effective mechanism to resolve corporate governance related disputes? Identifying the trade-offs can be a useful tool to find an answer. A questionnaire on different categories and qualities of corporate governance related disputes drafted by the OECD Secretariat and circulated among participants prior to the meeting was the focus point for the discussion in this session.

Introductory Presentations
The afternoon session started with two introductory presentations on the issues set out in the questionnaire. Presenters considered the questionnaire as a good basis for approaching the issues related to the resolution of disputes related to corporate governance and in particular for developing an inventory or toolbox of the different options in this field. As to the role of arbitration and specialized courts, it was stated that they should be seen rather as complimentary than exclusive mechanisms, as each of them had advantages but also disadvantages. Reference was made to the positive experiences with specialist courts or quasi-courts in the field of complex corporate governance issues, such as takeover cases, and to the shortcomings in relation to transparency and creation of case law as regards arbitration proceedings. Moreover it was suggested that in the policy-making process consideration should be given to the substantial differences of purely domestic and cross-border disputes, as well as to the different needs of developed and developing countries. Setting up specific corporate governance panels may be a good alternative to each of arbitration and specialized courts, bringing together the goods of each of these mechanisms; such dedicated body might well serve effectively the purpose, which in the end should be the overall driver.

The next presenter stressed that arbitration should not be regarded as a substitute for necessary reforms of the judiciary, which should be an absolute policy priority in particular in emerging markets. Reference was made to some of the supposedly positive characteristics of arbitration (such as speed and the perceived cost-effectiveness), but the numerous shortcomings of arbitration were also stressed, especially in the context of less-developed economies (e.g., enforceability of arbitration awards, especially, when the non-prevailing party to a dispute was a state body; multiparty disputes; limited publicity as to bad corporate governance which was crucial for raising awareness on corporate governance issues among small shareholders). A suggestion was then made to have auditors have a prevalent role in the resolution of corporate governance related disputes, especially in the prevention of such disputes in the first place, by auditing companies as to their compliance with corporate governance rules. Such 'corporate governance audit' could be carried out by lawyers or any person recognized as having sufficient expertise to do it. It would be best to have the corporate governance audit to be done by someone other than the company's financial auditors as this will secure greater independence and it can be carried out mid-year so the findings can be made in time to be followed up by the financial auditor.

Observations

In immediate reactions to the two presentations, it was stated that the OECD Corporate Governance Principles represented internationally accepted best practices and were intended to be benchmarks for both developed and developing countries, however, without either restricting the ways and means how adherence to them is achieved and safeguarded or advocating a one-size-fits-all approach. It was also said that businesses in many of the developing countries needed rapid solutions for effective dispute resolution (such as arbitration or specialized courts), since the reform of courts would take many years to come. In relation to arbitration, the problems related to the application or non-application of anti-trust rules in corporate governance related disputes were highlighted. The important role of auditors in preventing litigation was recognized (for example, in Sweden, corporate governance practices are part of a company's audit). However, many participants thought that auditors had only limited competence to solve disputes on an ex-post basis. Furthermore, the controversial role of auditors in recent accounting and auditing scandals was mentioned. Finally, discussants emphazised the importance of the media and institutional investors regarding corporate governance disputes, the former of which should therefore be the focus of educational efforts in this respect.

Questionnaire Outcomes - Categories and Qualities

The OECD gave a brief summary of the responses received to the questionnaire, in which 15 categories of corporate governance related disputes (Categories) and 15 qualities for the resolution of such disputes (Qualities) were set out. Each respondent had given a ranking among Categories and Qualities. The overall results were as follows:

a) as regards the Categories (see Box 1.), (i) self-interested transactions, (ii) minority-shareholder rights, (iii) takeover procedures, (iv) mismanagement, as well as (v) share valuation and (vi) nomination of board members, were considered as most important;

Box 1. Categories of Corporate Governance Related Disputes

Self-interested transactions; typical examples include: related party transactions, insider trading, conflicts of interest by board members, executives and senior management

Annual accounts; typical examples include: disputes between shareholders and the board and/or auditor over the (withholding of) shareholder approval

Nomination / appointment of board members; typical examples include: disputes between shareholders and the nomination committee and/or the board over nomination and/or appointment of board members/executives, as well as regarding the criteria for nomination/appointment

Remuneration / bonuses board members; typical examples include: disputes between shareholders and the remuneration committee and/or the board over remuneration and/or bonuses of board members/executives, as well as regarding the criteria for remuneration/bonuses

Share valuation; typical examples include: disputes between shareholders and the board and/or auditors on the valuation method in case of (a) squeeze out, and (b) share/bond issues

Takeover procedures; typical examples include: disputes between shareholders and boards regarding terms and conditions of a proposed takeover, and/or compliance with internal (articles of association) and/or external (listing rules, securities legislation etc.) rules

Disclosure requirements; typical examples include: disputes between shareholders and boards regarding compliance with (non-) financial disclosure requirements

Corporate control (in M&A transactions); typical examples include: disputes between shareholders and boards regarding a proposed acquisition or disposal of a substantial part of the company's assets

Minority shareholders rights; typical examples include: disputes between majority shareholders and minority shareholders in squeeze out scenarios or on nomination / appointment of board members

Bankruptcy / suspension of payments; typical examples include: disputes between shareholders and/or bondholders and boards and/or receivers in corporate restructuring

Share / bond issues; typical examples include: disputes between shareholders / bondholders and boards on dilution issues

Discharge of individual board members / executives; typical examples include: disputes between shareholders and board members / executives on individual discharge regarding their performance in the past fiscal year

Mismanagement; typical examples include: disputes between shareholders and boards on supposedly mismanagement of the company

(Non-) compliance with corporate governance codes; typical examples include: disputes between shareholders and boards on the application of 'comply or explain' principles as provided in corporate governance codes

Works' council; typical examples include: disputes between shareholders / boards and works' councils on the interpretation and applicability of works' council legal corporate governance related rights

Source: OECD 2006

b) as to the ranking of Qualities (see Box 2.), (i) speed, (ii) quality, (iii) costs, (iv) enforceability and (v) effectiveness, were rated the most relevant by the respondents.

Box 2. Qualities for Corporate Governance Related Disputes Resolution Mechanisms

Speed
Quality
Transparency
Predictability
Costs
Consistency
Enforceability
Formalities
Clarity
Accessibility
Legitimacy
Effectiveness
Pro active
Appeal possibilities
Scope of judgment

Source: OECD 2006

Tour de Table

In the subsequent *tour de table*, participants had the opportunity to comment on the questionnaire as such and to provide the reasoning behind their ranking. More general comments referred to the need for clarification of some of the categories and qualities, the possible adding of further categories and qualities (e.g., deterrent effect), and the need for a flexible approach, since ADR mechanisms would not permit a clear-cut categorisation.

It was proposed that the experience gained in ADR in other areas, such as environment, should be taken into account, as well. It was also explained that arbitration was hardly used in Japan, whereas mediation, also by judges, proved very popular in the resolution of commercial disputes. Participants suggested that the assessment of the different dispute resolution mechanisms would have to take into consideration not only the legal framework but also the overall infrastructure in place (e.g., efficiency, experience, impartiality, costs). In this respect, shortcomings as to the correct application of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958 in a country were considered as having a damaging effect on this country's reputation and business environment, and should be brought to the attention of UNCITRAL. It was moreover discussed in how far the effectiveness of ADR mechanisms in developing countries could depend on the fact whether such a mechanism was demand-driven in that country or not. As to mediation, it was stressed that it could serve as a means for reducing tensions at an early stage and also that it could be particularly suitable for complex disputes.

A Centralized Specialized EU Corporate Governance Court?

Regarding the idea of establishing a centralized specialized EU court adjudicating corporate governance related disputes (or commercial disputes in general) in all Member States, participants referred to the numerous obstacles in this respect (in particular, different legal systems in Member States, ie common and civil law; conflicting approaches to the legal capacity of companies, ie seat and incorporation theory; and, more generally, the opposition from a number of Member States to further centralization at EU level). A more viable approach for the time being would therefore be enhanced co-operation and exchange of information between (specialized) courts across Member States.

The Swedish Securities Council

The role of the Swedish so-called 'Securities Council' in relation to the promotion of best practices as to corporate governance issues of listed companies (including takeovers) was explained in more detail. On request by a shareholder or company, this self-regulatory body, established in the 1970s, issues legally non-binding statements – *ex ante* or *ex post* – as to whether a behavior could be regarded as being in compliance with best practices of corporate governance, however without giving an interpretation of applicable provisions. The Securities Council is composed of a wide range of experts from different sectors (e.g., academia, banks, investment firms, law firms). So far, some 350 written statements, which are public if not requested otherwise, have been issued. A statement would not be given in hypothetical cases and in cases already or likely to be in front of courts. The Council has no sanctioning powers, but has a role supporting the Swedish Financial Regulator in sanctioning unlawful behavior in relation to takeover procedures. In the more than 20 years of its existence the Council has succeeded in avoiding any conflicts of interests. Finland is currently considering the setting up of a Finnish equivalent of the Securities Council.

Policy Considerations

With respect to the trade-offs between arbitration and specialized courts, the following policy considerations were considered relevant for a comprehensive assessment:

a) *Speed* of dispute resolution

b) *Impartiality of judges and arbitrators*: here, problems could arise if a company involved in a dispute is a major player in the country
c) *One case – one court*: all integral parts of a dispute should be dealt with by one court, which could pose difficulties in arbitration and specialized-court proceedings, where jurisdiction is usually restricted to specific matters
d) *Flexibility*: arbitration is likely to have more flexible procedures, so that arbitration could lose its appeal the more formalized arbitration procedures become
e) *Costs*: are costs to be borne by the non-prevailing party in all circumstances (e.g., in share-redemption actions involving small shareholders)?
f) *Consolidation of actions*: this could be regarded as a major drawback of arbitration proceedings, where parties either have to agree, or bylaws of companies have to provide for the possibility to consolidate similar actions into one single action
g) *Transparency*: in principle, full transparency should be the objective, but a more nuanced approach depending on the subject-matter could be advisable
h) *Evidence*: in this respect, powers of arbitrators would be limited, but this is not necessarily an issue of major relevance for the assessment
i) *Enforcement*: experience would show that in cross-border cases enforcement of arbitration awards was a simpler route
j) *Options*: who should decide on either of the options where to submit the corporate governance related dispute, i.e. to a specialized court or to arbitration?
k) *Settlement of cases*: consideration should be given as to whether courts or arbitration proceedings create opportunities for settling a dispute through mediation or other non-contentious mechanisms
l) *Justice, fairness and predictability*: regarding these criteria, courts might have an advantage

1.3 Closing Session; recommendations for next steps

Regarding the follow-up work to this meeting, participants considered further comprehensive analysis of these topics very important, including (i) procedural aspects of ADR mechanisms, (ii) substantive-law issues of company law, including the issue of arbitrability of corporate governance related disputes, and also (iii) constitutional requirements (e.g., as to the insertion of mandatory arbitration clauses for corporate governance related disputes into company statutes). In this respect, the regional OECD Corporate Governance Roundtables would provide a useful source of information and could also serve as a sounding board. The OECD work should ultimately result in an inventory of policy options, based on two legs, i.e. the analytical work and the collection of data (possibly using the Questionnaire).

Finally, participants of the meeting welcomed that the Global Corporate Governance Forum has been active in the field of mediation and would continue its support of the OECD's work on an inventory and toolbox of flexible (informal) solutions.

2 Corporate governance regulation and enforcement in the US and the EU

Jaap Winter

2.1 Introduction

In the past five years we have witnessed many changes in the regulation of corporate governance of listed companies. New rules have been introduced, existing rules have been amended and tightened and this has led to higher expectations on how the various parties involved in the governance of listed companies fulfill their roles. In the EU an interesting new combination has emerged of changes in legislation and new, non-binding practice rules in the form of a corporate governance code. Many questions have arisen as to the role of those non-binding rules.[1]

The European approach, based on a non-binding code, is quite different from the US response to the corporate governance scandals, as evidenced in the form of the Sarbanes-Oxley legislation. Sarbanes-Oxley provides for mandatory legislation with firm and increased public and criminal law enforcement, and with civil law enforcement options. Apparently, there are fundamental differences between the US and Europe when it comes to the objectives and importance of regulation and enforcement in corporate governance matters. The reasons for those differences are partly cultural and partly based on rational arguments as to the function of regulation and enforcement. Another important factor explaining the difference are the specific ways in which the powers to regulate in corporate and securities law have been assigned to the federal/union level or state/member state level in the US and in Europe. In addition, political factors and the manner in which political decision-making can be influenced by interest groups determine a jurisdiction's system of regulation and enforcement.[2] And lastly, there is the reality of the law: the actual facts and behavior of the parties. This reality is partly determined by rules and enforcement, but it also develops independently from them[3] and, in turn, shapes legal norms. All of this means that it is difficult to determine the effects of different types of corporate governance regulation and enforcement in different jurisdictions. Comparing this to physics, one could say that it does not resemble Newton's mechanics where action precisely determines reaction, but rather quantum mechanics where observations affect the reality, which we often cannot describe any more pre-

1 See for a discussion of the Dutch Code and the meaning of best practice provision in law Bartman (2004:123 et seq.), Das (2004: 126 et seq.) See also my contribution 'In Nederland aanvaarde inzichten omtrent corporate governance', in: LT, Verzamelde 'Groninger' opstellen aangeboden aan Vino Timmerman, part 44 in the series Uitgaven vanwege het Instituut voor Ondernemingsrecht, 2004, p. 331/342. The European Corporate Governance Forum, set up by the Commission to advise it on future corporate governance developments in the EU, intends to review in more detail how the corporate governance codes operate in the various Member States, what the effects are of the comply or explain mechanism etc. See http://europa.eu.int/comm/internal_market/company/docs/ecgforum/minutes-21-11-05_en.pdf for the minutes of the meeting of the Forum where this was discussed.

2 Roe (2003)

3 See Coffee (2001b)

cisely than in terms of probabilities. This creates uncertainty, which should go hand in hand with a certain caution against major changes in rules and enforcement systems. The good thing, however, about uncertainty is that it forces us to think. I would like to make a small contribution to our thinking by outlining developments in the US and the EU and their background.

2.2 Corporate and securities law in the US and the EU

The corporate governance system of regulation and enforcement is embodied in corporate and securities law. There are variations from country to country as to the substance of regulation and in what area of law any matter is regulated. As a general rule the internal organization of the company is a matter of company law. Disclosure requirements are partly a company law matter (disclosure serves as a tool to hold management accountable to shareholders and as an instrument to protect third parties dealing with the company) and partly a securities law matter (periodic and incidental disclosure to the market on the basis of which investors can make investment or divestment decisions). The same applies to public offers; offering rules and disclosure requirements are normally part of securities law. The ability to defend the company against unfriendly takeovers is normally a matter of company law. In practice there is often an overlap, and there is frequently a random element in the classification of subjects under company law or securities law. The area of law under which a subject is regulated does affect the nature of the rules and the manner of enforcement.[4]

For both the US and the EU a second distinction is relevant, the distinction between regulation at federal/union level and regulation at a state/member state level. The distribution of powers between the federal government and the union on the one hand and the states and member states on the other hand is different in the US Constitution and the EU Treaty and in the regulatory practice that has been followed. In the US, company law is mainly a state matter, but in securities law the federal government has a dominant role. In the EU, the division between union and member states less clearly follows this distinction between securities law and company law. However, the main focus of the regulation of securities law has in recent years shifted from member states to the union. The matrix of these two distinctions, corporate vs. securities law on the one hand and federal/union vs. state/member state on the other hand, works out differently for the two jurisdictions. This also affects the institutional and political dynamics that influence corporate governance regulations and enforcement.

2.3 The balance in the US

In the US, the distribution of powers between states and the federal government is based on the Commerce Clause in the US Constitution. According to this clause, the US Congress has the power 'to regulate Commerce with foreign Nations, and among the several States,

4 See Bouchez (2001).

and with the Indian Tribes'.[5] This provision enables Congress to intervene both in state company law and in state securities law. In reality, the federal government has focused on securities law, and has left company law largely to the states. Traditionally, the federal government has issued rules on capital and other markets and corresponding disclosure requirements, anti-fraud rules and insider trading rules. The federal securities laws of 1933 (Securities Act) and 1934 (Securities Exchange Act) form the principal basis for the federal securities legislation and the activities of the Securities and Exchange Commission (SEC). In addition to federal legislation, many states have their own securities legislation, but this is often limited in nature and usually concerns anti-fraud provisions (the so-called 'blue sky laws' named after a legal ruling which described the object of these provisions as preventing 'speculative schemes which have no more basis than so many feet of blue sky'), and registration of brokers and dealers and of securities sold in the state in question. State rules complement federal legislation, and they sometimes duplicate it.[6]

The Commerce Clause in the Constitution would enable the federal government to intervene in company law, but this has rarely happened. In practice, a pattern of federal restraint has developed based on the 'internal affairs' doctrine. Areas unrelated to the securities market, disclosure requirements, anti-fraud, or insider trading, are considered to be internal affairs and are left to the states to regulate. This does not mean, however, that the federal government completely refrains from regulating in those areas. After corporate or market crises, in particular, the federal government is inclined to use the securities law route to intervene in state company law. An example of this is the proxy solicitation regulation in the 1934 Act. These rules describe in detail the circumstances under which companies whose securities are registered with the SEC must enable their shareholders to vote by means of a proxy. The rules also specify the information to be provided to the shareholders and the circumstances under which shareholders themselves can submit proposals for decision-making in the shareholders' meeting through the proxy system.[7] In doing so, federal law does intervene extensively in the decision-making process within companies, which is traditionally a company law issue matter. Elements of the Sarbanes Oxley legislation of 2002 essentially are no different. The requirement that companies registered with the SEC have an audit committee consisting only of independent non-executive directors, and have procedures for internal control in connection with financial reporting, intervene extensively in the management structure and organisation of companies.

2.4 Facilitating company law

Bratton and McCahery describe how over the years a type of balance between state and federal legislation has emerged.[8] In this balance, state company law legislation is highly facili-

5 US Consitution art. I, par. 8, cl. 3.
6 See Ratner (1985: 5). The fact that state securities legislation is not entirely irrelevant has been shown by the New York public prosecutor Eliot Spitzer, who has initiated prosecutions for New York securities law violations.
7 See Ratner (1985: 73-76) and van Ginneken (1998: 134).
8 Bratton and McCahery (this volume, ch. 3)

tating. *i.e.* it is directed towards the wishes of managers who incorporated companies in the state which could best meet those wishes. Until 1920, that state was mainly New Jersey. Later, the torch was passed to Delaware. The company law system (legislation, registration, court decisions) is focused on being attractive to managers. As a result, managers incorporate companies in Delaware, which annually receives substantial amounts in registration fees and taxes. This symbiosis has led to company law legislation, and based on that, case law, which is accommodating to managers. This is shown, *inter alia*, by the great degree of freedom given to boards of companies to defend against hostile takeovers.[9] Rights of shareholders to be involved in the decision-making within the company are usually very limited. The General Meeting of US companies lacks many of the rights enjoyed by shareholders meetings of European companies. The key power rests with the board. The core of shareholders' control is the appointment and dismissal of board members, but even that right is often limited by 'staggered board elections', which frustrates a shareholders meeting's ability to remove the entire board, and by the inability of shareholders to use the proxy system to nominate candidates to the board.[10]

2.5 Delaware and Disneyland

Another result of the manager friendly character of company law is the limited scope for personal liability of directors under Delaware law. This is shown by the recent and fascinating ruling of the Delaware Chancery Court in the *Disney* case.[11] This case revolves around the appointment and dismissal of, and related remuneration arrangements made with, Michael Ovitz as number two of The Walt Disney Company ('Disney'), directly behind Michael Eisner, the company's Chairman and CEO. Ovitz had set up a very successful film business and was a good friend of Eisner's; Eisner had wanted to recruit him for Disney for some time. He finally managed to do so in the second half of 1995. Eisner let the chairman of the Compensation Committee of Disney´s board negotiate with Ovitz about his remuneration package. That package was very generous. It offered him an annual income of approximately USD 24 million for a five-year period, and a severance payment equal to the remaining annual salaries and bonuses (USD 7.5 million per year) if he would be dismissed without any fault on his part ('No Fault Termination', NFT), as well as an immediate issue of a first series of options with a guaranteed value of USD 50 million and USD 10 million in cash as compensation for not receiving a second series of options. After just over one year Ovitz was dismissed 'without cause', shortly after having received his annual bonus for 1996. Ovitz received his full NFT package. A number of Disney shareholders, led by a Disney family member, then sued Ovitz, Eisner and the other members of Disney's board for breach of their fiduciary duties and squandering the company's assets. In his decision, Judge Chandler first explains in a few noteworthy paragraphs that Delaware law does not hold directors li-

9 See van Ginneken (2005: 121-141).

10 See the proposals of the SEC to open up the federal proxy system for shareholders to use when nominating candidates to the board, see http://www.sec.gov/rules/proposed/34-48626.htm for the proposed rule. The proposal has met huge opposition from the business community. See further footnote 20.

11 Delaware Chancerey Court re: The Walt Disney Company, August 9, 2005, CA No. 15452.

able for a failure to meet 'aspirational ideas of best practices', and he warns against decisions based on hindsight. Judge Chandler then considers:

> 'The redress for failures that arise from faithful management must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court. Should the Court apportion liability based on the ultimate outcome of decisions taken in good faith by faithful directors or officers, those decision-makers would necessarily take decisions that minimize risk, not maximize value. The entire advantage of the risk-taking, innovative, wealth-creating engine that is the Delaware corporation would cease to exist, with disastrous results for shareholders and society alike. That is why, under our corporate law, corporate decision-makers are held strictly to their fiduciary duties, but within the boundaries of those duties are free to act as their judgment and abilities dictate, free of post hoc penalties from a reviewing court using perfect hindsight. Corporate decisions are made, risks are taken, the results become apparent, capital flows accordingly, and shareholder value is increased.'

It is up to the claimants to prove that directors are not entitled to protection under the business judgment rule, which rule precludes judiciary review of the substance of board decisions, because the directors have violated their fudiciary duties of care and loyalty, have acted in bad faith or have made 'unintelligent or unadvised' judgments, by failing to inform themselves on all relevant information that was reasonably available before they took their decision. Judge Chandler then expressed heavy criticism, in particular towards Eisner:

> 'a reasonably prudent CEO (that is to say, a reasonably prudent CEO with a board willing to think for itself and assert itself against the CEO when necessary) would not have acted in as unilateral a manner as did Eisner when essentially committing the corporation to hire a second-in-command, appoint that person to the board, and provide him with one of the largest and richest employment contracts ever enjoyed by a non-CEO….. Eisner's actions in connection with Ovitz's hiring should not serve as a model for fellow executives and fiduciaries to follow. His lapses were many. He failed to keep the board as informed as he should have. He stretched the outer boundaries of his authority as CEO by acting without specific board direction or involvement. He prematurely issued a press release that placed significant pressure on the board to accept Ovitz and approve his compensation package in accordance with the press release.

> To my mind, these actions fall short of what shareholders expect and demand from those entrusted with a fiduciary position… all of the legitimate critiscims that may be leveled at Eisner, especially at having enthroned himself as the omnipotent and infallible monarch of his Magic Kingdom…'

This, however, does not lead to liability because Judge Chandler concludes that Eisner had acted in good faith in believing that his resolute conduct in recruiting Ovitz was in the company's interest. Eisner did not violate his duty of care because his actions had not been grossly negligent. As to the members of the Compensation Committee, some of whom had and some who had not been intensely involved after Eisner's fundamental decision to recruit Ovitz, and the other members of the board, Chandler also ruled that they had believed that they were acting in the company's interest and had not arrived at their judgment in an entirely uninformed manner. The Delaware Supreme Court has upheld this decision.[12]

The *Disney* case is in line with case law of Deleware courts, who act as 'good cops with kid gloves', as Bratton and McCahery put it. The courts often express moral judgments on the conduct of managers, without reversing the effects of decisions of these managers or holding them liable. However, in doing so, the courts do issue a warning for future cases.[13]

2.6 Mandatory securities law

As I mentioned above, the emphasis of federal legislation is on securities law, in particular the regulation of the securities markets and the disclosure obligations of companies whose securities are registered with the SEC. In this area, an impressive structure of legislation and public oversight has emerged. Central to this is the principle that investors should be protected and the integrity of the securities markets should be safeguarded. Protection of investors is implemented by ensuring that they all have access to a certain minimum of information before they take investment decisions. The integrity of the markets is safeguarded by strict anti-fraud and insider trading rules. The SEC also supervises compliance with regulations via intermediaries, such as securities exchanges and securities traders. These rules are completely different in nature than the facilitating company law. They are mostly mandatory and usually very detailed, and they compel listed companies and firms involved in securities trading to strict compliance. An extensive Enforcement Division within the SEC supervises compliance with enforcement procedures under both public law and civil law. The public law procedure involves an Administrative Law Judge, who can make recommendations for sanctions to the SEC. Under the civil law procedure, the SEC will institute proceedings before a US District Court, which may issue various sanctions, including an order to pay considerable fines. The SEC annually files 400 to 500 civil lawsuits in federal courts.[14] In

12 *In re The Walt Disney Company Derivative Litigation,* No. 411, 2005, C.A. No. 15452, June 8, 2006.
13 See Bratton and McCahery (this volume, ch. 3:86). See also Rock (1997) and Veasey (2005).
14 See the SEC website, www.sec.gov/litigation, offering a detailed overview of cases filed by the SEC with US federal courts.

some cases, the SEC may also decide to apply to the US District Court for an order excluding a person from holding a position as director or officer of a legal entity for a fixed or indefinite period.[15] Many federal securities law provisions are also subject to firm criminal sanctions. In July 2005, for example, Bernie Ebbers, CEO of Worldcom, was sentenced to a prison term of 25 years for securities fraud and for seven counts of filing misleading reports with the SEC. Finally, an important part of securities law enforcement takes place through 'private securities litigation' by investors. Federal legislation does not explicitly entitle investors to sue persons for violation of securities laws, but in the past few decades the US Supreme Court has accepted that investors have an implicit right to claim compensation under a great number of federal securities law provisions, including those relating to misleading reporting and insider trading.[16] With the assistance of US procedural law a real industry has emerged out of securities class actions initiated by the so-called 'plaintiffs bar', attorneys who specialize in this type of class action. In order to control this trend, the Private Securities Litigation Reform Act was introduced in 1995. This Act discourages, in particular, the 'race to the courthouse' in order to be the first to institute a class action, and the use of 'professional plaintiffs'. This does not appear to have resulted in fewer class actions.[17] It should be noted that most class actions do not end in convictions by the court but in settlements.[18]

2.7 Good cop, bad cop

These mandatory securities laws and strict enforcement lead Bratton and McCahery to position the federal government as the bad cop, versus the good cop of state company laws and kid glove enforcement. This creates a balance in which the federal government corrects what has been left unregulated by the state governments. In times of crisis, however, the federal government intervenes in states' regulation of their internal affairs, as shown recently by the Sarbanes Oxley legislation. At state level there are few stimuli to amend legislation as a result of corporate scandals. The federal securities legislation, however, has been tightened, thus partly crossing the internal affairs boundary. In this process, the state company law is not set aside, but specific federal norms are imposed, to be enforced in accordance with the federal enforcement system. Compared to legislation at state level, managers have considerably less influence on the outcome of legislation at federal level, if only for the reason that the SEC, as a key player at federal level, is under an instruction to safeguard the interests of investors. Moreover, as the response to the corporate governance scandals originates from the area of securities law, the approach is rather one-sided. The reaction in the US is essentially limited to the corporate governance process relating to financial reporting by listed companies to the market. The Sarbanes Oxley legislation does not deal at all with the relationship between shareholders and boards, or with the functioning and composition of boards in general, the role of the chairman and CEO etc. Outside the context of the Sarbanes

15 See on this power of the SEC, Bras and Winter (2004: 328-334).

16 See Ratner (1985: 519-532).

17 See Grundfest and Perino (1997). See also Peng and Roell (2005). The website http://securities.stanford.edu/research.html offers a detailed overview of securities class actions in the US.

18 Grundfest and Perino (1997) note that in the period 1988-1996 ca 87% of all securities class actions ended in settlements.

Oxley legislation, the SEC has suggested that certain shareholders be given the right to propose candidates for appointment to the board of directors via the federal proxy system, followed by a discussion among all shareholders about the proposal.[19] This suggestion has met a great deal of opposition from the business community, and it seems unlikely that it will become law.[20] Currently there is no integrated and comprehensive regulatory approach to corporate governance issues in the US.

In summary, the US system of regulation and enforcement of corporate governance is characterized by facilitating rules of company law, which only lead to liability of directors in exceptional circumstances, and mandatory rules of securities law, which are actively enforced by a public oversight authority with extensive powers and violation of which can result in considerable public, criminal and civil law sanctions. In general terms, the business community is given wide discretion without any substantive ex ante or ex post influence of shareholders, but the provision of information to the market is regulated in great detail and heavily enforced. It is essentially through the market, as Judge Chandler stated in Disney, that shareholders must seek to redress failing but otherwise faithful management, not through the internal decision taking process of the company and through holding management liable for their failures.

2.8 The game in Europe, protective company law

As is the case in the US, in the EU both company law and securities law are matters for the union and for member states, but the legislative powers have been divided differently than in the US. In the EU, both company law and securities law play a particular role with regard to two of the four core freedoms of the communal market: the freedom of establishment and the free movement of capital. With regard to company law, the European Treaty has a special provision instructing the European Council and the European Commission to coordinate the safeguards which member states require of companies for the protection of the interests of shareholders and others, with a view to making these measures equivalent throughout the union (Article 44 (2)(g) EC Treaty). The key mechanism used for this purpose so far is the directive: an instrument binding upon member states who should implement the substance of the directive in their national laws. The harmonization provision in the Treaty so far has been the basis of eleven directives. The approach of this harmonization process is rather one-sided, in the sense that it appears to restrict the EU's involvement in company law to coordination of safeguards to protect shareholders and other interested parties (particularly creditors). The rationale behind this particular focus on protection of shareholders and creditors was to prevent a race to the bottom: by offering increasingly less protection to shareholders and creditors, member states would compete in providing management of companies with the most attractive company law. This focus on the protection of shareholders and creditors has made that the European company law agenda by definition is not particu-

19 See Proposed Rule 34-48626 , http://www.sec.gov/rules/proposed/34-48626.htm.

20 See Lipton and Rosenblum (2003) who pose serious objections against the proposals. See also Silvers and Garland (forthcoming) and http://www.sec.gov/cgi-bin/txt-srch-sec?text=34-48626#section2.

larly management-friendly, as the majority of the current company law directives show. Protection of creditors and shareholders is at the heart of the Second Directive on capital maintenance. Directives which are intended to facilitate corporate transactions, such as the Third and Sixth Directives on mergers and divisions, are full of formalities to be met in order to protect shareholders and other interested parties. In the cross-border area, it is the employees who are protected, by the special provisions on information, consultation and participation in the Directive on Employee Involvement in the European Company (SE) and in the Tenth Directive on cross-border mergers. These directives impose EU company law on member states that is far from facilitating.[21] In addition, the mechanism of harmonizing the laws of the member states through directives that need to be implemented in member state law, has made that a truly separate EU company law, independent from the member states, does not exist. EU and member state company law are knitted together.

2.9 Uniform securities law

Securities law has expanded tremendously at EU level as a result of the European Commission's Financial Services Action Plan (FSAP) of May 1999. The purpose of the FSAP is to achieve an integrated European capital market to which offerors of securities and investors have access on equal terms. The FSAP has been the basis for many securities law directives. The Prospectus Directive and the Transparency Directive, as well as the Market Abuse Directive, detail the disclosure requirements for listed companies. The EU Regulation on International Accounting Standards imposes on listed companies throughout the EU an obligation to apply IFRS. The Regulation is directly applicable in member states. The FSAP has even led to a special regulatory system, the Lamfalussy System, which is based on different levels of regulation. At a first level there are directives to be adopted by the European Council and the European Parliament, and at a second level there are implementation regulations to be drawn up by the European Commission. These implementation measures, in particular, will restrict the freedom of member states in implementing the directives. In the areas covered by the FSAP, there is a far-reaching level of harmonization. The substance of the member states' rights is almost entirely determined by European law. One could speak of more or less uniform EU securities regulation. A significant difference with the US is that there is no supervisory authority at union level to monitor compliance with securities legislation. Supervision is carried out by 25 national supervisory authorities; they supervise compliance with the national laws. This creates the risk of different implementation and application of basically uniform EU securities laws. To prevent this the national supervisory authorities

21 The High Level Group advised the Commission to move away from the focus on shareholder and creditor protection. The primary objective of company law should be to facilitate efficient and competitive business in Europe , see p. 29 of the report A Modern Regulatory Framework for Company Law in Europe. The Company Law Action Plan nontheless sets out as the first objective the protection of shareholders´ rights and of third parties, see par. 2.1 of the CLAP. It may be that the Commission has formulated this in order to clearly stay within the harmonization framework of article 44 of the Treaty. See for the report of the High Level Group and the CLAP http://europa.eu.int/comm/internal_market/company/modern/index_en.htm. Commissionar McGreevy in the meantime applies a much more facilitating approach, see his speech for the second European Corporate Governance Conference in Luxemburg on 28 June 2005 and his speech for the third derde European Corporate Governance Conference in London on 14 November 2005. Both speeches can be downloaded from http://europa.eu.int/comm/commission_barroso/mccreevy/speeches/index_en.htm.

coordinate their various ways of implementation and application of securities law directives and Commission regulations through the Committee of European Securities Regulators, CESR. It remains to be seen whether and to what extent this structure will indeed prevent national supervisory authorities from straying in different directions when implementing and applying EU securities laws.

2.10 Subsidiarity, enforcement, playing chess on two boards and optionality

Three important elements of EU governance determine the relationship between matters regulated at European level and those regulated at member state level. Firstly, there is the principle of subsidiarity. Article 5 of the EC Treaty since 1992 (the Maastricht Treaty) provides:

> 'The Community shall act in accordance with the power conferred upon it by this Treaty and of the objectives assigned to it therein.
>
> In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.'

Ultimately, the decision as to what, based on this principle of subsidiarity, falls within the Community's competence and what within the member states' competence is a political one.[22] The text suggests a certain bias for regulation at member state level. In company law, initially little attention was given to this principle of subsidiarity. Full harmonization of company law at EU level was the goal at the start of the process. Only later, when it became increasingly difficult to achieve agreement on directives among member states, the principle was 'discovered' in company law to support the argument that the union should have no involvement in a certain subject. The application of the principle in company law matters is not stable and consistent and will remain subject to the political dynamics of the governance of the EU, as well as the, usually arbitrary, ways in which interests groups either want to use the principle as an argument for a need of EU involvement to ensure certain regulation they could not otherwise achieve at member state level, or precisely the opposite to block EU involvement for fear of imposition of undesired regulation, which they believe would not otherwise be imposed at member state level.

22 See on the subsidiarity principle Burca (1999)

The decisions of the European Court of Justice in the *Centros, Uberseering* and *Inspire Art*[23] cases have influenced the thinking on the relevance of subsidiarity for company law in the EU. The Court's message, in summary, is that if member states fail to decide to harmonize areas of company law, each member state may organize its company law in any way it wishes. Companies can then choose to incorporate in the member state with the most favorable company law and develop their business anywhere in the EU and member states are then unable to impose their own company law on such company incorporated in another member state or to frustrate the participation by such company in legal and economic activities. For small, private companies in particular, this case law does seem to have a certain effect of incorporation in one member state and developing activities in other member states.[24] In response to this, certain member states such as the Netherlands, France, Spain and Germany do actually compete in making or keeping their company law attractive to private companies.[25] This responsiveness of national legislators to facilitate private companies in their jurisdiction leads to a certain level of market driven convergence of company laws from the bottom up. Such market driven convergence stands a better chance of offering appropriate and efficient company law mechanisms to business than regulatory harmonization imposed from the top. Together with such other factors as cultural and language issues and existing tax obstacles for transferring businesses to another member state, this makes it unlikely that a clear Delaware will emerge in Europe.[26]

The High Level Group, which advised the Commission on the future development of European company law, felt that EU law should be focused on actual cross-border problems which cannot be solved by individual member states. The Group also believed that the focus would have to be on company law for listed companies, as comparability and transparency of corporate structures is of greater importance where such companies are concerned. In this respect, company law should remain aligned with the increasingly uniform European securities laws.[27] For private companies the need to impose harmonization of company law is much smaller, but some level of market driven regulatory convergence will occur.[28]

A second important element determining the division of powers between the union and the member states is the basic premise that the union has no enforcement rights of its own against private parties. This is the case in both company law and securities law. In both areas, member states have to implement European directives into their laws, and it is within their discretion to take enforcement measures appropriate to their system of law. At best, a European directive may instruct the member states to take appropriate enforcement measures that will contribute to compliance with the laws arising from the directive.[29] However,

23 EHvJ C-212/97 (9.3.1999), C-208/00 (5.11.2002) and C-167/01 (30.9.2003).
24 See Becht, Mayer and Wagner (2005).
25 See Becht et al. (2005: 16-17). See for the Netherlands the proposals for simplification of the BV-rules, http://www.justitie.nl/themas/wetgeving/dossiers/bvrecht/index.asp.
26 See also Bratton and McCahery (this volume, ch. 3).
27 Report of the High Level Group of 4 november 2002, p. 34-35. See also Wymeersch (2004: 171).
28 See Winter (2004: 13-17).
29 See for example article 50 of the draft directive to amend the 8th directive on statutary audit, see below.

the European Union cannot take enforcement measures directed to companies and civilians on its own. As I said before, even in securities law, which is now, to a large extent, uniform throughout the union, there is no European supervisory authority which could monitor uniform compliance with European rules. This task rests with the supervisory authorities of the individual member states, who coordinate through CESR. The CESR Himalaya report suggests this coordination should be strengthened, ensuring that at least national supervisors have equivalent powers, strengthening their cooperation, possibly delegating tasks or powers to each other and may in the future also include pan-European powers, for example in areas such as the application of IFRS.[30]

Thirdly, there is one other significant difference with the situation in the US. The governments of member states which decide through their national parliaments on the substance of their own law are the same governments that, as the European Council, decide on instruments of European law. These governments, and those who lobby them, are simultaneously playing chess on two boards. In some cases, by supporting regulation at EU level, a member state's government can force a breakthrough in a situation that cannot be resolved within the member state for political reasons. In other cases, a member state's government will try to block an unwanted development at national level by raising obstacles at European level. Arguing that 'this is a matter for Europe to resolve first' is often an effective way of postponing the resolution of a problem at member state level. All this, combined with the practice of European governments to reach compromises at European level on totally unrelated issues, makes it entirely unpredictable what will be regulated at a European and what at a member state level.

The debate on the division of powers between the union and members states in general and the inability of member states to agree on core issues of company law in particular, have lead to a recent regulatory pattern in which the final EU legal instrument agreed to by member states offers options to member states or sometimes directly to companies to choose from. In the Statute on the European Company (SE), those wishing to incorporate an SE must be given the option to have either a one-tier board system or a two-tier board system, see article 38 SE Statute. The Statute contains many other options for member states when implementing the Statute in their national legislation. The 13th Directive on Takeover Bids in article 12 introduces an explicit option regime for the application of the rules of articles 9 and 11 that restrict the use of certain takeover defenses. Member states can opt-out of these rules and do not have to impose them on listed companies in their jurisdiction, but most offer the ability to these companies to voluntarily op back into these provisions. In a similar vain, to avoid member states not being able to agree, the High Level Group has advised the Commission to launch a study into an alternative to the current capital maintenance rules in the second directive, which alternative should not be based on backward looking mechanisms to protect legal capital, but on a forward looking solvency test. The system

30 See http://www.cesr-eu.org/index.php?page=document.details&from.title=Documents&id=2541 for the Himalaya report. See also the speech of Arthur Docters van Leeuwen, chairman of CESR, The European Discount? Supervisory convergence in Europe, 22 february 2006, http://www.afm.nl/marktpartijen/default.ashx?DocumentId=6232.

based on a solvency test should not mandatorily replace the current capital maintenance regime but should become an option for member states to adopt instead of the current regime.[31] The Commission has launched a call for tender for a feasibility study on this subject and will launch a further call for tender in early 2006.[32] Hertig and McCahery welcome this option approach as a means to reach agreement more easily, to limit the options available from which companies can choose and therefore establish a lighter form of convergence and to offer a low cost barrier through default rules to abusive use of the freedom of choice.[33] However, the option arrangements in the 13th Directive show what monstrous results an option arrangement can lead to just for the sake of compromise. These arrangements have created a situation of fundamental uncertainty on the applicability of rules in cases of takeover bids, which is bad regulation as such, and can be easily manipulated. Options and default rules need to be created with caution and the effects need to be thought through thoroughly before adopting such rules. Otherwise they will only offer an easy escape to compromise to EU lawmakers which will leave the parties that have to live with them with inextricable complexities.

2.11 Corporate governance regulation in the EU

The factors discussed above have shaped the EU's response to the corporate governance scandals which have come to light since 2001 and have resulted into this response being quite different from the response in the US. Where the system of state company law in the US is not organized to react to a crises of that scope, the federal government has intervened quickly and severely with the Sarbanes Oxley legislation. The picture in Europe, on the other hand, is mixed. Many member states have produced their own responses to the scandals by amending their company laws in accordance with their own traditions and directed at the specific governance issues existing in each member state. The Company Law Action Plan[34], drawn up by the European Commission on the basis of the High Level Group's advice, also places the emphasis on the member states. Each member state is supposed to develop its own corporate governance code, to be enforced on a minimum basis of 'comply or explain'. In any event, there will not be a European corporate governance code for the time being. The Commission has set up the European Corporate Governance Forum to advise it on future governance developments in the EU. In addition, the European Commission has issued two Recommendations on the role of independent supervisory directors and non-executive directors, and on directors' remuneration.[35] The Recommendations are not binding on member states. The Commission recommends that member states incorporate the substance of the Recommendations in national legislation or in corporate governance codes. The Com-

31 High Level Group report of 4 November 2002, p. 86-89.

32 See the Commission' s consultation on future priorties for the Company Law Action Plan, p. 17-18, http://europa.eu.int/comm/internal_market/company/docs/consultation/consultation_en.pdf.

33 Hertig and McCahery (2004:40-45).

34 See http://europa.eu.int/cgi-bin/eur-lex/udl.pl?REQUEST=Service-.Search&LANGUAGE=en&GUILANGUAGE=fr&SERVICE=all&COLLECTION=com&DOCID=503PC0284.

35 Recommendations of 15 February 2004, see http://europa.eu.int/comm/internal_market/company/directors-remun/index_en.htm en http://europa.eu.int/comm/internal_market/company/independence/index_en.htm.

mission will assess, as per June 2006, to what extent member states have done so. The Recommendations in a sense form a type of comply or explain system between the Commission and member states: the latter have to report to the Commission on what measures they have taken in implementing the Recommendations. If their efforts are not satisfactory to the Commission, it may make proposals for mandatory arrangements to be imposed through directives.

In addition to the Recommendations, the Commission has submitted a proposal for the amendment of the Fourth and Seventh Directives regarding annual accounts and consolidated annual accounts.[36] The purpose of the amendment is, *inter alia*, to require listed companies to provide for a corporate governance statement in their annual report, which would include a reference to the corporate governance code they have applied and an explanation of any deviations from such code (see proposed Article 46*bis* of the Fourth Directive). The proposal also provides that the member states shall ensure that members of managing, executive and supervisory bodies of the company are collectively responsible towards the company for the preparation and publication of the annual accounts and annual report in accordance with the Fourth Directive, and that the member states ensure that their statutory and administrative provisions concerning liability shall apply to the members of those bodies (article 50*ter* and 50*quater*). Enforcement of the responsibility for the annual accounts clearly rests with the member states.

I note that looking at the various corporate governance codes adopted in member states as well as the two Recommendations of the Commission, their scope is much wider than only the governance arrangements related to the process of financial reporting, which has been the focus of the US Sarbanes-Oxley legislation. It is about the role and composition of the board, independence of directors in general, transparency on director remuneration and the relation to and appropriate influence of shareholders. In fact, regulation of the process of financial reporting, including auditor independence, the role of the audit committee and public oversight over auditors, has followed a different track, which was already underway in Europe well before the corporate governance scandals emerged in 2001-2003. It was certainly influenced by these scandals and the US response to this and has resulted in a Directive to amend the 8th Directive on statutory audit, see below.

2.12 Enforcement ex ante by shareholders

The substantive principle on which the European corporate governance approach is based is that listed companies may have different corporate governance structures which suit their own history, culture, type of shareholding (widely or closely held), legal infrastructure, financial structures and other specific circumstances. They should not be made subject to the same detailed and binding governance requirements. This is why an approach was chosen based on codes per member state, which describe best practices which are to be applied by

36 Proposal of 28 October 2004, see http://europa.eu.int/comm/internal.market/accounting/board/index.en.htm.

listed companies or in respect of which they have to explain their reasons for deviating. Shareholders are the primary parties to monitor the application of the corporate governance code by listed companies, *i.e.* compliance with best practices or an explanation for deviating acceptable to shareholders. Supervisory authorities do not have a role in this.[37] In this respect, the European corporate governance approach is fundamentally different from the US approach. The critical enforcement mechanism of good corporate governance is the debate with shareholders and the ability for shareholders to use their rights in order to convince or force boards of companies to apply appropriate corporate governance arrangements. To ensure that shareholders are able to effectively exercise their powers, the Commission has issued a proposal for a Directive on shareholders' rights.[38] The Directive seeks to increase the efficient participation of shareholders in the company's decision making as a precondition to effective corporate governance and tries to remove obstacles particularly for cross-border voting. The concern about shareholders' rights also lies at the heart of the study that Commissioner McGreevy wishes to have undertaken into the deviations of the 'one share one vote' principle.[39] The study on this subject is likely to be launched in the course of this year.

The intended involvement of shareholders in the company's governance is a form of enforcement *ex ante*. It limits executive and non-executive directors' freedom of movement as they require shareholder approval for key corporate decisions and shareholders can effectively (threaten to) dismiss them. This restriction on directors' behavior is, however, more limited than in another form of *ex ante* limitation: imposing mandatory rules. Directors have the freedom to act as long as they have the shareholders on their side. I note that in Europe litigation by shareholders *ex post* is of little importance as an enforcement instrument. Securities litigation on the scale as we see in the US does not exist in any EU member state. The abilities for shareholders to sue directors in private on basis of company law rules are also severely restricted in most member states. In addition, the rules of procedure in member state usually do not cater for the facilities of class action suits and contingency fees that have boosted securities litigation in the US. As a result, *ex post* litigation against directors is virtually absent in the EU as an enforcement mechanism, a factor which is frowned upon usually as a weakness of European style of governance enforcement by many involved in policy setting in the US. But look at what is happening in Europe today. The intention of Deutsche Börse to launch a takeover bid for the London Stock Exchange last year was thwarted by a group of active shareholders and the CEO and the Chairman of the Supervisory Board both resigned as a result. The agreement of a Dutch company VNU to merge with a US company was frustrated by a group of active shareholders and VNU has now been taken over by private equity funds. These examples show that active shareholder involvement in major corporate decisions can have an enormous impact on the governance and strategies of companies. The enforcement effect of shareholder involvement, whether for the good or the bad, can be at least as effective and I would not doubt sometimes more effective than the

37 See explicitly the minutes of the meetings of the Europeacn Corporate Governance Forum of 21 November 2005, p. 2, http://europa.eu.int/comm/internal.market/company/docs/ecgforum/minutes-21-11-05.en.pdf.
38 See http://europa.eu.int/eur-lex/lex/LexUriServ/LexUriServ.do?uri=CELEX:52005PC0685:EN:NOT.
39 See his speech on November 14, 2005, see note 21.

(prospect) of shareholder litigation afterwards. Judging by the comments made by many executives and non-executives in Europa today, the involvement of shareholders in key decisions and the corporate governance in general poses a real threat to them. A key question for Europe´s corporate governance developments going forward is whether this development is, on balance, indeed for the good or the bad of the success of European companies. I will return to this question in the last paragraph on challenges for the European corporate governance model.

2.13 Diet SOX

I have already mentioned the amendment to the Eighth Directive on the auditing of annual accounts[40] This proposal, is in fact the European , lighter version of the US Sarbanes Oxley legislation, focused on strengthening of financial reporting procedures, a sort of 'Diet SOX'. It sets out new independence requirements for auditors, and imposes an obligation on member states to implement a form of public supervision on auditors of annual accounts. Thus, public oversight over auditors is to be introduced in Europe through company law (the Eighth Directive is a company law directive), whereas this supervision is organized in the US as part of securities law by the PCAOB, an independent authority created under the Sarbanes Oxley legislation and supervised by the SEC. In many member states, however, the supervisory authorities for the securities markets will be charged with this responsibility, as for example in the Netherlands. In exercising their supervision, the supervisory authorities of member states have to cooperate and provide assistance to one another. Apart from public oversight over auditors, member states will also introduce supervision of financial reporting by listed companies as part of the implementation of IFRS as accounting standard for listed companies from 2005.[41] This will lead to a system of public supervision of financial reporting by listed companies and of auditors in Europe which will closely resemble the US securities law system of supervision by the SEC (and PCAOB). An important question for the future development of corporate governance in Europe will be whether the public oversight over financial reporting will have a similar governance enforcement function as it has in the US. The combination of relatively strong shareholder influence on key corporate decisions and governance matters on the one hand and strong and effective public oversight over financial reporting to the market is new, an experiment. We have not been able to study the combined effects, but more worryingly, we have not anticipated and thought through how this will play out in the future. The combination is a result of a process of regulatory developments in the areas of securities law and company law which have not been coordinated with a view to creating an optimal corporate governance regulatory regime. And the outcome is very difficult to predict.

40 Proposal of 16 March 2004, http://europa.eu.int/comm/internal.market/auditing/officialdocs.en.htm. The proposal was agreed upon by the Council and the European Parliament in the fall of 2005 after some amendments were made loosening the requirement to have an audit committee. The proposal now awaits formal adoption.

41 See preamble 16 of the IAS Regulation 1606/2002.

2.14 Future challenges for corporate governance developments in Europe

Apart from the outcome of this interplay between a tighter regulatory regime for public oversight of financial reporting to the market and company law measures dealing with corporate governance matters, I see two key, related challenges for the future development of regulation and enforcement of corporate governance in Europe.

The first challenge is to understand how the various corporate governance codes in Europe, based on comply or explain, actually work and what their effect is on the governance of companies. Working with non-binding codes that allow for flexibility but require accountability to shareholders on the way they are applied, who are the prime enforcers, was a deliberate choice to strengthen corporate governance in Europe. Member states in the meantime have implemented corporate governance codes. The legal basis for these codes varies per member state. Some link application of the code to listing rules (e.g. the UK, Sweden, Estonia), others link it to company law (e.g. Germany and the Netherlands) and again others so far have not yet created any legal basis and rely mainly on voluntary application of the code (e.g. France). Some member states have set up committees that monitor the application of the code by listed companies and amend the code over time if so desired. Sometimes government officials are members of such committees, in other cases these committees are strictly privately organized by participants of the business community. The role of other stakeholders, employees in particular, is sometimes addressed explicitly. A key element of a proper functioning of the corporate governance code is a high quality of the explanation given for deviation of the code. This requires for companies to be candid in their explanations and for shareholders and those who advise them a willingness to be open to such explanations and to take a view beyond mere box ticking. A specific concern exists where a company is controlled by one or a small group of shareholders, who also control(s) the board. What can we then expect of enforcement by shareholders of proper governance practices? Particularly where so many listed companies in Europe are controlled by one or more shareholders(s), this poses a specific challenge to the functioning of corporate codes.

The European Corporate Governance Forum has made it a priority to increase our understanding of the operation of corporate governance codes in member states and their real effect on the governance of companies. It will liaise with organizations in the member states charged with responsibility for corporate governance codes and their application to get a better understanding of these questions and challenges and to learn from the experiences in member states. Here, the diverse landscape of the regulation of corporate governance codes in member states offers a specific benefit: the variations in mechanisms to make corporate governance codes work in practice allow for failures, but more importantly also allow for identifying successful methods of working with corporate governance codes. Like in evolutionary biological processes, variation is essential for improvement. In this phase, where we need to learn much more about what works and what does not work, the ability to learn from failures and successes is much more valuable than any benefit from imposing a level of uniformity across Europe.

The second challenge is posed by the reliance on shareholders enforcing proper corporate governance practices. As I explained, this requires shareholders to actually participate within the company and use their rights to bring about changes in governance practices. The challenge here is to find the right balance. The effective exercise of shareholders' rights across Europe is not ensured and needs to be developed. The draft Directive on Shareholders' Rights aims to improve this. It does not make sense to grant shareholders extensive governance rights if they lack the legal infrastructure to use these rights efficiently. Cross-border ownership structures create specific challenges in this respect,[42] which the draft Directive addresses only partially. Another type of obstacle that may frustrate a proper involvement of shareholders in the governance of listed companies is posed by disproportionate distributions of control rights and financial rights over certain shareholders or (classes of) shares. I say may frustrate. The variation of forms of disproportionality is enormous in Europe and various forms have completely different objectives and effects. It is not at all clear that a disproportionate distribution of control and financial rights is improper and inefficient per se. The study to be commissioned by the Commission and in which the European Corporate Governance Forum will be closely involved, will have to describe and review the various forms of disproportionality, their objectives and effects, their financial functions for companies and in markets in general and their prevalence in member states. Only on that basis can we come to a considered view as to which forms of disproportionality are appropriate and which are not and what we are going to do about the forms which believe no longer to be appropriate.

The concerns I have discussed so far are concerns that shareholders may not be able to exercise their rights sufficiently efficiently and as a result their enforcement function in corporate governance fails. The opposite concern is also important. The rise of institutional investors, and specifically hedge funds, whatever that term may mean in practice, the developments in the securities markets over the last few years, shareholders' activism in the governance area in general and in incidents such as those involving Deutsche Börse and VNU, have fed concerns that more and more shareholders are only or mainly focused on short term gains, to the detriment of the long term success of the companies they invest in. Improving the shareholders' ability to use their rights and extending their rights will only make this worse, some believe. A counter movement is starting to plead for more possibilities for companies to effectively limit the rights of short term investors, for example by granting additional voting rights or dividend rights to long term investors. Obviously, shareholders seeking to exercise control over companies inevitably will make mistakes on occasion. But in that respect they are not very different from the managers they seek to control. The real question is whether a growing influence of shareholders will, because of their increasingly short term horizon, be structurally detrimental to the development of successful companies.

42 See the report of the Expert Group on Cross-border Voting, http://www.wodc.nl/publicatie/oudereeksen/onderzoeksnotitie. See also Winter (2003).

Finally, another still somewhat unknown factor needs to be considered. Do modern, more transparent corporate governance practices really make a difference for the performance of companies? If not, than shareholders in the long run will loose interest and rightly so. On this score the jury is still out there. A wealth of literature has not yet yielded decisive evidence of a positive correlation between 'good' corporate governance and firm performance, troubled partly by trying to define what actually produces good corporate governance. Many would probably hold intuitively that, if good corporate governance does not increase the performance of companies, at least it is a factor reducing the risk of failure or long term underperformance.

So, on balance, the approach taken in the EU poses many new questions and challenges and so far offers little certainty of positive results. I am not really bothered by that. It is the reality of operating in a complex world, where certainties do not exist and we are forced to make choices based on an understanding we can arrive at to the best of our abilities. A challenge for sure.

PART II: THE DELAWARE APPROACH TO CORPORATE LAW AND ADJUDICATION

3 The Equilibrium Content of Corporate Federalism

William W. Bratton and Joseph A. McCahery

3.1 Introduction

This is a time of spirited debate about the state-federal allocation of corporate regulation. Arguments about the legitimacy of charter competition and Delaware's national role as a corporate law maker are as intense as ever. The Sarbanes Oxley Act simultaneously has triggered a loud discussion about the legitimacy of federal intervention into corporate internal affairs traditionally regulated by the states. We, however, see no cause for excitement on either front. Despite recent evidence of infirmities in the charter market, we think Delaware legitimately plays a national role. At the same time, we see no support for the view that recent federal expansion into internal affairs territory destabilizes or impairs corporate law's federal structure.

This Article explains why corporate federalism remains robust, offering a positive political economy. Drawing on the history of corporate law and basic concepts of evolutionary game theory, we locate the content of corporate federalism in two stable equilibriums. The first equilibrium prevails in the charter market, following from Delaware's successful pursuit of an evolutionarily stable strategy to maximize rents from the sale of charters. The strategy, first followed by New Jersey, caused a radical change in corporate law in the late nineteenth century. Since then, stability has ruled. Corporate law's basic, enabling outline changed little during the twentieth century. Operative incentives, market structure, and regulatory results have been more constant than dynamic, even as Delaware often has adjusted its strategy as it has adapted to events.

The second equilibrium is more political than economic and prevails among the makers of national corporate law – Congress, the Securities and Exchange Commission, the stock exchanges, and the federal courts. These actors react to events in a more volatile manner. But even here equilibrium has prevailed since 1934. In theory, under the prevailing norm, national regulation covers the securities markets and mandates transparency respecting firms with publicly traded securities while internal corporate affairs are left to the states. In practice, federal lawmakers sometimes disregard the norm, entering into internal affairs as the national system grows episodically. But they follow a norm of cooperation even as they make these incursions. Federal regulators never structure interventions so as to disrupt the state equilibrium. They leave Delaware in place, along with its stable strategy and its rents. In our view, this is the core of the federalism, a view that contrasts with a prevailing subject matter-based conception.

The cooperative federal strategy gradually evolved toward stability after 1934. Federal regulatory restraint was politically contested for much of the twentieth century, as progressives objected to rent-driven lawmaking in the states and proposed preemption of the entire field. But the public interest approach steadily lost political salience. On the other side, beginning in the latter part of the century, free market proponents made a case against any national corporate law, in effect proposing an irrebuttable presumption favoring state regulation of internal affairs. That case also has lacked political salience. The actors who make corporate law have resisted the influence of both ideological paradigms, instead regulating by reference to a governance agenda. This is a set of regulatory strategies, mostly process-based, directed to the amelioration of agency costs in publicly traded, management-dominated firms. Discussions of agenda items tend to devolve on functional questions about performance and welfare effects. Ideological lines tend to be drawn only when questions arise as to the relative costs and benefits of self regulation and process mandates. Since answers tend to be cautious, they by default favor state autonomy. At the same time, the internal affairs presumption yields quickly whenever a national political imperative presents itself.

In the evolving pattern, the federal system mandates while Delaware consistently favors self regulation. The federal government is the bad cop. Its mission is to make sure that firms tell the truth about themselves. It performs the mission with a massive, mandatory apparatus peopled by prosecutors with political aspirations and greedy plaintiff's lawyers, imposing fines and large money judgments and occasionally sending miscreants to jail. Delaware is the good cop. It arbitrates between shareholder and management interests, making sure never to chill risk taking. It articulates governance standards in a dialogue with the actors it regulates. It only polices when forced. Even then it chooses its techniques with care, sometimes enjoining a transaction but almost never imposing a money judgment. Its mandarin corporate case law is conversant with financial technicalities and full of procedural nuance.

The good cop/bad cop routine follows from the federal structure. Delaware's sales of domiciles to firms operating nationwide can implicate externalities. Externalities do occur because Delaware's strategy structurally favors management on allocational questions. It follows that a state with Delaware's incentives would not be tolerated as a de facto national lawmaker absent the possibility of federal preemption to reverse or modify state law results. At the same time, when financial crises and compliance breakdowns coincide,[1] national lawmakers worry about the reactions of the median voter. There result national political demands concerning the conduct of corporate business. Delaware is disabled from responding to such demands, self regulation and kid glove treatment being essential components of its evolutionarily stable strategy. Charter competition embeds enabling state corporate law and inhibits policing. By default, then, the job of confronting external shocks goes to actors at the national level. This leaves Delaware structurally vulnerable to shifting preferences and abrupt changes in response at the federal level.

But federal responses have over time become progressively less threatening to the state equilibrium. Federal elected officials tend traverse internal affairs on the upside to satisfy in-

1 Price declines have been triggering governmental regulation of the securities markets for 300 years, see (Banner 1998).

terest group demands, expecting no adverse political consequences. On the downside, officials legislate in response to more broadly-based political demands, acting to avoid finding themselves on the wrong side of median voter preferences rather than acting at the behest of the interest groups. Meanwhile, median voter demands have moved away from early and mid twentieth century populist concerns like corporate bigness and labor relations. Now, in the era of shareholder capitalism, national political demands tend to be driven by shareholder value. Today's populist agenda concerns compliance with laws designed to assure accurate market prices.

These downside legislative packages are designed to correct policy imbalances in the voters' eyes and avoid any fundamental restructuring of corporate law. This makes political sense in light of Delaware's emergence in the good cop role. Just as the good cop's role is untenable without a bad cop in the other room, so does the bad cop make use of the good cop. As the good cop, Delaware figures in the wider politics of shareholder value. It follows that interference with the state equilibrium implies more than just interest group opposition; it also holds out political risks with the median voter.

Where national corporate law is driven by valuations in securities markets, state corporate law is driven by rents. Many take this point as a basis for questioning the system, persuasively showing that the state equilibrium does not measure up as first best when analogized to an efficient product market. While we agree with the second best description of the charter market, we do not see any negative implications for Delaware's legitimacy, in theory or in practice. For us it suffices that the system is consensual, responsive, and monitored at the national level. Indeed, it is not clear to us that a first best market for law could exist in the first place. Law rarely works as product in the real world because lawmakers lack entrepreneurial incentives. It accordingly is unsurprising to find a jackpot of rents in the financial profile of a state that not only turns itself into an entrepreneurial shop but successfully pursues the same business plan for a century.

Summing up, this Article brings five points to corporate federalism discussions. First, federal intervention into internal affairs is inevitable because Delaware follows an evolutionarily stable strategy that constrains its ability to respond to shocks that create national political demands. Secondly, national interventions are structured so as to leave the rent-driven state equilibrium undisturbed. Thirdly, the cooperative federal strategy has come to respond to political demands focused on shareholder value. Fourthly, the state equilibrium's second-best quality has no bearing on corporate federalism. From all of this follows a fifth point – the threat of federal intervention has sunk into the deep constitutional structure, leaving Delaware safe in the present context.

Part 1 recounts the evolution of state corporate codes from the appearance of charter competition in New Jersey in 1888 through the takeover wars of the 1980s. This account shows that an enabling approach quickly became embedded in corporate law due to the appearance of a stable strategy for charter market success. The discussion goes on to describe the opposing evaluative models drawn on by the charter system's opponents and proponents – the trust paradigm of Berle and Means (and successors) and the market paradigm of Henry Manne and Michael Jensen (and successors). Finally, Part I takes up the question whether the charter market's second best properties make any difference for federalism and the internal affairs norm, concluding that they do not matter.

Part 2 turns to national law, setting out a political economy of federal incursions on corporate internal affairs since 1934. This begins with two prominent initiatives that failed, federal chartering and federal protection of hostile takeovers, and shows how both the trust and market paradigms both fell short as political motivators. Discussion turns to incursions that succeeded, mostly prominently the Williams Act, the Foreign Corrupt Practices Act, and the Sarbanes Oxley Act. These histories show that where the state system is embedded, federal corporate lawmaking is politically contingent and responsive to events. Even so, federal regulators respond to events in predictable ways, hewing to the governance agenda, the shareholder value enhancement objective, and a cooperative pattern of respect for the stable state equilibrium.

Part 3 focuses on state responses to developments in the national political economy, looking at Delaware's evolution since the mid 1970s. Delaware, under national pressure, adjusted its strategy to make itself a more credible source of corporate fiduciary law. It learned how to draw on the governance agenda to build self regulation into fiduciary enforcement. It emerged in the role of national good cop, the important point being that it found a way to police and without defecting from its equilibrium strategy. Delaware also held to its strategy on the focal point issue of antitakeover protection, in the teeth of federal pressure. Today, with takeovers off of the federal political agenda and newly empowered shareholders taking up governance slack, Delaware looks in better shape than ever. Part 4 concludes.

3.2 Political Economy at the State Level

National regulators – Congress, the Securities Exchange Commission, the federal courts, and the stock exchanges – have generated a long list of disclosure and governance mandates that expand on the state corporate law system, imposing additional duties on corporate managers and according shareholders additional rights (see Thompson and Sale 2003; Seligman 1993). These national regulations tend to supplement the state system, rarely displacing it altogether. (see Thompson 1999). The pattern of restraint does not follow from a constitutional mandate – Congress could draw on the same Commerce Clause[2] on which it draws in supplementing the state system to occupy the entire field of corporate law. The restraint instead follows from informal norm of federalism, termed 'internal affairs.' This abstracts from the post 1934 regulatory pattern to hold that federal law appropriately addresses trading markets, adding disclosure, antifraud, and insider trading mandates. All other corporate subject matters concern 'internal affairs' and presumptively are left to the states. At the national le-

2 U.S. Const. art. I, § 8, cl. 3.

vel we have markets and mandates, and at the state level, internal affairs, free contract, enabling governance strategies, and ex post fiduciary review.

The internal affairs norm is fragile, both descriptively and normatively. Even as it influences the national regulatory agenda at some level and federal regulators habitually restrain their entries into state territory, the norm has not contained the federal agenda in a formal sense. With the proxy rules, for example, the federal securities law shifts from regulation of market transactions to regulation of shareholders meetings, going deep into internal governance territory. National market regulators also traverse the states' enabling internal regime as they seek to assure the quality of financial reports, imposing compliance systems and committee requirements. As the list of such interventions lengthens, a subject matter-based description less and less describes the content of corporate federalism.

Corporate law's complex, overlapping pattern results from more than a century of political and economic interaction among actors in large firms, in the securities markets, and in state and federal governments. As a descriptive matter, it follows that the federalism's content can be accessed fully only if the static picture is recast in the historical, political, and economic framework that created it. Such a dynamic description will help us address corporate federalism's central issue – the weight to be accorded state control of internal affairs in national corporate regulation. Two questions state the issue more specifically. The first is descriptive: Whether the internal affairs norm in fact operates as a presumption that constrains national level lawmakers. The second is normative: Whether, to the extent the internal affairs norm does constrain at the national level, it follows from a reflexive subsidiarity and lacks policy content or, in the alternative, possesses welfare enhancing properties. To address these questions, this Article undertakes a comparative political economy of corporate lawmaking. This Part evaluates lawmaking in the states.

At the state level, charter competition determines corporate law regulatory strategies. The question concerning the appropriate strength of the federal internal affairs presumption accordingly tends to overlap the question concerning charter competition's welfare effects. The discussion that follows enters onto this contested territory with a descriptive agenda. The description leads us to depict the states as noncooperative players of a rent-driven game and Delaware as the follower of a successful, evolutionarily stable strategy. Corporate law emerges in a stable equilibrium state. The description in turn implies a favorable normative evaluation.

Section 3.2.1 traces the evolution of the state system, identifying its principal political and economic determinants. This is a history of regulatory responsiveness induced by rents paid by management. The funding removes state corporate law from the ordinary influences that shape democratic government and embeds state level governance strategies, which show a notable constancy over time. It also structurally removes corporate law from the ordinary political conditions that shape regulation, whether at the state or national level. Externalities emerge as a distinct possibility. It follows that, absent the possibility of federal intervention at the behest of actors disadvantaged by the state system but not represented in the chartering state, state-level charter competition would be intolerable in a federal system.

Section 3.2.2 looks at theories that evaluate charter competition. First comes the trust paradigm of Berle and Means and Cary, and its race to the bottom description. Next comes the market paradigm of the late twentieth century and its race to the top description. We show that each paradigm was directed as much against the competing paradigm as either was directed toward accurate description of the state system and its political economy. Contemporary descriptions correct the shortcoming, showing that the charter market is uncompetitive and riddled with economic distortions. We do not dispute the accuracy of these descriptions. But we do question whether they have any significant implications for the internal affairs norm. In our analysis the presumption leaving internal affairs with the states emerges unscathed even as economic analysis places the charter market deeper and deeper in second best territory.

3.2.1 The Competitive Era

New Jersey and Delaware.
In 1888 the government of New Jersey needed new sources of revenue. James Brooks Dill, a New York lawyer, suggested to the state's politicians that significant sums could be raised if the state provided an attractive domicile for the nation's growing corporate population (see Grandy 1989). The politicians countered that West Virginia already had tried this, liberalizing its corporate code, but without significant fiscal results. Indeed, in 1888 West Virginia's Secretary of State was stationed at the Fifth Avenue Hotel in New York, the seal of the state in hand, ready to sell charters but not finding many takers. Dill assured the politicians that it would be different with New Jersey. The state would not only draft a more liberal code, it would market the code more successfully. Toward the latter end, Dill organized The Corporation Trust Company, which would both serve as the state's marketing arm and as a local agent for incorporating firms, providing them a physical office within the state. Dill, who made sure to put New Jersey's Governor and Secretary of State on the Corporation Trust board of directors, got his corporate code (see Stoke 1930, Hovenkamp 1991).

The regulatory strategy was enabling. By 1896, all significant ex ante constraints on corporate agents had been stripped from New Jersey's code. Governance processes took their place. Corporations were left free to change their business, alter their equity capital structures, and amend their charters. More importantly, the code left them free to merge and combine in holding company structures toward the end of facilitating anticompetitive arrangements. New Jersey thus opened the door for mergers even as other states were following the federal government and enacting antitrust laws modeled on the Sherman Act.[3]

3 By 1914 all but New Jersey and six other states had done so.

New Jersey's code also held out a critical innovation respecting governance process: For the first time in any state code, initiation rights were vested in the board of directors subject to shareholder ratification.[4] This gave managers agenda control over fundamental changes, including, critically, reincorporation to another state. (Previously, an agency theory of board authority had prevailed and shareholder initiative had been the rule.[5]) There was also an innovative governance mandate: All shareholders meetings had to be held in New Jersey, providing not only rents for the state but assuring that voting would be by proxy, making challenges less likely. New Jersey's 1896 code became the template for the evolution of the state level corporate regime.[6] Subsequent departures from it have opened new stretches of enabling territory but have not changed the system fundamentally. The New Jersey code became the template because it succeeded competitively. Half of the nation's largest corporations were domiciled in New Jersey by 1899. The state's deficit was wiped out. By 1905, its governor even boasted that none of the state's income was contributed by direct payments from individuals.

Other states entered the new charter market. In 1899, Delaware's Joseph A. Marvel marked up his state's corporate code to mimic New Jersey's. (He also formed the Corporations Services Company and mailed advertisements.) Marvel's code offered fewer restrictions on the issuance of stock and lower franchise fees. It also carried the contractarian model to its logical conclusion by providing that the charter could contain any provisions not contrary to law (see Dodd 1936). Delaware attracted a handful of large firms but did not threaten New Jersey's dominance. Even so, corporate revenues quickly constituted an important source of Delaware's revenues, rising from 7 percent of total revenues in 1899 to 20.5 percent in 1900 and 30.6 percent in 1906 (see Nader et al 1997). West Virginia, Maryland, Maine, and Kentucky quickly followed with revisions of their own codes. Other states soon fell into line. By 1912 the laws of most of the states had been revised in varying degrees to follow the enabling strategy.

New Jersey backtracked on February 17, 1913, enacting a series of antitrust amendments called the 'Seven Sisters.' These variously prohibited monopolization, price fixing, and other anticompetitive behavior, following an agenda set by Governor Woodrow Wilson, who was about to be inaugurated President. The number of charters issued in New Jersey declined in succeeding years. The state's lawmakers then had second thoughts, removing the salient prohibitions from the corporate code in 1915 and 1917. Chartering firms neither forgave nor forgot New Jersey's defection to the antitrust side. Delaware saw a significant increase in large firm incorporations and reincorporations, numbers that would peak during the boom years of the 1920s. By 1917, 36.4 percent of Delaware's revenues came from chartering. (The percentage peaked at 42.5 in 1929, see Nader et al, 1976). By 1922, Delaware had a clear lead,

4 Dill (1899) (New Jersey General Corporation Act § 27).

5 See Angell and Ames (1871), Morawetz (1888). Delaware followed in its corporations code of 1899, See Section 135 of the Act of 1899, 21 Del. Laws, 1899, ch. 273. These agenda control provisions diffused into the codes of other states during the subsequent decades. By 1960, 25 state codes conditioned charter amendment on board approval; see 2 Model Bus. Corp. Act. Ann. 230-31 (1960) Thus, by 1970, 28 state codes did so. See 2 Model Bus. Corp. Act. Ann.2d 260-61 (1971).

6 New Jersey's code in 1929 resembled 'very much the laws of 1896.' See Stoke (1930, p. 579).

emerging as the state of incorporation of 55 percent of the firms listed on the New York Stock Exchange.

State corporate law emerged fully formed by the boom years of the 1920s. Then, as now, the terms of affiliation of corporate agents were left to be arranged through contract. Then, as now, the law imposed no significant protections for creditors or other constituents. Then, as now, ex post fiduciary law provided the principal constraint. Then, as now, ultimate shareholder control had to be achieved through the exercise of governance mechanisms, the board of directors held agenda control, and the proxy voting system operated as a barrier to soundings of shareholder voice (see Dodd, 1938, p 51). State law emerged in this mature form in a hotly competitive environment, with two states enjoying the lead in succession and others affirmatively vying for business. Competing state actors were highly incentivized, between the twin payoffs of a significant positive impact on state revenues and private rents for key state actors from stakes in service companies.

Two additional points should be noted about the early period. Charter competition was invented by a New York corporate lawyer, and from the very beginning was fully compatible with the interests of New York's corporate bar. Transactions involving New Jersey and Delaware corporations closed in New York, stage managed by New York lawyers, without any fee sharing with New Jersey or Delaware lawyers. From the beginning, lawyers in financial centers opined on due organization under New Jersey and Delaware law, ignoring the usual formal requisite of membership in the bar of the state law applied in the opinion.[7] Delaware's famously well-compensated bar[8] conducts a litigation practice.

Secondly, the states competed for charters and created enabling codes against a constant threat of federal intervention. Bills proposing federal incorporation of large firms, modeled on nineteenth century corporate codes that restricted size, lines of business, and mergers, were a staple of congressional life from 1900 until 1914. All were motivated by a perceived public interest in competitive production and against industry concentration. But the clamour for corporate reform abated after 1914. At both the state and federal level a consensus formed that the Sherman Act's approach to antitrust, broadly directed to restraints of trade, worked better than corporate law's rules-based restrictions on lines of business and combinations, which had not provided a viable basis for distinguishing between good and bad mergers.

State Corporate Codes after 1913

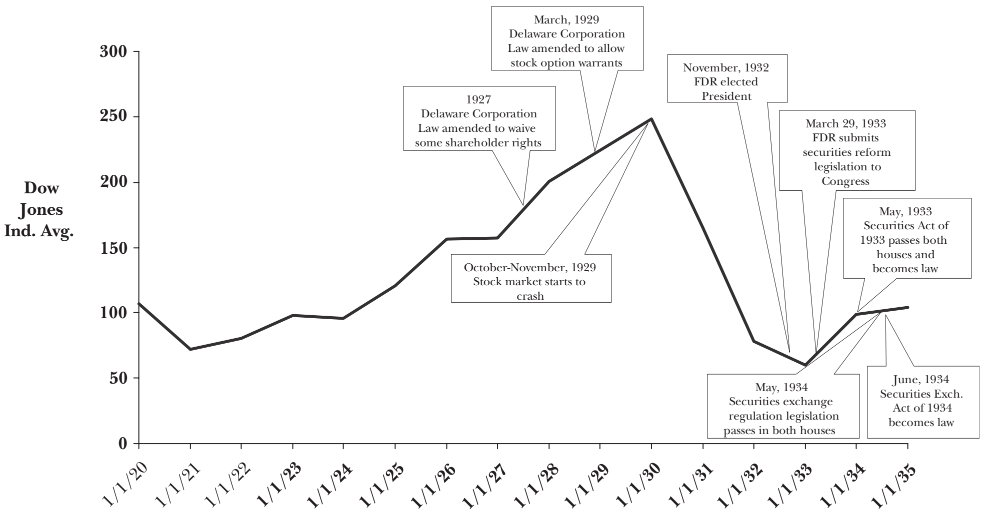
Legislative innovation at the state level never again reached the intensity experienced in the wake of New Jersey's competitive initiative. But three smaller waves of change did occur in subsequent decades. Here we describe the first two, which occurred in the 1920s and 1960s. The third wave, the state antitakeover statutes of the 1980s, will be taken up below.

7 See Association of the Bar of the City of New York (1998) (explaining that New York lawyers give Delaware law opinions); Committee on Corporations (1990).

8 See Kahan and Kamar (2002)(showing that Delaware lawyers are the most highly paid in any state).

The first round of innovation came in wake of the boom stock market of the 1920s. Corporations and their promoters, utilizing the corporate codes' allowance of nonvoting preferred and common, took advantage of the market boom to float new equity issues that carried no sacrifice of control. But, in 1926, the New York Stock Exchange intervened with a one share one vote rule. Delaware followed up with give backs, removing from its code some remaining constraints on stock issuance. First, in 1927, it removed one last mandate respecting affiliation terms – preemptive rights, which thereafter became optional (see Seligman 1982). Secondly, in March 1929, it amended its code to permit blank stock charter provisions, permitting corporations to waive shareholder ratification respecting the terms of new stock issues, enhancing managements' freedom of action respecting equity capital structure.[9] Thirdly, and also in March 1929, Delaware sanctioned the issue of stock option warrants, facilitating the distribution of bargain purchase rights to insiders even in a world of one share one vote.

Figure 1: Market Context 1920-41



Source: Yahoo Financial (graph developed using the opening level of the Dow Jones Industrial Average on the first trading day of each month over the course of the cycle

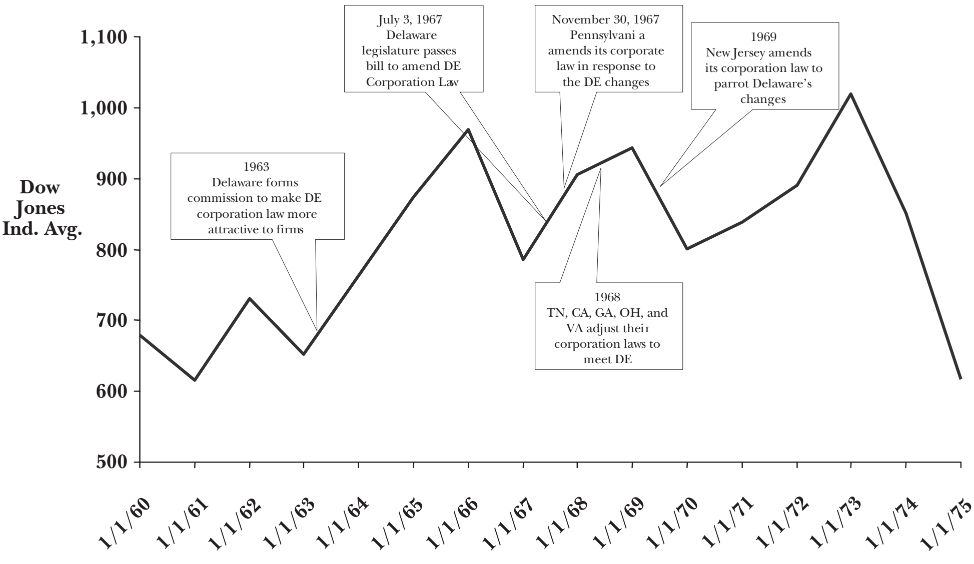
The stock market crash six months later caused the venue of corporate law innovation to move to the national level and stay there for three decades. At the same time, new incorporation activity in Delaware slowed substantially. Delaware would not equal the dollar amount of its 1929 chartering revenues until 1952 (see Nader et al. 1976, p. 505). Even then, 1952 in no sense equalled 1929 so far as concerned Delaware's public fisc. The portion of its revenues

9 Delaware also added a loophole in its legal capital provisions in the late 1920s – the 'nimble dividend.' See Nader et al. (1976).

contributed by chartering would remain under 10 percent of the total until after 1967. Worse, during the 1950s and early 1960s, reincorporation to Delaware continued only at the diminished pace set during the Depression.

By 1963, revenues from chartering had declined to 7 percent of Delaware's total, and its lawmakers began to fear competition from New Jersey and Maryland. The legislature organized a law revision commission to review the code. Another round of innovation followed, with the amendments becoming effective in 1967. These added an enabling section liberalizing indemnity of officers and directors found liable for breaches of fiduciary duties.[10] The amendments also significantly narrowed the class of shareholders accorded merger appraisal rights,[11] facilitating acquisitions by large firms. Figure 2 shows that the equity market environment at the time resembled that prevailing during the first round of code innovations of the late 1920s: Delaware returned to an aggressive, competitive mode in the 'go go' stock market of the 1960s, during which the Dow Jones Industrial Average reached the 900 level for the first time since 1929.

Figure 2: Market Context 1960-75



Source: Yahoo! Finance (graph developed using the opening level of the Dow Jones Industrial Average on the first trading day of each month over the course of the cycle)

10 Del. Gen. Corp. L., Del. Code Ann. tit. 8, § 145(2001).
11 Del. Gen. Corp. L., Del. Code Ann. tit. 8 § 262(b) (2001).

Delaware's initiative yielded palpable rewards. Incorporations and reincorporations of large firms increased markedly in 1966 and continued through 1971 at levels not seen since the 1920s. Even though other states quickly copied the new provisions, Delaware's market share recovered to one-third of NYSE companies. Since then, Delaware has steadily increased that market share: By 1977, 40% of publicly traded companies were organized in Delaware; in 1981 the figure was 44 percent; the 50 percent figure was reached again by 1991; and by 1999 the figure was 57.8 percent (see Dodd and Leftwich 1980, Bebchuk and Cohen 2003).

Stability and Political Insulation.

We emerge from this discussion with a confirmation, a prediction, and a structural conclusion. The confirmation is that state legislative innovation tends to enhance management's freedom of action by expanding the enabling envelope. The prediction is that management friendly innovation tends to occur against the background of a strong stock market. Concerns about legitimacy and federal intervention could have something to do with this. But marketing does also. Corporations tend bring reincorporation proposals to their shareholders in the wake of abnormal run ups in their stock prices (see Bradley and Schipani 1989). The competitive state strikes while the iron is hot, drawing attention to its product line so as to focus management's attention of the benefits or reincorporation.

The structural point concerns the overall trajectory of state legislative innovation. The post-1913 rounds of innovation amount to minor adjustments to a stable legal regime. New Jersey set the states' enabling agenda in 1888 and the agenda remained stable for eight decades thereafter. The economic shock of crash and depression at most brought quietude. The only political shock came when Woodrow Wilson took the presidency and New Jersey legislature opened its code to the influence of the broader public's political concerns. The management customers in the charter market reacted emphatically. The message has never changed: Public politics and corporate law do not mix; any significant departure from the norm means reincorporation to another state.

Political theorists evaluate political systems in terms of their accountability and representativeness. Accountability is high when voters can identify the actors responsible for making policy and oust those who perform badly. Representativeness is high when policies reflect the preferences of a large spectrum of voters (see Persson and Tabellini 2003). The larger the political subdivision, the more likely it is that policies are broadly representative, as politicians are forced to seek the support of broad coalitions, representing multiple socio-economic groups. In smaller districts, competing politicians may cater to narrower, geographical constituencies.

Charter competition rearranges the conventional patterns. The possibility of reincorporation out of the state assures a high degree of accountability. But now accountability goes not to the voters of state (whether a broad or narrow coalition), but to the firms' managers and shareholders, who react not as voting citizens but as economic interest holders. Paradoxically, we simultaneously see a high degree of representativeness, at least in the one state with a stake in chartering revenues. So far as the concerns the people of Delaware, any corporate law policy that suits the chartering customers also suits them. This complete concord between the voters of the chartering state and the chartered firms cordons off corporate law from conventional political influences and concomitant regulatory volatility. Such a stable political settlement could never be reached at the federal level, where broad political coalitions could contest it.

The stable settlement holds out a possibility of externalities, of course. Even as the dominant chartering state makes corporate law without regard to conventional politics within its borders, its firms carry its law across the wider national political and economic geography. As a national lawmaker, it potentially impacts the economic interests of actors nationwide, actors who may be badly represented or entirely unrepresented in its lawmaking process and as to whom it is unaccountable. To the extent that corporate law has political implications at the more broadly representative national arena, such an arrangement is politically tolerable only given the possibility of preemption by the national government. Any disadvantaged group or broad public interest coalition gets a right to contest the state level result by making a political appeal to the Congress. In view of the fact that chartering state may impose its law outside its borders only due to a federal constitutional mandate, federal political contestability makes structural sense.

3.2.2 Chartering Races

Because national level political appeals are a constant structural possibility, national respect for state control over internal corporate affairs remains in a contingent posture. The magnitude of respect accorded could vary in response to prevailing views on the state system's welfare effects, with normative frameworks used in evaluating the state system bearing on national responses. This section sets out the two leading evaluative paradigms – trust and market. Under the trust paradigm, charter competition is described as a race to the bottom. The market paradigm reverses the story, describing a race to the top.

The Trust Paradigm and the Race to the Bottom.

The race to the bottom charge dates back to charter competition's first appearance, when critics denounced it for facilitating anticompetitive activity.[12] Subsequent decades saw no abatement of criticism, even as the critics shifted their focus. The leading basis for denunciation became the trust paradigm articulated in 1932 byAdolf Berle and Gardiner Means in *The Modern Corporation and Private Property.*

The enabling state system, said Berle and Means, had facilitated the appearance and success of the large, mass-producing, management-controlled corporation. The law thereby had become implicated in the creation and perpetuation of an unsatisfactory separation of ownership and control. The big corporations of the twentieth century had split the classical

12 See *Liggett v. Lee,* 288 U.S. 517 (1933)(Brandeis, J,. dissenting).

entrepreneurial function between salaried executives, who sat atop hierarchical organizations, and anonymous equity participants, who held small stakes and prized market liquidity over participation. This presented problems of competence and responsibility absent in an ideal, classical capitalist world inhabited by self-employed individual producers. In the classical model, market competition effectively controlled the producers, constraining both the incompetent and the greedy and legitimating private economic power. But corporate mass production on a large capital base broke those parameters, with firms taking on significant attributes and powers, social as well as economic. Industrial oligarchs exercised unified control over the wealth under their charge, and the law played a role in investing the power. Therefore, said Berle and Means, corporate property should no longer be deemed private property. That assertion in turn supported a presumption favoring new regulation of corporate internal affairs.

Berle and Means recommended no pervasive system of national oversight, however. Instead they focused on the problem of management self dealing in the context of the enabling system. Corporate insiders were writing their own contracts, with immunity clauses and waivers of shareholder rights allowing much diversion of corporate profit to managers' pockets. The law, they said, would do a better job if it were rewritten to follow basic principles of trust law. More particularly, there should be a pervasive equitable limitation on powers granted to corporate management (or any other group within the corporation) by the enabling system: Power should be exercisable only for the ratable benefit of all the shareholders. Enforcement of the equitable limitation safely could be remitted to the state judiciary. In Berle and Means' view, charter competition impacted only statutes, leaving the common law of fiduciary duties as the one area of corporate law remaining robust: 'Flexible and realistic' judges, 'if untrammeled by statute,' could be expected to find solutions to problems that demanded a remedy.

Events did not unfold in accordance with the book's description, however. Delaware's judges did indeed prove 'flexible and realistic,' but their flexibility followed their realism and so benefited management interests. By the 1960s, observers attempting to explain why no other state had wrested a significant market share away from Delaware were mentioning Delaware's courts as well as its code. The accumulated stock of precedent was mentioned, along with competence and fairness. But Sam Arsht, a dean of the Delaware bar, added a telling point – corporations considered Delaware the most favorable forum available.

The results frustrated proponents of the trust paradigm, whose views were embodied in William L. Cary's (1974) famous indictment of Delaware, published in 1974. Cary reviewed leading Delaware opinions, along with the statutory developments reviewed above, and concluded that Delaware had 'no public policy left . . . other than the objective of raising revenue.' To Cary, the 'public policy' at stake was the integrity of corporate managers. Rents had led a single state to 'grant management unilateral control untrammeled by other interests,' thereby sacrificing the national public interest. Charter competition was a 'race to the bottom.' The stable settlement between Delaware and the chartering firms meant that corporate law addressed only the interests of a narrow class of management consumers, causing it to be more and more removed from the public interest.

Cary recommended a preemptive federal regime of fiduciary standards, a traversal of internal affairs that might have enervated the charter market. Unlike the federal mandates we see in practice,[13] fiduciary standards would have removed fiduciary lawmaking to the federal courts, destroying Delaware's body of case precedents and removing its judiciary from the front line of corporate lawmaking. Given the gradual convergence of corporate codes, Delaware's customers thereupon might have reappraised the costs and benefits of domicile in the state.

The Market Paradigm and the Race to the Top.

The market paradigm rebuts both the trust paradigm's description of separated ownership and control and its call for regulation. This perspective, which originated in economics during the 1960s and 1970s, recasts the firm as an incident of contracting among rational economic actors. The firm becomes a series of contracts joining inputs to outputs, with equity capital as one of the inputs and corporate law as a part of the input's governing contract. The imperfections identified under the trust paradigm reemerge under the denomination 'agency costs,' costs that firms must minimize due the free market's competitive force. Managers are no longer seen as empowered actors and responsibility is no longer seen as a problem. When managers fail, they get removed – either a hostile offeror takes over the company and throws them out, the firm with a high agency cost base fails to survive in the product market, or poor managers fail to survive in the management labor market (see Manne 1965). Their incentives accordingly are focused on long run productive success for the firm. Given these market deterrents, corporate property again becomes private, the regulatory agenda goes blank, and a powerful presumption lies against national intervention (see Bratton 1992).

The market paradigm also counters Cary's denunciation of Delaware. It draws on public choice theory to debunk the public interest ideal of regulatory motivation and assert that regulators should be expected to behave no differently than actors in private economic relations. There is, accordingly, nothing suspicious about the sale of charters. This point, coupled with the market deterrent story of well-aligned agent incentives, reverses the race to the bottom into a race to the top. (see Winter 1977). In the race to the top description, state corporate codes and judicial venues are viewed as products consumed by corporations. Competition for the legal business of firms forces the states to adapt the law to the dynamic conditions in which the firms operate. State lawmaking emerges as a trial and error process suited to the accurate identification of optimal corporate arrangements (see Romano 1993).

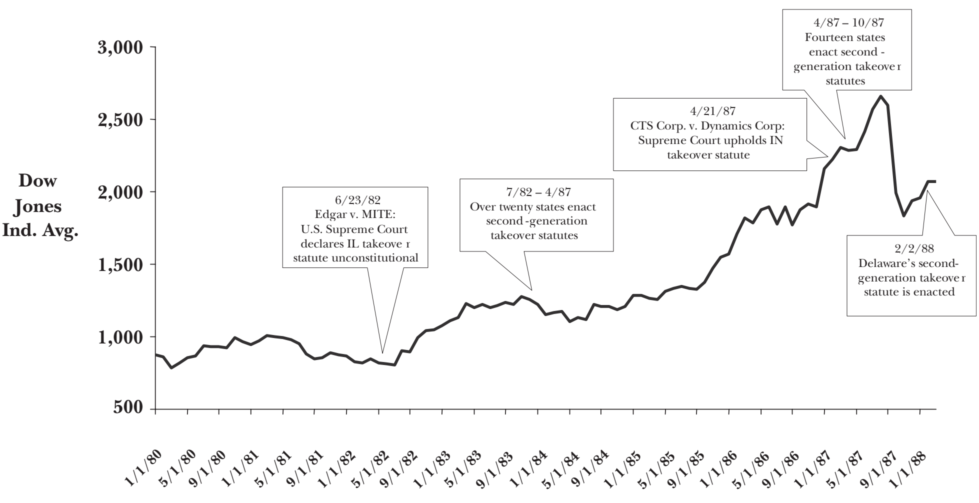
13 If the federal mandates described above at any time adversely affected Delaware, they did so in the period between 1929 and 1967, when Delaware lost market share and suffered reduced revenue support from chartering. Since the mandates stayed in place after Delaware's 1967 recovery, it seems sounder to refrain from inferring a negative impact during any period.

State Antitakeover Statutes, the Structural Defect, and the Failure of the Market Paradigm.

Each paradigm, trust and market, has a strong ideological affinity. The trust perspective suits progressives disposed to impose regulations that disempower managers and protect actors in vulnerable economic positions. As such it lost its leading role in public policy discussion after 1980, along with the general collapse of confidence in regulatory solutions to economic problems. The trust paradigm still echoes in a significant body of academic commentary (see Stout and Blair 1999). But it neither informs corporate law agendas in the wider polity nor figures importantly in contemporary criticisms of the charter competition system.

The market paradigm presents an ideological mirror image. It suits deregulatory policy agendas and devolutionary federalists. The deregulatory 1980s should have carried it to unquestioned ascendancy in corporate law discussions. But it instead ran into an unanticipated public choice problem when the mature, state-level enabling system underwent a third and final round of statutory innovation.

Figure 3: Market Context 1982-88



Source: Yahoo! Finance (generated using the closing price of the Dow Jones Industrial Average on each day of the historical period)

During the 1980s, a majority of the states added antitakeover provisions to their codes. The statutes entered territory where free contract formerly had prevailed, making takeovers more expensive and variously containing shareholder rights of alienation and decisionmaking. The statutes began to appear in the 1960s and 1970s, but changed in form after 1982, when the Supreme Court, in *Edgar v. MITE*,[14] invoked the commerce clause to invalidate state statutes that subjected hostile tender offers to substantive review by state securities administrators. The new statutes, which operated in traditional internal affairs territory, passed constitutional inspection in 1987, when the Supreme Court decided *CTS Corp. v. Dynamics Corp. of America*.[15] Twenty states enacted such statutes in the years between the two rulings, with fourteen more acting in the six months after *CTS*. Delaware, lagging, followed in 1988.

The antitakeover round followed the earlier pattern of state law innovation in two significant respects. The statutes once again were enacted against the backdrop of a booming stock market, as shown in Figure 3. They also catered to management's interest in freedom of action.

But the antitakeover statutes also broke the pattern in significant respects. Innovations in the bull markets of the 1920s and 1960s facilitated dealmaking; here the states chilled transactions. Formerly, state law innovation almost always moved in an enabling direction. Here, even as the governance device of shareholder ratification figured prominently, so did mandates. Formerly, the first mover had been Delaware, the charter market leader. Here states that did not pursue charters made the first move. Where Delaware innovated with an eye to business preferences nationwide, the states enacting antitakeover statutes moved at the behest of nervous managers with local influence. The politics were unrepresentative. Threatened managers and local lawyers, acting independently of local business, labor, and community leaders, used their influence to procure legislation. The responsive legislators in effect externalized the costs of takeover defense on out of state shareholders. Rising stock prices also figured into picture: Takeover activity, friendly as well as hostile, rises and falls with the stock market.

The Delaware process differed, reflecting the more diverse constituency swept in by its law's national reach. Managers seeking protection (and their lawyers) lobbied in favor, some even threatening to pull out of the state. They were countered by institutional investors, shareholders organizations, and SEC commissioners. A weak statute emerged.

The equilibrium pattern broke because, with the hostile offers of the 1980s, the enabling framework, for the first time in its history, held out an effective means of management removal unimpeded by the shareholder collective action problem. When the states adjusted by erecting new barriers, the shareholders, again for the first time in corporate law history, went into irreconcilable opposition. Previously, the states' successive moves to extend managers more slack had failed to rouse shareholder opposition. There were a number of reasons for the shareholders' cooperative attitude. First, as the trust proponents noted, the shareholders suffered collective action problems. Secondly, under the 'Wall Street Rule,' shareholders were content to resort to exit by market sale when excessive slack led to poor results.

14 457 U.S. 624, 640-46 (1982).
15 481 U.S. 69 (1987).

Thirdly, since 1934, the SEC had stood in to protect the shareholder interest at the national level.[16] Sleazy market practices facilitated by enabling innovations in the 1920s had been dealt with by federal disclosure and market regulation mandates. In the 1980s, however, federal regulators did not come to the shareholders' rescue. Institutional shareholding, meanwhile, ameliorated the collective action problem. Now organized, the shareholders found their voice, a dissenting voice.

Just as the market paradigm had enervated the trust paradigm, so did the market paradigm now suffer enervation. The market-based race to the top validation of state law had bypassed the problem of the shareholders' lack of influence over state lawmaking with a reference to the control market deterrent. The assertion, in effect, was that the managers' option of exit adequately disciplined the states, while the possibility of shareholder exit by tender to a hostile offeror adequately disciplined the managers. The collaboration of managers and state politicians to hamper the market deterrent presented a manifest case of charter market failure. The responsive states had acted to contain the very mechanism on which the market paradigm relied to incentivize corporate agents. Charter competition, far from acting as a check on rent seeking activity, had promoted it. State law results were anything but first best efficient.

The failure of the market analogy was inevitable, given the crystallization of opposing views between shareholders and managers on the power implications of the shareholders' right of free transfer. The law as product analogy works as a policy justification only to the extent that the supplying jurisdiction purveys an unbundled regulatory product to a consumer with a unitary set of preferences, without externalizing costs on anyone else. The charter market does meet the former qualification – Delaware's customers take only its corporate law free of all other regulations. The latter qualification has always been problematic, for it depends on the heroic assumption shareholder and manager interests always are perfectly aligned, rendering irrelevant the mandated agenda control managers enjoy under the state system. Where, as with takeovers, interests do not stand aligned, the state system displays a structural defect. Because the market forces a state that actually competes to focus on the variables that influence incorporation decisions, there follows a concern for management preferences rather than shareholder value itself. Accordingly, nothing at the state level prevents suboptimal accommodation of management preferences respecting ex post affiliation terms and fiduciary standards (see Bebchuk 1992).

Since the defect is intrinsic to the system, regulatory correction must occur at the national level. Should the issue be joined there, and should the diagnosis of suboptimal results prevail there, the internal affairs presumption, standing alone, would present no barrier to intervention. The economics of federalism posit intervention to police interstate externalities as a principal justification for the very existence of the national government. Moreover, such intervention could be designed so as to cause minimal disruption at the state level. It could

16 The promulgation of the proxy rules in the 1950s provides an example of this.

even prove beneficial. We have suggested elsewhere that the federal government could partially preempt the states' provision of management agenda control and mandate a right of shareholder initiative to effect reincorporation. We projected that such an adjustment could jumpstart the charter market and import a state level incentive to create a regime more single-mindedly directed to shareholder value maximization (see Bratton and McCahery 1995). Lucian Bebchuk and Allen Ferrell (2001) apply this strategy in a different direction, suggesting that the federal government create a parallel takeover regime and accord the shareholders a privilege to opt into it. There is, then, no shortage of regulatory strategies fitted to the task of correcting the charter market's defects. Yet the federal government has not intervened, even as the era of shareholder capitalism dawned in the wake of the takeover wars of the 1980s.

How Robust is the Charter Market?

A growing body of commentary criticizes Delaware and the charter market from a different perspective, that of microeconomic theory. The market, it is charged, little resembles an efficient product market – a market that maximizes welfare by producing in the competitive equilibrium quantity (see Bar-Gil and Bebchuk 2001). It is instead a bundle of suboptimal distortions. Delaware charges much more for its product than its marginal cost of production and its franchise tax rates implicate price discrimination (see Kahan and Kamar (2001, p. 1205, 1215-19). Other states have no incentives to compete with Delaware, leaving their regimes open suboptimal influence activities by managers and lawyers (see Kahan and Kamar (2002, p. 735-40). Even if actors in another state had incentives to attempt to enter the market to take market share from Delaware, structural barriers would make competitive success highly unlikely (see Bebchuk and Hamdani 2002). Delaware, for example, takes the benefit of network and learning externalities incident to the sale of an integrated legal system (see Klausner 1995, Kamar 1998). Its system also is surprisingly friendly to litigating plaintiffs, toward the manifest end of generating rents for its bar (see Macey and Miller 1987, p. 471-72, Kahan & Kamar 2002, p. 695).

This thickening description teaches us much about the charter market. But we do not perceive any significant implications for the internal affairs presumption and the content of the federalism. We have five reasons. First, the regulatory competition description of state law only provides a self-standing justification on the assumption a parallel market for corporate control imports incentive compatibility. Once the states chilled the takeover threat, federal intervention could be justified whether or not Delaware faced active competition. Secondly, the structure of state law showed remarkable stability between 1896 and the takeover wars of the 1980s, and that structure was determined in a manifestly competitive environment. Potential entrants prompted Delaware to legislative action as late as 1967. Thirdly, Delaware always remains subject to potential competition from other states. If, like New Jersey in 1913, it defected from the political settlement and took a public interest view of regulation, the firms would find somewhere else to go. The same thing would happen if the quality of its lawmaking took a costly adverse turn. Similarly, were Delaware to raise its rents to the point where firms found it too costly, its business would drop off, causing it to reconsider both its franchise tax scheme and litigation rules. Fourthly, no one forces firms to go to Delaware and pay the rents. And if there is a group of consumers in the world well suited to contractual self protection, it is Delaware's customers. Indeed, more than forty percent of publicly traded firms choose to stay out. So, even though a pinpointed federal intervention could in theory jumpstart the charter market, such intervention is a remote possibility as a political proposition. Excess rents to Delaware and other imperfections highlighted by analogy to the economics of industrial organization seem an improbable basis for invoking national entry into internal affairs.

Fifthly, and most importantly, the economics federalism look beyond competition to support a presumption favoring state and local level regulation. So long as production costs are equal, decentralized regulation is favored because it is more responsive – it narrows the variance in the distribution of preferences, reduces the likelihood of bundled preferences, and ameliorates problems of asymmetric information (see Bratton and McCahery 1997, p. 215). On the majority of matters as to which management and shareholder interests stand in alignment, the century-old political settlement between firms and the competitive chartering state, with its extraordinarily high degree of accountability, fits this description. At the same time, the market paradigm succeeds in an important respect, despite its shortcomings. Cary's public interest objection to the sale of corporate law no longer carries weight. Charter competition is no longer seen as inherently corrupt. It is viewed functionally in the wider legal and economic framework of shareholder capitalism.

The picture of an uncompetitive charter market holds out devastating implications not for the internal affairs presumption but for the economic theory of regulatory competition. This economics dates back a half century. It got off to a bright start. For a while it was thought that devolution within federations could be relied on to trigger races to the top respecting diverse subject matters. Competition for domiciliaries and factors of production was posited as the cure for public choice problems: Under the theory, citizens signal their preferences respecting legal goods and services when they migrate from regime to regime. Their ability to exit disempowers government actors, whose welfare diminishes as citizens depart, taking along votes and revenues. Competition for domiciliaries and factors of production, having disabled the interest groups, then causes government policies to be matched with diverse citizen preferences (see Romano 1993, p. 4-5). A preference for state over national lawmaking also is implied, since the revenue enhancement constraint on the national government is less intense. Because national level competitive constraints also are less intense, the national lawmaking process will be slower, less responsive to productive concerns, and more susceptible to the influence of organized interest groups.

The theory ran into two problems. First, multiple frictions at the state level impair competition. These include product bundling, mobility costs, spillovers, information asymmetries, and the absence of entrepreneurial incentives on the part of government actors (see Bratton and McCahery 1997, p. 260). Secondly, even assuming competitive incentives at the state level, the economics proved incapable of predicting stable, long-term equilibriums in competitive lawmaking situations (see Bratton and McCahery 1997, p. 261). Charter competition, along with other cases where a conflict of laws regime allows actors to chose a nominal jurisdictional situs for a legal relationship, are the exceptional cases where the theory has descriptive power. This is because nominally sited legal relationships can be sold separately as unbundled legal products (see Bratton and McCahery 1997, p. 267). Given something to sell, entrepreneurial lawmakers can appear. Of course, as we have seen with New Jersey and Delaware, a concomitant private sector sideline in the form of service company profits may be necessary to jump start the operation. But the service companies, along with other rent-seeking intermediaries, also serve a market function because they correct information asymmetries. With corporate law, a stable lawmaking equilibrium resulted. But, as we also have seen, externalities have remained a problem.

The scholarship highlighting the charter market's uncompetitive character shows that the problems do not stop with externalities: Even in these close to ideal conditions we have yet to see a competitive lawmaking equilibrium that stands up when inspected under the criteria applied to product markets. We suspect that entrepreneurial incentives lie at the core of the problem. New Jersey and Delaware are exceptional in their entrepreneurship. We do not tend to see similar behavior in other state and local situations where proponents suggest competitive regulatory solutions. Given this, we find it odd to hear that the charter competition system is infirm because rents provide its incentives. Absent the rents it is difficult to imagine the charter competition system ever coming into existence in the first place.

Competition, then, does not provide a stand alone justification for a strong internal affairs presumption. But we do not think this makes for a federalism problem for Delaware. To our knowledge no first best lawmaking equilibrium has ever been identified, so it not clear to us why the charter market needs to be judged by that measure in the first place.

3.2.3 Summary: The Stable Equilibrium

The state system can be described as a stable equilibrium. Drawing on concepts from evolutionary game theory, we see that, prior to 1920, New Jersey adopted a noncooperative strategy, turning corporate law-making into a strategic game directed to the acquisition of rents from managers looking for responsive, enabling legal frameworks, despite negative consequences for other states. There followed a period of learning (or adaptive behavior) during which other states adjusted their strategies, following New Jersey (see Samuelson 1997, p. 22-24). New Jersey then abandoned its strategy for exogenous political reasons. Delaware, playing New Jersey's original strategy, captured its rents. Delaware has been playing noncooperatively vis a vis the other states ever since. Within the game, an enabling corporate code that also vests agenda control over governance matters in management amounts to an evolutionary stable strategy – any state without one risks the loss of its significant charters; any state innovation that fails to follow the strategy will not succeed. Meanwhile, Delaware's agents resemble rational maximizers, seeking to protect the state's rents. They update and learn on an ongoing basis, adjusting their strategies respecting the terms of corporate law as they face new situations. The history shows that so long as the states are left alone to play the game, corporate law nearly approaches a stationary state.

The state system and its stable equilibrium pose two questions for federal lawmakers. The first is whether to respect the equilibrium's exclusion of regulation referenced to the wider public interest. Here a federal decision to intervene could so displace the states as to destroy the equilibrium and the strategies and rents that keep it stable. The second question is whether the state equilibrium succeeds as shareholder capitalism, according the shareholders meaningful ultimate control and succeeding in directing management in the shareholders' interest. Here views differ on the probable state level effects of federal intervention. Some argue that the states' failure to contain externalities and regulate toward the end of shareholder value maximization rebuts the internal affairs presumption and justifies corrective intervention. As we have seen, they also argue that this can be done in such a way as to force the states to change their strategies, accommodating the shareholder interest and changing their strategy without cutting off the rent incentive. Others take the position that the stable equilibrium holds out such benefits that any shortcomings must be forgiven. They point out that the political agenda at the federal level is highly contestable. Management remains a more concentrated group than the shareholders and thus more able to wield influence. It could co-opt a federal reform process, for example procuring legislation making takeovers more expensive still. That risk, together with the possibility of perverse effects stemming from the federal habit of governance by mandate, implies a preference for the states' enabling equilibrium, with its high degree of accountability within the corporate community (see Carney 1998, p. 757, Romano 1993, p. 4-5, 48-50, 75-76).

The corporate federalism question devolves into an assessment of the weight to be accorded these warnings. To assist that appraisal, the next part of the Article inquires into the political dynamics that trigger federal intervention into internal affairs. It shows that the notions of the public interest that motivate national level regulators have over time synchronized better and better with the state equilibrium.

3.3 Political Economy at the National Level

The federal government took the lead in regulating the securities markets when it added disclosure, antifraud, and insider trading mandates in 1933 and 1934.[17] Under the internal affairs norm, as thereafter articulated, markets and disclosure were federal subject matters, while other corporate subject matters were presumptively left to the states and the stable equilibrium. Despite the norm, the federal government and the stock exchanges since that time have progressively, albeit episodically, entered into internal affairs. These interventions are historically contingent, occurring when political demands are registered nationally.

17 The federal disclosure regime less displaced the states than it did the New York Stock Exchange listing requirements, which had required annual financial reports in 1907, semiannual financials in 1917, quarterly financials in 1923, and independent audits in 1932.

Despite the contingent and episodic nature of these federal entries, the federalism has evolved toward an equilibrium balance. Where the exchange of a product for rents describes the state equilibrium, the federal equilibrium is political. Where the state equilibrium is self-enforcing, federal actors have a range of strategies at their disposal and a zone of discretion. They could play uncooperatively, intervening so as to terminate the rents and the state equilibrium. They also could be wholly cooperative, leaving internal affairs to the states. Strategies actually chosen depend on political norms and pressures, which in turn depend heavily on the environment in which the game is played. We accordingly should not expect the federal-state game to replicate the stability we see in the states because the federal game is political and driven by exogenous events. Even so, four patterns can be discerned in the history of federal incursions on internal affairs. Together they suggest the evolution of a stable, cooperative strategy at the federal level.

The first pattern concerns subject matter. Interventions tend to address topics, legal compliance most prominently, as to which unilateral action by Delaware would be inadequate fully to satisfy national political demands. This follows in part from the federal structure: National demands create a need for parallel action across all 50 states. It also follows from the properties of the state equilibrium. In the charter market, the evolutionarily stable strategy is fidelity to the management interest. If Delaware shifted to a strategy of imposing hard wired accountability and enforcement, it would be viewed as a defection against management and would disrupt the equilibrium, reducing Delaware's rents. The same thing would happen if Delaware mandated governance processes. It follows that not only does federal intervention accomplish results unavailable in the states, the stable equilibrium disables the states from preemptively anticipating federal strategies. The states' evolutionarily stable strategy embeds the legal regime. At the same time, because the federal government never makes full use of its constitutional preemptive authority, the federal-state equilibrium has a cooperative aspect.

The second pattern concerns political substance. Federal chartering, the public interest strategy holding out the greatest threat to the state equilibrium, never reached the top of the federal political agenda after 1920. More generally, initiatives implicating sharp ideological partisanship do not find their way into federal level mandates. Neither the trust paradigm (broadly or narrowly stated) nor the market paradigm has motivated national level interventions. But a third approach, which we call the 'governance agenda,' does carry descriptive weight. Under this, the federal government intervenes to adjust state equilibrium results for the benefit of the shareholders, largely restricting itself to governance instruments found on a self regulatory menu. The pattern implies a norm of cooperation.

The third pattern concerns the relative influence of shareholders and managers. The presence of the SEC hardwires an influential voice for the shareholder interest at the federal level, even as the management interest at times also proves influential. Either way, federal interventions are stock market sensitive, with shareholder directed interventions coming in the wake of adverse economic shocks and management directed interventions occurring during buoyant markets.

The fourth pattern manifests the operative federalism. Even as the federal government and the stock exchanges cross the internal affairs line and mandate governance strategies, they have never disrupted the state equilibrium. National intervention has impacted neither the basic terms of the state settlement nor Delaware's rent flows, once again implying a cooperative strategy. Contrariwise, even as federal moves have prompted Delaware to adjust its strategies on occasion, Delaware never goes so far as to imitate federal strategies.

The next section looks at the counterfactual empty set, federal level agendas under the trust and market paradigms and the failure of both federal chartering and the protakeover agenda. Section 4.3.1 looks at the political climate surrounding the two most prominent federal interventions into internal affairs since 1934, Foreign Corrupt Practices Act and the Sarbanes-Oxley Act. Section 4.3.2 contrasts the political climate surrounding the Williams Act and other management directed federal interventions. Section 4.3.3 summarizes.

3.3.1 The Trust and Market Paradigms at the Federal Level

Federal incorporation proposals antedate the federal government itself – James Madison (1966) mooted the idea at the Constitutional Convention. Federal incorporation went on to reach the top of the national policy agenda as a first reaction to the appearance of charter competition. But its proponents in successive administrations never managed to put together the broad-based coalition needed to secure passage in Congress. After 1920, federal chartering never regained comparable political salience, even as the trust paradigm's adherents brought it back to the national agenda on two later occasions. This section takes the benefit of hindsight to explain those later failures, drawing a parallel to the failure of the market paradigm's proponents to invoke federal preemptive power to protect the hostile takeover.

The New Deal.

Federal incorporation had a place on the agendas of a number of prominent New Dealers, President Roosevelt and SEC Chairman William O. Douglas not least among them (see Seligman 1982). They were joined by Senators Joseph O'Mahoney and William Borah, who promoted the idea in Congress during the second Roosevelt administration. Borah and O'Mahoney wanted to make federal incorporation the vehicle for an omnibus progressive assault on management discretion. O'Mahoney's proposed billrevived old antitrust agenda items, adding to them Berle and Means' rule of trusteeship and other current items from the governance agenda. O'Mahoney also included the labor agenda, mandating compliance with the National Labor Relations Act as an internal corporate duty.

Unfortunately for O'Mahoney, prominent actors in the administration were opposed. Even Douglas had other matters at the top of his agenda and in any event opposed the inclusion of antitrust and labor compliance. The best that O'Mahoney could get from Congress was the formation of a study committee, the Temporary National Economic Committee.

This brought together six members of Congress and six agency representatives under O'Mahoney's chair. The committee held hearings but never got behind O'Mahoney's omnibus approach. Its final report in 1941 had no impact.

The bundling of the labor agenda has been accorded a causal role in the failure of the O'Mahoney initiative. To second the point, reference can be made to the labor movement's Congressional agenda since World War II, which has never targeted empowerment in corporate internal affairs. Under an enduring American political settlement, labor works within the model of contractual engagement, where, since the enactment of the Taft Hartley Act in 1947 (see Lichtenstein 1998), it has been fighting a rearguard political action. Organized labor works to improve its rights to organize shopfloors, empower the NLRB (or nominate a stronger enforcement agent), and secure the power of the secondary boycott (see Smith 2000). State law also shows up on the agenda, but labor wants right to work laws preempted rather than state corporate codes (see Romano 1987, p. 134-37). Today, even as union pension funds use their shareholdings for antimanagerial initiatives, they tend to stick to items on the institutional investors' governance agenda, avoiding labor movement issues in order to retain plausibility (see Schwab and Thomas 1998).

The Watergate Era.

When federal chartering returned to the political stage in the 1970s, labor figured in only incidentally.[18] The antitrust agenda of the day also was separately pursued, resulting in the Hart-Scott-Rodino Antitrust Improvements Act of 1976.[19] Federal chartering proponents, who this time came from outside of government, pursued a more general notion of the 'public interest.' Social reformers like Ralph Nader linked the conduct of corporate business to a range of social problems (see Nader, Green and Seligman 1976). It was thought that the benign, pluralist vision of government had failed. Legislative results were not protecting the public interest because business had overwhelming political influence. Indeed, under a theory in circulation at the time, business did not even need to lobby aggressively to get results: Politicians automatically backed anything that encouraged investment because they were terrified of the political consequences disinvestment during of economic downturns. The proponents sought to surmount the problems and enforce the public interest through legal control over internal affairs. This public interest agenda came in from the fringe when news of improper political contributions and foreign payments made management's conduct of business a national political issue in the post Watergate environment.

18 Two items from the contemporaneous labor agenda show up on one piece of proposed legislation. Representative Rosenthal's Corporate Democracy Act of 1980, H.R. 7010 (introduced April 2, 1980) contained a plant closing notification provision and would have amended the NLRA to add a good faith termination provision.

19 Pub. L. No. 94-435.

But only a handful of legislative proposals materialized. Three bills mandating federal chartering were introduced between 1972 and 1980.[20] Of these, the focal point initiative was Senator Howard Metzenbaum's Protection of Shareholders' Rights Act of 1980,[21] a bill that drew on the Berle and Means trust paradigm, omitting the broader public agenda and focusing on the shareholder interest and the governance agenda. Following Cary, it imposed federal fiduciary standards, adding a series of process mandates including an independent director board majority, audit and nominating committees entirely made up of independent directors, a shareholder nomination mechanism, and cumulative voting. But time was running out for antimanagerial politics in 1980. When the Reagan administration came in the following year, the federal agenda shifted to the market paradigm. Federal chartering has not been heard of since on Capital Hill.

The trust paradigm did better in the federal courts of the era than it did in Congress. Federal courts of appeals expanded the implied right of action under Rule 10b-5 to cover equitable fraud and breaches of fiduciary duty.[22] Had the expansion been sustained, the states' fiduciary regime might have been rendered superfluous as plaintiffs opted for a more hospitable federal venue. But, in 1977, a Supreme Court majority rejected the expansive reading of 10b-5,[23] emphatically employing the internal affairs presumption into its interpretation of the securities laws.[24]

The Takeover Era.

The political tables turned in 1980. Now adherents of the market paradigm dominated the SEC. Although friends of the internal affairs presumption, they soon ran into their own problems with the states. The states, still following the evolutionary stable strategy, were moving to chill hostile takeovers. The market paradigm supported preemptive intervention. Although generally committed to regulatory devolution, the paradigm also counseled central regulatory intervention to the extent necessary to protect a market by keeping transactional lanes open and policing externalities (see Bratton and McCahery 1997, p. 211-12). The paradigm's adherents won a single great victory when the same Supreme Court that had protected the states from the federal antifraud regime invalidated first generation antitakeover statues as a burden on interstate commerce.[25] Unfortunately, the states took advantage of the court's interpretive preference for state control of internal affairs and redrafted their statutes, winning the second round in the Supreme Court.[26] It accordingly was up to Congress to protect the market for corporate control. Unfortunately, the takeover wars of

20 Corporate Citizenship and Competition, H.R. 7481 (introduced May 22, 1975) (reintroduced as H.R. 9076, July 29, 1975); Democracy Act of 1980, H.R. 7010 (introduced April 2, 1980); Protection of Shareholder Rights Act of 1980, § 2567 (introduced April 16, 1980).

21 Protection of Shareholder Rights Act of 1980, S. 2567.

22 See *Ruckle v. Roto Am. Corp,,* 339 F.2d 24 (2d Cir 1964); *Shell v. Hensley,* 430 F.2d. 819 (5th Cir. 1980); *Santa Fe Indus. v. Green,* 533 F.2d 1283 (2d Cir. 1976), *rev'd* 430 U.S. 464 (1977). But see *Schoenbaum v. Firstbrook,* 405 F.2d 215 (2d Cir. 1968), *cert. denied,* 395 U.S. 906 (1969) (refusing find a violation in a sale of treasury stock to a related party at a deflated price).

23 *Santa Fe Indus. v. Green,* 430 U.S. 464 (1977).

24 *Cort v. Ash,* 422 U.S. 66, 84 (1975) (asserting that state law governs internal affairs).

25 *Edgar v. MITE,* 457 U.S. 624, 640-46 (1982). See also Pritchard (2003) (discussing Justice Powell's participation in both decisions and his managerialist opposition to hostile takeovers).

26 *CTS Corp. v. Dynamics Corp. of America,* 481 U.S. 69 (1987).

the period left Congress inundated with antitakeover constituent pressure. Most proposed bills were antitakeover (see Romano 1988, p.458-60). The interest group alignment in Washington tracked that in the states, with the management voice sounding louder than the shareholder voice and the shareholders showing no cognizable public support for preemptive intervention against the states. Administration opposition sufficed to block the antitakeover initiatives, leaving the federal government in gridlock. The outcome accordingly was decided at the state level.

Summary.

Now comes the question as to what these accounts teach us about the content of corporate federalism. More specifically, to what extent should we infer that the internal affairs norm played a causal role in these federal level outcomes? Drawing causal inferences from an historical pattern of inaction is a risky business, so we take a flexible approach in addressing the question. Three contrasting inferences may be drawn.

a) *No Federalism.* Nothing in these cases compels the inference that federalism concerns played an operative role. The events plausibly can be read narrowly, as a series of federal level political failures acted out against an inherited state level default condition. Such a default persists so long as the actors at the higher level of government fail to agree, and can persist even though the terms of state regulation no longer embody a preferred outcome due to changed conditions. No inference of respect for the states need be drawn. O'Mahoney acted at the moment in history when intervention against the states and corporate management had a comparatively high level of political plausibility. But he asked for too much in challenging the political settlement that excludes labor from internal affairs, a settlement long embedded at both the national and state levels. Metzenbaum asked for less, but taking advantage of hindsight, we can see that in 1980, the trust paradigm did not command a political base adequate to push business law reform past the management interest and into law. (The Reagan SEC and the market paradigm encountered the same problem a few years later.) Indeed, by 1980 the trust paradigm probably lacked the political gravitas to reach the top of the Congressional agenda, much less to defeat the opposing interest group.

   Both the trust and the market paradigms emerge in this description as political failures. Whatever their substantive merits, they were the projects of narrow networks of academic and policy elites. Neither resounded strongly enough, either with the median voter, or alternatively, the partisan agenda setters, to stay (or even arrive) at the top of the agenda, much less to override interest group opposition (see Murphy and Shleifer 2004). No general observation about the political influence of narrow, elite networks is intended. Academic paradigms help shape political agendas, perhaps even contributing a focal point solution in a case where a problem has multiple competing solutions. But the likelihood of such influence decreases as the distributional consequences of the competing outcomes increase (see Garrett and Weingast 1993). Here, given high stakes, it is unsurprising that the politics failed to work out for the proponents.

   Significantly, both paradigms did better in the courts. There, given interpretive slack, network members in positions of authority can find room to maneuver. At the same time, the judicial rulings show us the only points in the sequence of events implying that respect for the states operates as an independent and causative value. There may have been members of the *CTS* court who preferred the market for corporate control and economic federalism as a policy proposition but who also felt bound by a conflicting juridical tradition of reserve, here bound up in the internal affairs notion.[27]

b) *Parallel Politics.* Alternatively, we can read these events as a product of parallel normative views at the state and federal levels. On this view, no federal intervention occurred because actors controlling federal outcomes saw nothing amiss in state corporate law. This view can be restated in public choice form: Whether or not most federal actors approved of state results, the federal interest group *gestalt* paralleled that of the states, with the management interest proving sufficiently dominant to protect the state regime (see Romano 1988, p. 475-76). An astute federal actor would anticipate an all out interest group assault on any legislation that threatened the state equilibrium. Management and related interest groups like the corporate bar and the financial intermediaries have a significant investment in Delaware law. Quite apart from any policy preferences, such investors can be expected to fight (or pay) to protect the yield from their sunk cost[28] and federal politicians can be expected to settle in their favor, perhaps exacting tribute.

c) *Federalism.* Finally, it remains possible that independent federalism considerations operated to deter federal intervention. The operative federalism notions could have been either juridical or economic. We prefer an economic reading. The next sections of this part look at a number of high profile cases where Congress did cross the internal affairs line, suggesting that any barrier posed by constitutional traditions yields easily. As to economic notions of federalism, a different inference arises. None of these incursions on internal affairs have disrupted the state equilibrium, permitting an inference of respect for state control over internal affairs, viewed from an economic perspective.

3.3.2 Federal Incursions on Internal Affairs under the Governance Agenda

In 1934, William O. Douglas, then still a Yale law professor, published an article in the *Harvard Law Review* in which he described the shortcomings of the about-to-be enacted federal securities statute.[29] He noted scandals that had come to light in the aftermath of the Great Crash, variously involving secret loans, undisclosed profit sharing plans, self dealing contracts, and insider trading. Disclosure would not be enough, he said, more in the way of regulation was needed to prevent the repeat of such sorry spectacles in the next cyclical market rise. The problem, said Douglas, lay in the separation of ownership and control. Taking care to endorse the trust paradigm, he nevertheless articulated a second agenda. Control of the board of directors needed to be taken out of management's hands and placed in those of an independent director majority. He proposed a monitoring model – a board made up of

27 It should be noted that Justice Powell opposed takeovers and wanted the states to be left free to contain them, see Pritchard (2003, p. 905-20).

28 See Jonathan Macey (1990, p. 274-75). Macey predicts that so long as existing state rents are greater than the rents created by federal regulation, the beneficiaries will pay Congress in return for retention of state control.

29 See Douglas (1934).

independent shareholder representatives who supervised from a position of power.[30] Douglas also wanted more disclosure of conflict of interest transactions and maybe even a per se prohibition of loans to officers. Finally, Douglas noted that the present legal structure did little to move corporate governance in the direction indicated. He was flexible about means to the end of improvement. Any of federal incorporation, self help by the shareholders (given a federally instituted organizational base on which to solve collective action problems), or improvement of state law, might move things in the right direction.

Douglas' article set out the basic terms of the governance agenda that has guided corporate law reform ever since (see Eisenberg 1976). Where both the trust and the market paradigms have failed, this academic paradigm has influenced both actors in the corporate sector and federal legislators. Significantly, the agenda is narrow, viewed in the broad scale of things, addressing only the management-shareholder relationship and eschewing other constituents and unrelated notions of the public interest. It has two branches. The first branch goes to the board of directors' make up and institutional role. Here two categories of question come up. The first goes to the identification of best corporate governance practices. The second concerns whether a best practice, once identified, should be mandated, overriding the enabling state system. The agenda's second branch concerns compliance with law. This branch in part tracks state corporate law, looking to enforcement of fiduciary duties. But the compliance agenda has an independent federal side tied to the federal antifraud enforcement regime. This will be the point of entry against state control of internal affairs.

The rest of this section recounts the appearance of the two statutes that do most to carry the governance agenda across the internal affairs barrier, the Foreign Corrupt Practices Act of 1977 (FCPA)[31] and the Sarbanes Oxley Act of 2002 (SOX).[32] We will see that Congress traverses internal affairs on a fire patrol basis (see McCubbins and Schwartz 1984). In both cases, a bi-partisan Congress acted in response to an external shock. In both cases, the state equilibrium precluded significant corrective action. In both cases, corporate compliance failures triggered broad-based political demands. And in both cases, the federal compliance regime reached more deeply into internal affairs.

The Watergate Era.

During the Watergate investigations of 1973-74, the special prosecutor discovered corporate political slush funds that evaded normal accounting controls. Payments included illegal domestic political contributions and bribes to officials abroad – termed 'questionable foreign payments' – made in connection with the sale of American goods and services (see Greanias and Windsor, 1982). In March 1974, the SEC announced a voluntary disclosure program, asking companies to admit to any questionable payments to foreign officials (see Pines

30 In a later address he would add boards should be smaller, salaries should be adequate, and outsider directors should acquire a thorough knowledge of the firm, see Seligman (1982 p. 207).

31 Exchange Act, §§ 13(b)(2), 30A, 32, 15 U.S.C. §§ 78m(b)(2), 78dd-1-2, 78ff, added by Pub. L. No. 95-213, 91 Stat. 1494 (Dec. 19, 1977).

32 Pub. Law. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

1994). There resulted admissions by over 450 companies implicating over $400 million in payments.[33] The public, already disgusted with corruption in government and agitated by the media, demanded a clean up of corruption in corporate America. Corporate governance became bound up with the politics of corruption in high places.

The SEC responded in 1977, taking up governance agenda items looking toward majority independent boards and committees. It held public hearings. But, unfortunately, the SEC had no statutory authorization to mandate committee structure. Aside from section 14 of the 1934 Act,[34] which authorizes the SEC proxy rules, the agency could only mandate disclosure. So the SEC worked the agenda into new disclosure rules concerning board and committee membership and structure. It wanted each director tagged as independent or affiliated. Management, however, made its voice heard and the SEC had to settle for less direct means of getting pertinent facts into the public filings. Movement toward board and committee process mandates shifted over to the American Law Institute, which was taking up a corporate governance project. But so averse to mandates was management that it raised its voice at the ALI as well, stifling even a mandatory statement encapsulated in a nonbinding principle.[35] Efficiency worries had come to the fore in the stagflating economy. The governance agenda was remitted to the less threatening venue of self regulation, where it prospered.

But a handful of mandates were forthcoming. The SEC pressured the NYSE to amend its rules to require an audit committee comprised solely of independent directors. Putting the proxy rules to one side, this amounted to the first national level mandatory push into internal affairs pursuant to the governance agenda.

Additional mandates came with the FCPA, which prohibited bribery of foreign officials, making the 'questionable' payments illegal. More importantly for present purposes, it amended the 1934 Act to go deeply into internal affairs, imposing record-keeping and internal control requirements on reporting firms. The FCPA also gave the SEC oversight over the formulation of accounting principles. It was said to amount to the extensive application of federal law to the regulation of corporations since 1934.

The FCPA's mandates would have been inconceivable in the state law framework. The stable equilibrium, with its enabling approach, excluded them. Compliance systems were not even on the states' formal enabling menu. In theory compliance with law fell within the regime of fiduciary review; in practice there was no enforcement commitment.[36]

33 The lead item was the revelation of $22 million of bribes abroad by Lockheed Aircraft, see Pines (1994, p. 187-188).

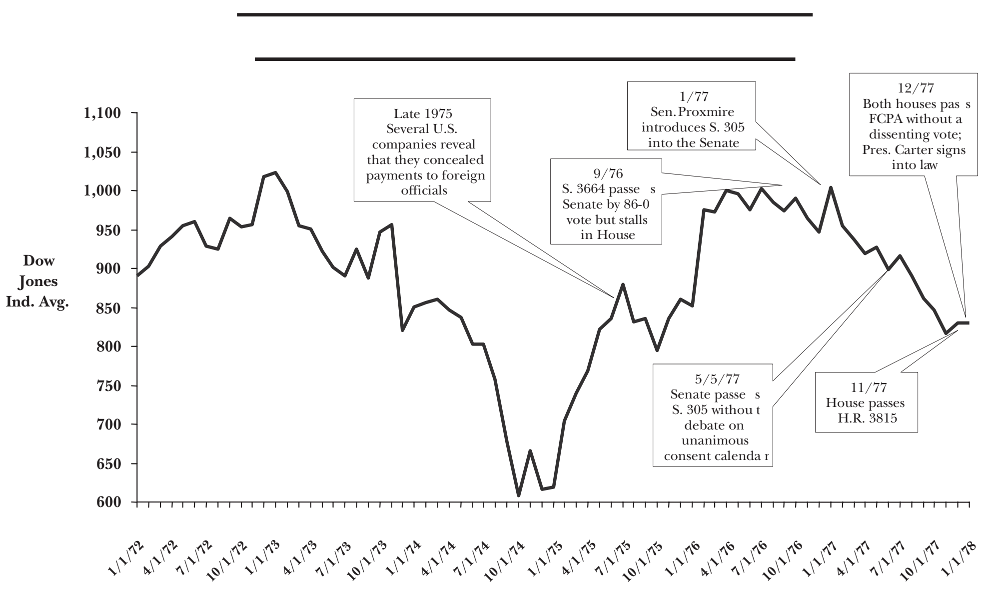
34 15 U.S.C. § 78n.

35 Mandatory independent board structure was proposed in the first draft of the American Law Institute's *Corporate Governance Project*, but was cut back to precatory status in later versions. Compare ALI, Principals of Corporate Governance and Structure: Restatement and Recommendations § 3.03 (T.D. No. 1 1982) (mandatory majority of independent directors), with 1 ALI, Principals of Corporate Governance: Analysis and Recommendations § 3A.01 (1994) (majority of independent directors as practice suggestion).

36 The classic citation is *Graham v. Allis Chalmers*, 188 A.2d 125 (Del. 1963) (declining duty of care review of antitrust compliance breakdown).

The FCPA grew out of a presidential investigation and spate of committee hearings conducted in 1976, an election year. There was significant political disagreement. The Ford Administration backed a disclosure-based statute; Democratic senators and their presidential candidate, Governor Jimmy Carter, wanted directives and criminal penalties. The Senate unanimously passed a weak bill before the election, but the House recessed before taking up the matter When the new Congress convened in 1977, Carter had won and the new administration backed a strong bill. The strong version passed unanimously by the end of the year. As Figure 4 shows, the scandals unfolded against the backdrop of a volatile stock market in which long term investors made no money. The market crashed during the Nixon-Ford administration, to recover in the run up to the 1976 election. But, given the high inflation of the period, the recovery did not make whole the losses. As Congress finally took up the FCPA in 1977, the market again stumbled badly.

Figure 4: Market Context 1972-78

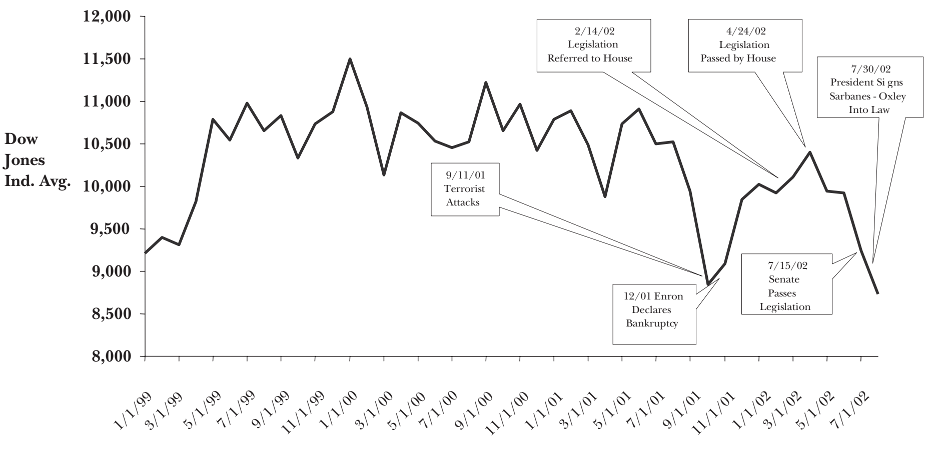


The Enron Era.

The scenario acted out in the mid 1970s repeated in 2002 in the wake of reporting failures at Enron, WorldCom, and other firms. Three ingredients once again combined – a major and ongoing decline in the equity markets (depicted in Figure 5), headline-grabbing stories of corporate corruption, and popular anger towards corporate management. Once again, legislation intended to 'reign-in' corporations passed with bipartisan support. Once again, internal affairs were traversed without apparent concern for the federalism norm. The result was the Sarbanes-Oxley Act of 2002(SOX).[37]

SOX had a quick gestation. The Enron scandal and accompanying media frenzy began with news of paper shredding in January 2002. The House enacted its bill in April, by a vote of 334 to 80.[38] WorldCom fell while the Senate held hearings on the House bill, triggering an accelerated timetable and passage by voice vote on July 15. The Conference Report, passage by both Houses, and presidential approval all followed before the end of the month (see Romano 2005). The Republicans disliked many provisions, but with an election coming up and a falling stock market (coming on the heels of a precipitous plummet two years earlier), they fell in line. Even the leading business lobbies were split, with the Business Roundtable saying yes and the Chamber of Commerce saying no. So rapidly was the package cobbled together that little of its contents received much in the way of considered attention.[39]

Figure 5: Market Context 1999-2002



Some of the SOX mandates pick up where the FCPA left off. For example, SOX requires that the CEO and CFO certify public reports, making them responsible for the maintenance of the firm's internal controls system,[40] along with accompanying criminal penalties.[41] While these go to internal affairs, the affairs they address long have been federalized. Moreover,

37 Pub.L. No. 107-204, 15 U.S.C. §§ 7201 et seq (2002).

38 See thomas.loc.gov. (report on Public Law 107-204).

39 Roe (1998) is the leading discussion of the politics that follow upon economic adversity. On the recent scandals, see also Grundfest (2002) (analogizing the development of the securities laws to the 'punctuated equilibrium' theory of evolution in which 'species are relatively stable over long periods of time, but "events of rapid speciation occasionally punctuate this tranquility"').

40 Sarbanes Oxley Act, § 302.

41 Id. § 906(a)(enumerating penalties for knowing violation of similar certification requirement).

the integrity of the disclosure system still stands out as the ultimate goal. In effect, the federal government, having instituted the mandatory system, reacts to successive compliance failures by reaching further and further back to cover the internal processes that generate the mandated reports. The federal political response resembles that seen with other regulatory regimes implicating criminal penalties: High profile noncompliance triggers a ratcheting up of duties and penalties, symbolically reassuring the public. No one in Congress wants to be seen as soft on crime, of whatever variety.

SOX also traverses internal affairs in regulating auditor client relationships, forbidding a list of nonaudit services.[42] But here also the territory already had been federalized; the list of nonaudit services merely tracks a list already instituted by SEC rule.[43] The new audit oversight board instituted by the statute tracks regulatory templates already established for regulation of securities market professionals.

Federally speaking, SOX shocks in requiring audit committees composed entirely of independent directors, defining independent director, laying down audit committee duties and powers, and requiring disclosure respecting the expert status of committee members.[44] The shock does not follow from the regulation's terms. The committee-based governance agenda dates back to Douglas. The same goes for the other headline internal affairs item in SOX – the ban on corporate loans to officers and directors.[45] When Douglas mentioned this one in 1934, he was only restating a suggestion made many times in the early decades of the twentieth century. SOX, then, is an ideal manifestation of Kingdon's model of a law reform idea that sits at the bottom of agenda for decades, waiting for a window of political opportunity to open and a normative entrepreneur to put it at the right spot on the agenda at that time (see Kingdom 1984).

It also can be noted that SOX's transformation of self regulatory process devices into mandates implies little in the way of real world institutional adjustment. Most large firms were organized with audit committees and compliance systems already, reflecting the influence of decades of self regulatory conversations about best governance practices. National level audit committee mandates date from the Watergate era, albeit through the medium of exchange listing requirements. Indeed, amendments to NYSE listing requirements mooted in 2002 and approved in 2004 track the SOX audit committee provisions and extend them to the compensation and nominating committees before going on to the final redoubt of the boardroom to mandate a majority independent board.[46] The stock exchange remains primary source of new mandates from the governance agenda.

42 Sarbanes-Oxley Act, § 201.
43 See Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 76,008-01 (2000)(codified at 17 C.F.R. §§ 210.2-01, 240.14e-101).
44 Sarbanes Oxley Act, §§ 301, 407.
45 Sarbanes-Oxley Act, § 402(a).
46 See NYSE Listed Company Manual 303A.

The Congress' off-handed but emphatic revision of the internal affairs line drawn after 1934 does upset settled expectations (see Bainbridge 2000). The present question is whether it implies anything further for corporate federalism. In addressing this question, we put standard cost benefit criticisms of SOX off to one side[47] to look at the political pattern. FCPA and SOX have sufficient similarities to suggest a template for federal traversals of internal affairs. First, both statutes respond to compliance failures by pushing federal regulation past the end product, the reports themselves, to the generative processes. Both concern compliance with law (or in the case of 'questionable payments,' quasi law), and respond to political demands appearing in the wake of high profile noncompliance. In both cases, the political demands could not have been satisfied at the state level, partly due to dispersion of response across fifty states and partly due to the stable equilibrium. Meanwhile, in both cases, the political demand stemmed from the general public, rather than from organized interest groups. (We think that the interest groups benefited, lawyers and accountants primarily, amount to incidental beneficiaries rather than prime movers.) Both statutes draw on a nonideological source, the governance agenda, and surmounted partisan politics in the course of their enactment. Finally, neither statute appears to have disturbed the state equilibrium. Isolated mandates from the governance agenda do not amount to external shocks that force strategies to change at the state level. They apply across the board, putting no competitive pressure on Delaware. Because they supplement the states' enabling framework, no state level adjustment is necessary. It is management that has to adjust. Congress intervenes against management, not Delaware.

SOX also demonstrates the political implications of the rise of the shareholder class. As the shareholder class rises, sharp stock market reverses and concomitant corporate misdeeds are more likely to hold out national political ramifications. Significantly, federalism concerns did show up prominently in the history of the FCPA – the Ford administration wanted to respect the post-1934 internal affairs boundary. But with SOX twenty five years later, federalism concerns did nothing to deter either the Congress or the Republican administration. The political demands, or at least Washington's perception of them, seem to have materially increased in magnitude. So, to the extent Delaware's management customers continue to behave badly, it can expect the zone of federal mandate to continue to expand. When this happens Delaware should blame its customers rather than the Congress, which is only responding to a highly representative politics.

Delaware does run a risk here. Future cumulative SOX-type mandates could so hard wire governance processes that firms decide that the choice of state of incorporation is irrelevant and stop paying Delaware's premium price. This seems a low probability contingency, however. Although the enabling code is a core component of the state equilibrium, it is not something Delaware sells today. Most of the state codes converged on key equilibrium terms decades ago.

47 The complaint is that SOX raises compliance costs more than more compliance benefits firms and shareholders. In particular, the costs bear more heavily on a marginal class of firms that will be discouraged from going public or, if already public, might be forced to go private. In addition, foreign listings may be deterred.

3.3.3 Federal Incursions on Internal Affairs at Management's Request

We complete the post-1934 description of federal traversal of state territory with reference to three interventions originating in management demands. The Williams Act of 1968,[48] the National Securities Markets Improvements Act of 1996 (NSMIA),[49] and the Securities Litigation Uniform Standards Act of 1998 (SLUSA).[50] All three pieces of legislation stem from management dissatisfaction with the state system. All three were enacted in rising stock markets. None of the three disturbed the charter market equilibrium, with which management presumably had no dissatisfaction.

The Williams Act.

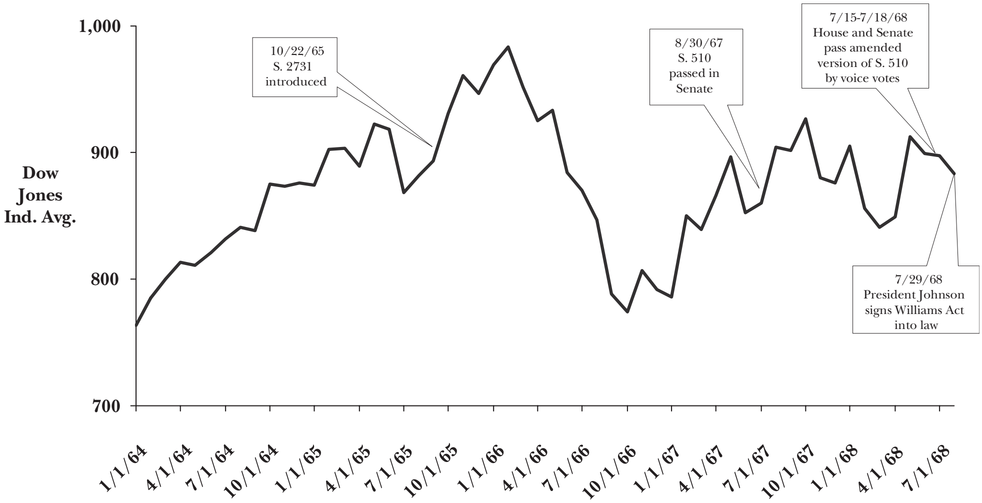
The Williams Act imposes, inter alia, disclosure and process constraints on tender offerors and target companies. It modifies what previously been a state law zone of free contract between arm's length buyers and sellers of shares. The Act reduces the contracting space with process constraints on the conduct of tender offers. It should be described as management protective: Its minimum duration period strengthens the hand of target management, importing a window of opportunity in which to employ defensive tactics.

The Act stemmed from concern over the increasing impact of 'corporate raiders,' and was conceived as a device to curb cash tender offers. Senator Harrison Williams introduced the legislation in 1965, making clear his management protective motive, speaking of 'white collar pirates' who took advantage of the 'leniency of our laws' to loot 'proud old companies.' But Williams' pro-management draft failed to attract support from the SEC and therefore failed to gain traction in the Senate. Then, as later, views on takeovers conflicted.

Williams tried again in 1967, with a less stringent draft. This time he emphasized that the bill was not meant to discourage tender offers per se. Reflecting the view of SEC Chairman Cohen, Williams assured that the bill was neutral towards both bidders and targets. In this case narrow policy networks had an impact: The final Act's modest compass stemmed in no small part from suggestions of the securities industry and academics, who took the bidder's part. With support secured from the SEC[51] and the stock exchanges, the bill passed easily, by a series of voice votes.[52]

48 Pub. L. No. 90-439; codified in 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2004).
49 Pub.L.No. 104-290, 112 Stat. 3416 (codified in scattered sections of 15 U.S.C.)
50 Pub.L.No. 105-353, 112 Stat. 3227.
51 The SEC broadly accepted the Williams Act as passed due to its desire for a bill that neither favored nor disfavored corporate takeover activity through tender offers.
52 See 113 Cong. Rec. 24,664 (1967); 114 Cong. Rec. 21,483-21,484 (1968); 114 Cong. Rec. 21,954 (1968).

Figure 6: Market Context 1964-68



Source: Yahoo! Finance (graph developed using the opening level of the Dow Jones Industrial Average on the first trading day of each month over the course of the cycle)

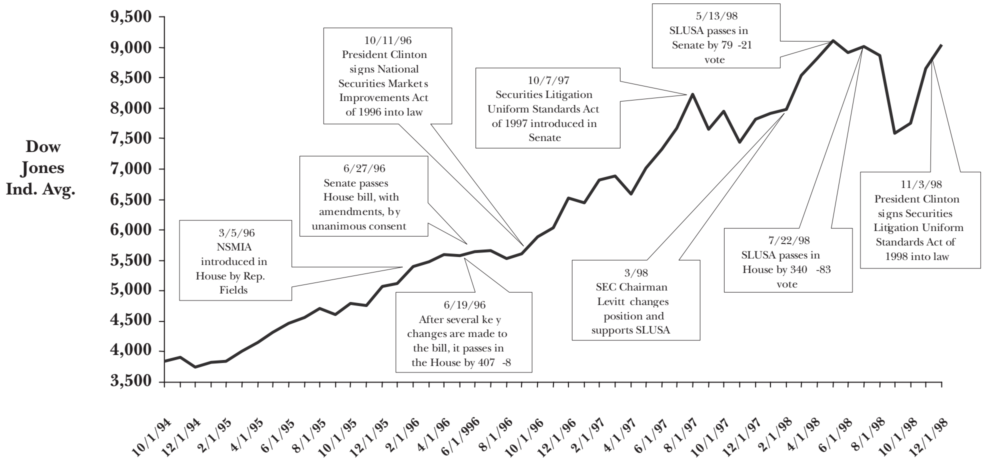
The stock market correlation is interesting. Figure 6 shows that Williams introduced the legislation at the height of the 'go go' years. The period of inactivity in the legislative history coincided with a sharp downward correction. Then, the market having recovered in part and with the shareholder interest better protected, the bill finally passed.

Securities and Litigation Reform.

The NSMIA of 1996 preempts much of the parallel state system of securities regulation, long called the 'blue sky laws.' More particularly, the NSMIA (1) preempts state level merit review and disclosure requirements for firms registered at the federal level, federally registered investment companies, and most private placements;[53] (2) preempts much state level regulation of broker-dealers;[54] and (3) provides for exclusive federal regulation of advisors to federally registered investment companies and other advisors with large portfolios. Thus constituted, the statute harmonizes and streamlines securities regulation. It does not traverse internal affairs, narrowly defined. Nor does it disturb the charter competition equilibrium: The Blue Sky laws apply to offers and sales of securities within each state, regardless of the issuer's domicile.

53 15 U.S.C. § 77r.
54 15. U,S.C. § 78o(h)(1).

Figure 7: Market Context 1994-98



Source: Yahoo! Finance (graph developed using the opening level of the Dow Jones Industrial Average on the first trading day of each month over the course of the cycle)

The Act originated on the Republican side, as a deregulatory initiative. The Democrats and the SEC both complained that it went too far in reducing protections for shareholders. The sponsors promptly dropped the most far reaching proposals.[55] Thereafter, the bill garnered bi-partisan support, passing the House by a 407 to 8 vote[56] and the Senate by a voice vote. President Clinton made no objection.[57] As Figure 7 shows, the stock market was rising throughout the sequence of events.

The SLUSA was drafted to cover a perceived loophole in the Private Securities Litigation Reform Act of 1995. Forum shopping was alleged – plaintiffs were bringing securities fraud class actions in state court, avoiding new federal level process strictures (see Painter 1998). The bill limited both state level class actions and fraud actions based on state law.[58]

In 1997, the bill was reported out on a bipartisan basis in both the House and the Senate. SEC Chair Arthur Levitt and Senator Paul Sarbanes both voiced opposition at hearings,

55 These included provisions that would have impaired the states ability to regulate small cap companies and otherwise enforce their laws.
56 See thomas.loc.gov (report on Pub.L. 104-290).
57 See thomas.loc.gov (report on Pub.L. 104-290.
58 Delaware was not a target: Under prevailing conflict of laws rules, the fraud actions are not decided under the law of the state of incorporation.

and the matter stalled for a few months.[59] In 1998, the legislation moved forward with renewed vigor, due in no small part to the steadily-rising stock market and the increasing political muscle of Silicon Valley.[60] High-tech companies and other corporations interested in pursuing the new legislation created a lobbying group for the occasion,[61] which was joined by the National Venture Capital Association, the American Institute of Certified Public Accountants, and the American Electronics Association (see Painter 1998, p. 49). Several organizations, including some consumer groups and organizations representing state and local governments, lobbied against the bill. But they lacked the political muscle of their opponents. But then, the stock market was going through the roof, as Figure 7 attests.

Silicon Valley got what it wanted. Levitt and President Clinton dropped their opposition in exchange for legislative history making it clear that no prohibition of federal suits for recklessness was intended. Although there were significant numbers of dissenters in both houses, the bill went through with strong majorities. But before passage, a Delaware-oriented carve out was added in the Senate, assuring that state litigation in respect of breach of fiduciary duty would be unaffected.

3.3.4 Summary

Douglas astutely predicted in 1934 that scandals stemming from management shenanigans in bull markets were going to remain a problem. The FCPA and SOX fulfilled the prediction, both responding to political demands for management accountability in the wake of scandals. In the case of the FCPA, the public responded to the scandal in the mode of the trust paradigm, casting managers as public actors. Power meant responsibility. Corruption was unacceptable, even corruption in pursuit of shareholder value. With the public proving willing to pay for ethical behavior (see Shleifer 2004), Congress moved to impose responsibility in law. In contrast, Enron, WorldCom, and SOX were shareholder value centered. Managers whose stocks had collapsed had failed to comply with law, with the compliance failure bound up with the losses of many investors. Congress felt compelled to toughen the compliance regime.

The broad-based political demands that led to FCPA and SOX occur only rarely. For the public to have an opinion, it first has to be informed and then has to deliberate. This rarely occurs on corporate governance matters, particularly so as to register political demands so strong as to surmount ideological divisions.[62] Retail investors, viewed as an interest group, have little political influence (see Langevoort 2004). But well-publicized corruption and

59 In mid-1997, there were many who questioned the need for a uniform standards act for securities litigation. In hearings, S.E.C. Chairman Levitt declared that it was still too early to assess whether or not a Uniform Act was needed; several senators, led by Senator Sarbanes, agreed with this assessment, see Caiola (2000). The SLUSA thereafter stalled due to a lack of support.

60 See Leslie Eaton, The Silicon Valley Gang: An Influential Industry With Lots of Money Is Getting Its Way on Capitol Hill, N.Y. Times, June 11, 1998, at D1.

61 Matthew Greco, Wait 'Til 1998 for Uniform Standards Bill: Congress Adjourns Early without Bringing Measure to the Floor, Investor Rel. Bus., Nov. 17, 1997.

62 FCPA and SOX thus can be distinguished from what White terms 'unifying issues'–issues that unite all business interests.

noncompliance raise the spector of a median voter interest[63] in corporate matters and thereby bring about the exceptional case. Stock market reverses also figure in. When stocks are rising, people tend not to worry about compliance and politicians are loath to rock the boat. Given market volatility due to noise trading and a widening pattern of equity investment, we can expect to see more such national political demands in the wake of compliance breakdowns.

FCPA and SOX reflect a cooperative strategy as they respond to the demands. Neither significantly disrupts the post-1934 division of subject matter between national and state levels. They do traverse internal affairs. But they do so largely toward the end of strengthening compliance with law, and the law in question for the most part is federal. The entries onto state territory occur as incidents to federal government's maintenance of the integrity of its own system, and the federal system in the first instance remains directed to the national securities marketplace. Nor do the FCPA and SOX appear to have disrupted the state level equilibrium. Viewed from an economic perspective, then, they substantially respect the state system. The issue with SOX is not federalism but costs and benefits at the national level.

Even when SOX breaks an historic federal-state subject matter pattern with its audit committee mandate, it only tracks more extensive mandatory interventions coming from the stock exchange, acting independently. Only the per se rule on loans to officers arguably takes SOX outside the national level box onto state fiduciary territory. But, in fact, executive compensation has always been a federal topic, with a strong interest in the matter reflected in the insider trading regime. In any event, federalization of conflict of interest transactions has a long way to go before it materially impacts the states. There is no risk of that happening in the present context. Indeed, with SLUSA, we saw the Congress take special care to avoid impairment of Delaware's litigation business. With FCPA and SOX, the loser is not Delaware, but management, which loses freedom of action in the shift from enabling to mandatory.[64]

We conclude, then, that FCPA and SOX do not significantly violate or reconstitute prevailing federalism norms. Instead they follow from a political equilibrium within which federal and state regulatory authority has been allocated for more than a century. Recall that, under the state equilibrium, corporate law responds directly to the demands of corporate principals and agents acting within their corporate capacities, with the system positioning the dominant chartering state's law to apply across the wider national political and economic geography. The equilibrium holds out a possibility of externalities, particularly to the extent that agent demands register more loudly than those of the principals. The states' stable strategy also makes them unresponsive when national political demands concerning compliance arise in the wake of external shocks. Any response must be national.

63 One third of American voters now describe themselves as 'investors,' and national politicians now cater to the so-called 'investor class.' See Just Who's in the 'Investor Class,' Bus. Wk., Sept. 6, 2004, at 42-43.

64 Whether the shareholders won or lost is an open cost benefit question.

If Delaware were to shift strategies and compete with the SEC in taking the shareholders' part on matters such as voting rights and rights of initiative, the shift would be viewed as a defection against the management interest and would disrupt the equilibrium. The same is true of the public interest in compliance with law. Delaware has never and cannot take the public's part on matters of executive compliance with law and ex post punishment. Delaware does not criminalize; it neither jails nor fines. We do get rhetoric from Delaware on the importance of compliance.[65] But we have not seen Delaware apply its duty of care so that directors of firms with compliance breakdowns are required to pay money judgments. We are highly unlikely ever to do so. There is no strategy available to Delaware that lets it protect its interest in subject matter territory by anticipating federal intervention and addressing and defusing the federal concern.[66]

FCPA and SOX show us the federal strategy followed when political demands flow against management. The Williams Act, NSMIA, and SLUSA show us a different class of federal play, the play that follows from the same sort of influence activity that determines results in the states. Here the general public has no knowledge and hence no opinion on the subject matter. The issues are what Mark Smith calls particularistic, that is, reflecting the interests of one business interest group, or conflictual, that is, triggering a difference of opinion within the business community. Here Democratic and Republican positions often blend into one another and elective politics has no direct bearing. Interest group influence tends to register more directly, giving management the same advantage at the federal level that it enjoys in the states. As at the state level, such management political operations tend to succeed against the backdrop of strong stock markets. But the federal-state political overlap is not complete. The difference lies in the SEC, which skews the federal agenda to weight the shareholder interest more heavily than the shareholder interest is or could be weighted at the state level under the stable equilibrium (see Langevoort 2004, p. 10-12).

3.4 Delaware

Delaware's competitive position gets stronger all the time. We have seen that its market share has increased steadily since its 1967 code revision. Delaware has done equally well by other measures. Major reincorporations to Delaware peaked at the height of the takeover wars of the 1980s, with 56 in 1987 (see Kaouris 1995). The numbers fell thereafter, but remained steady – there were 135 reincorporations between 1995 and 2001 (see Subramanian 2002). In 1983, the total number of firms chartered in Delaware was 153,044, in 1990, the figure was 202,893, and by 2000, the figure had grown to 322,971 to fall off slightly in the recession years that followed.[67] Table 1 shows that revenues from franchise taxes and corporation

65 See In re Caremark Int'Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).

66 The embeddedness point can be restated in terms of vetoes. In Delaware, management, along with the state bar, acts as a veto player. The larger the number of veto players in a lawmaking institution, the more policy becomes locked in and the more serious the status quo bias in the face of adverse shocks. See generally, Roubini and Sachs (1989).

67 Source: Email to author from Richard J. Geisenberger, Assistant Secretary of State, State of Delaware, June 25, 2004.

fees, taken as percentage of all state revenues, an historically volatile figure, regained the twenty percent level in 1992 and hovered around 20 percent ever since.

Table 1 – Revenues from Franchise Taxes and Corporation Fees as a Percent of all Revenues in Delaware[68]

1974	1975	1976	1977	1978	1979	1980	1981	1982
16.2%	15.3%	17.3%	14.4%	13.0%	12.1%	12.2%	12.2%	12.2%

1983	1984	1985	1986	1987	1988	1989	1990	1991
11.9%	12.0%	13.7%	14.8%	15.7%	17.6%	17.4%	17.1%	17.5%

1992	1993	1994	1995	1996	1997	1998	1999	2000
22.9%	21.3%	20.8%	20.4%	21.0%	21.8%	21.1%	21.2%	22.8%

2001	2002	2003	2004	2005
24.9%	22.1%	20.0%	20.8%	19.6%

In this part we look at Delaware's evolution in the wake of the federal incorporation threat of the 1970s and the takeover wars of the 1980s, both of which destabilized the state equilibrium. Delaware's courts emerge as model strategic players. Given a threat from a federal or state opponent, they pause between plays for rational introspection and adjust their strategies for future rounds of play. Even as they adjust, they tend to do everything possible to leave the state equilibrium undisturbed. In only one case do we see the judges experiment with a strategy that turns out to be inconsistent with management's equilibrium expectations. The courts then learn from the mistake, successfully remaking Delaware's profile in an era obsessed with law compliance by empowered actors.

In Section 3.4.1, we show how Delaware's bench dealt with the federal incorporation threat by taking fiduciary law more seriously. In so doing it experimented with and then rejected the trust paradigm, with its template of fairness review. Drawing on the governance agenda to substitute process scrutiny, the Delaware courts reinvented corporate fiduciary law. Their new strategy makes fiduciary review compatible with the management's prefer-

68 The Table picks up where the figures in Nader, et al., (1976, p. 535) leave off, bringing the data to date.

ence for a self regulatory approach. At the same time, Delaware's judges have emerged as leaders in ongoing discussions about corporate best practices, strengthening the state's tie to its corporate constituents. Delaware emerges as a national leader, the good corporate cop that contrasts with the federal bad cop. It should follow, in the event of an external economic or political shock that triggers questions about the charter system, that Delaware has a powerful base of support in Washington. As result, the federal-state equilibrium should remain relatively stable even as political demands respecting governance continue to show up nationally.

Section 3.4.2 discusses Delaware's takeover problem. Here Delaware dealt with incompatible demands: Management wanted antitakeover legislation and threatened to exit the state, while the federal government threatened to intervene to protect takeovers. Delaware responded by sticking with the evolutionarily stable strategy and staring down the federal government. It made the right political choice. The 1980s federal preemptive threat lacked political credibility and would not have disrupted the state equilibrium in any event.

Section 3.4.3 turns to Delaware in the era of shareholder capitalism. Time has been on Delaware's side. The federal government has lost all interest in takeovers. And, even as institutional shareholders remain dissatisfied with takeover defenses, their complaints register only in a narrow network. Ironically, their primary role at the state level has been to strengthen Delaware's position in the charter market. Today, due to the activist institutions, the shareholder veto on reincorporations means more than in the past, making even less likely the emergence of a competing state marketing a more management favorable product.

Section 3.4.4 concludes by asking whether it is helpful to analogize Delaware to a federal administrative agency. The discussion admits the power of the analogy, but questions whether it assists us at the bottom line, where the question goes to the strength to be accorded to the internal affairs presumption.

3.4.1 Fiduciary Law

Rent extraction, when visible, can come at the cost of diminished reputation. Cary (1974) imposed that cost on the Delaware courts when he accused them of monolithic support of management rent seeking, citing a cluster of cases as evidence. The Delaware courts proved sensitive to Cary's (1974, p. 684, 696-98) allegations of corruption, becoming more noticeably responsive to the shareholder interest in the three decades since 1974.[69] Most of the cases Cary cited are no longer good law.[70]

The break with the past first manifested itself in 1977, when *Singer v. Magnavox Co.*[71] imposed strict fiduciary standards on parent firms in cash out mergers. *Singer* is famous for having come down just after the Supreme Court removed the threat of federal preemption of state fiduciary rules under the antifraud rules of the securities laws.[72] The story told at the time was that the brush with preemption at the hands of the federal judiciary and the critical atmosphere provoked by Cary, Nader, and others prompted the Delaware Supreme Court to reverse its direction so as to better accommodate the interests of investors and thereby diminish the possibility of future threats of intervention. Indeed, around the time the case was decided in 1977, the SEC proposed a rule that required substantive fairness in the class of transactions covered by the case.[73] Delaware's defensive adjustment yielded results in the SEC's rulemaking proceeding – the final rule promulgated two years later dropped the fairness test and limited its reach to disclosure.[74] Thus did a federal threat impress upon the Delaware courts the practical importance of solicitude to shareholder interests.[75]

The post-Cary behavior pattern persisted as the courts articulated unexpected new shareholder-protective applications of basic fiduciary rules. The most famous examples con-

69 For empirical confirmation, see Branson (1990, p. 104-108) Branson's study of Supreme Court cases decided between 1974 and 1987 finds a larger number of proshareholder results than promanager results.

70 *Cheff v. Mathes,* 199 A.2d 548 (Del. 1964),a mainstay of management takeover defensive practice, fell to *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946, 954-55 (Del. 1985)(reversing *Cheff*and applying an expanded review of tender offer defensive tactics under proportionality test) and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.,* 506 A.2d 173, 182 (Del. 1985)(inventing a duty of management defending tender offer to auction company in limited circumstances), during the takeover wars of the 1980s. *Graham v. Allis-Chalmers Manufacturing Co.,* 188 A.2d 125 (Del. 1963), fell more recently, untenable in light of a generation of contrary management practice under the monitoring model of corporate governance. See *In re Caremark Int'l Derivative Litigation,* 698 A.2d 959 (Del.Ch. 1996). A similar fate could be suggested for *Getty Oil Co. v. Skelly Oil Co.,* 267 A.2d 883 (Del. 1970) See E. Norman Veasey & William E. Manning, Codified Standard – Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared to Delaware Law, 35 Bus. Law. 919, 929-30 (1980)(discussing *Graham*). *American Hardware Corp. v. Savage Arms Corp.,* 136 A.2d 690 (Del. 1957)(refusing to enjoin a defensive shareholders meeting called on short notice or to act respecting a proxy statement the court acknowledged to be incomplete) might well come out differently today, given *Unocal* and other cases more closely scrutinizing management procedural manipulations, see *Blasius Industries, Inc. v. Atlas Corp.,* 564 A.2d 651 (Del. Ch. 1988), and misrepresentations. See *Zirn v. VLI Corp.,* 621 A.2d 773 (Del. 1993)(confirming director duty of full disclosure of shareholders in connection with merger). Two cases Cary cited, *Federal United v. Havender,*11 A.2d 318 (Del. 1940)(permitting firms to use charter amendments effected through common shareholder voting power to strip preferred stockholders of contract rights), and *Hariton v. Arco Electronics,* 188 A.2d 123 (Del. 1963)(extending the doctrine of independent legal significance to mergers and acquisitions) are still good law, but operate in a less relentlessly management-favorable context. A good faith duty to preferred stockholders has been acknowledged, see, e.g., *HB Korenvaes Investments, L.P. v. Marriott Corp.,* CCH Fed Sec. L. Rep. 97,728 (Del. Ch. 1993), and mergers are subject a more broad-ranging fiduciary scrutiny. Only *Sinclair v. Levien,* 280 A.2d 717 (Del.1971)(leaving burden of proof on complaining minority shareholders), stands unqualified, and few today complain about it.

71 380 A.2d 969 (Del. 1977).

72 The case was *Santa Fe Industries v. Green,* 430 U.S. 462, 479-80 (1977).

73 See Securities Exchange Act Release No. 14185 (Nov. 17, 1977).

74 See Securities Act Release Nos. 6100, 6109 (August 1979).

75 Note also that judicial reputations depend on comparisons with the performance of judges on other courts, state and federal. Thus a critical atmosphere can arouse reputational concerns even with a less immediate federal threat.

cerned takeovers – *Unocal Corp. v. Mesa Petroleum Co.*,[76] and *Revlon, Inc. v. MacAndrews & Forbes Holdings*, Inc.,[77] which established a regime of fiduciary scrutiny of takeover defensive tactics. Friendly mergers also came under scrutiny – *Smith v. Van Gorkom*[78]and *Cede & Co. v. Technicolor, Inc.*[79] surprised everyone with surprisingly aggressive applications of the duty of care to board approvals of proposed mergers. *Paramount Communications, Inc. v. QVC Network, Inc.*,[80] later brought the takeover and the merger cases together with a broadly-phrased directive to managers under hostile attack to enhance shareholder value.[81]

But the pattern has been volatile. Equally famous cases restrict the application of the new rules. In fact, the *Singer* rule did not last long, being in turn rejected in 1983 for a looser, process based approach to cashout mergers in *Weinberger v. UOP, Inc.*[82]*Weinberger* later was itself cut back, when short form mergers were excepted from the category subject to fiduciary scrutiny.[83] The promises of *Unocal*and *Revlon* also went unfulfilled. Under *Moran v. Household International*[84] and its progeny, the poison pill remains a potent and largely unregulated defense.[85] In the eyes of critical observers, Delaware's cases amount to little more than a conjuring trick. The courts garnered publicity in a handful of highly-publicized cases, ruling against management and announcing vague standards that held out the prospect of shareholder value enhancement. But in less well-publicized subsequent cases, they used the camouflage of complex facts to refrain from applying the standards in management-constraining ways.[86] The full set of results tallied by the lawyers signaled considerably more room for management maneuver than did the public profile signaled by the leading cases.

Whatever the merits of the cases' holdings, Delaware's judges have transformed the state into a respectable lawmaker. This partly results from the quality of the bench – even when ruling for management in cases of palpable shareholder injury, its analyses are thoughtful. The bench's awareness of its national role also figures in. As judges, they have an independent reputational incentive to advocate for their system's legitimacy.[87] They now maintain a dialog on governance issues with the bar, financial intermediaries, and academics. Outsi-

76 493 A.2d 946, 954-55 (Del. 1985) (reversing *Cheff*and applying an expanded review of tender offer defensive tactics under proportionality test).

77 506 A.2d 173, 182 (Del. 1985) (inventing a duty of management defending tender offer to auction company in limited circumstances).

78 488 A.2d 858, 873-81 (Del. 1985) (suddenly expanding the duty of care to cover board approval of arm's length merger).

79 634 A.2d 345, 366-71 (Del. 1993) (applying a heightened duty of care scrutiny of boardroom merger decision and suggesting expanded remedial concept inclusive of post-merger gain).

80 637 A.2d 34 (Del. 1994) (holding that management has an obligation to achieve best value reasonably available for shareholders).

81 Less surprising but equally important is the recent invalidation of a delayed-redemption poison pill in *Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

82 457 A.2d 701, 704, 715 (1983) (overruling *Singer* in favor of less restrictive process scrutiny of cash out mergers).

83 See *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242(Del. 2001).

84 500 A.2d 1346, 1356-57 (Del. 1985) (sustaining poison pill defense under *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1150-54 (Del. 1989), made this clear with its allowance of extraordinary latitude to managers defending a tender offer that disrupts preexisting plans for a friendly merger. *Unocal*).

85 *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1150-54 (Del. 1989), made this clear with its allowance of extraordinary latitude to managers defending a tender offer that disrupts preexisting plans for a friendly merger.

86 For a readings of the cases after *Unocal* along these lines, see Brudney and Bratton (1993, p. 1087-95, 1129-30).

87 See Rasmussen (1994, p. 72-74, 78-80 1994) (offering a repeat game model of judicial motivation showing that judges follow precedent if there is a self-enforcing system based the need to uphold systemic legitimacy).

ders when Cary wrote, they are now important players in the elite governance policy network. They make a convincing case, explaining that they pursue the state's interest in balancing conflicting interest group demands, acting in a meditative capacity. They take care to point out that they not only mediate between management and shareholders, but as also protect market risk-taking even as they impose ethical constraints.[88] It has become hard to imagine a bench that could do a better job, given the constraints imposed by the state equilibrium.[89]

Two facets of the case law demonstrate the astuteness and innovation that the Delaware bench brings to its mediations.

The first is the special committee of independent directors, which can be traced to a footnote in *Weinberger v. UOP.*[90] The predecessor case, *Singer,* had effected Delaware's fiduciary about face, employing substantive review directed to the fairness or unfairness of the corporate action taken, very much in the mode of the trust paradigm. *Weinberger* dropped that to draw instead on the process-based governance agenda in scrutinizing transactions impacting the rights of minority shareholders. The court held out relaxed scrutiny provided that a committee of independent directors was constituted to negotiate on behalf of the minority. It was a brilliant compromise: Judicial scrutiny of the transaction still would be necessary, but scrutiny would extend only of the conduct of the constructed negotiation; this in turn obviated the need for direct, mandatory review of the transaction. Process was better than substance for two reasons: first, it diminished the likelihood of judicial confrontation with the salient question whether the majority was robbing the minority; secondly, it avoided confrontation with fact questions concerning the value of the firm. Since *Weinberger*, the independent committee device has been widely drawn on in Delaware fiduciary cases.[91] An additional, incidental benefit has appeared over time. Issues about the composition of special committees and their conduct of proceedings bring the Delaware courts to the forefront of debates about corporate best practices and the governance agenda.[92] The Delaware bench emerges as a focal point in the self regulatory discussion. This is exactly the right strategy.

The second salient aspect of Delaware's cases is the habit of making normative pronouncements on a prospective basis and avoiding imposition of damages. Delaware judges use their cases' complex fact patterns to make moral pronouncements about management behavior. The culpable manger is not, however, necessarily hit with an injunction against his

88 Moore (1987, p. 779-800) (at the time a Justice of the Delaware Supreme Court). They also have acknowledged the federal threat, see Quillen (1993, p. 129).
89 For a contrasting approbation of the Delaware courts, see Marcel Kahan & Edward Rock (2004) (comparing Delaware case law to 19th century jurisprudence and explaining that structural weakness causes Delaware cases to take on a neutral, technocratic gloss).
90 457 A.2d 701, 709 n. 7.
91 See, e.g., *Kahn v. Lynch Communication Systems,* 638 A.2d 1110 (Del. 1994).
92 See, e.g., *In re Oracle Derivative Litigation,* 824 A.2d 917 (Del.Ch. 2003) (expounding on the meaning of directorial independence).

or her deal; a money judgment is still less likely.[93] Instead, the court announces its dissatisfaction with the manager's conduct in the course of denying an injunction against the transaction or dismissing the complaint. It is the actor in the next deal who replicates the disapproved conduct that faces a litigation risk. Edward Rock argues that this works well: Delaware judges communicate normative standards to the business community through a network of lawyers and investment bankers. Significantly, the resulting behavioral deterrent is reputational rather than financial (see Rock 1997, p. 1012-1016).

The Delaware courts learned to take this kid gloves approach the hard way. The Delaware Supreme Court's innovative and aggressive application of the duty of care in *Smith v. Van Gorkum* did hold out an immediate prospect of a money judgment against independent directors. The result was nervousness in boardrooms, a substantial increase in insurance premiums, and much criticism of Delaware. The legislature had to intervene to undo the result of the strategic misfire. Prompted by the corporate committee of the state bar, it amended Delaware's code to permit firms to opt out of the duty of care by charter amendment.[94] The courts would not make the same mistake again.

With this prospective, dialogic approach, the Delaware courts break out of the conventional pattern of legislation and adjudication. In the conventional set up, only the legislature acts prospectively; common law is applied by judges on a present basis, even if the ruling is unprecedented. The litigant who breaches an extant duty on a new fact pattern loses the case and pays a judgment or has its course of conduct enjoined. From an abstract perspective, it is hard to see what makes corporate managers such delicate beings that they require an exemption from the ordinary rules of the game. The point must be that the exemption has been purchased, and solicitude is expected within the state equilibrium. The system appears to satisfy management, which is happy to pay attorneys to churn litigation that rarely entails more substantial costs in terms of money judgments or lost deals. Clearly the lawyers also are satisfied. For the shareholders, the system remains problematic even in the era of shareholder capitalism.

But it still is clearly superior to the system pre-Cary. In the 1970s, the Delaware courts decided that they would have to police in order to maintain the state's credibility as a national lawmaking center. Police they have, but in a unique fashion. In the federal state context, they have become the good cop to the federal government's bad cop.[95] Delaware's courts try to avoid falling into the conventional judicial role of enforcing positive law, even as the federal government's role as compliance officer expands and extends deeper into state territory with mandates and prosecutions. This distinguishes Delaware not only from the fed-

93 Although a money payment (probably in the form of a settlement) may follow where the injunction against the deal is denied but the complaint is not dismissed. See Rock (1997, p. 1015, 1039).

94 Del. Gen. Corp. L. § 102(b)(7), Del. Code Ann., tit. 8 (2001)(permitting opting out of personal liability for directors for duty of care violations).

95 The federal enforcement apparatus looms especially large in the context of state-federal comparison. Whether the actual enforcement numbers impress – the SEC brings only 500-600 enforcement actions per year and settles the vast majority, see Langevoort (2004, p. 6-7)–depends on the perspective of the observer.

eral government, but from the other states, the judges of which cannot be expected to play the game with such finesse.

Summing up, the Delaware courts responded to the instability, criticism, and challenges of the 1970s with a new strategy that merged fiduciary review with the self regulatory governance agenda. To look only at the case holdings is to see an unstable body of law.[96] To look at the cases in the wider equilibrium context is to see a stable strategy. The Delaware courts have learned that the salient part of the case can be the remedy rather than the holding. At the federal level, Delaware's prominence as a governance and dispute resolution center diminish its vulnerability to attack. With Delaware now holding a prestigious place within elite governance networks, federal agenda setters are unlikely view it as a problem. As its value increases in its customers eyes, Delaware will have more than adequate political support in Washington. Thus did Congress except Delaware from the SLUSA in 1998. The same did not follow with SOX. But SOX addressed political demands that Delaware's evolutionarily stable strategy makes it powerless to anticipate or confront.[97] And, despite its entry into internal affairs, SOX in no way impairs the charter market or Delaware's rent flows. A counterfactual suggestion arises. Delaware's new respectability assured that the Enron crisis worked itself out as a federal enforcement event. No one suggested that state level self regulation bore responsibility.[98] Indeed, Delaware judges have taken to voicing complaints about SOX and SEC governance initiatives in national venues, extolling the virtues of their good cop system.[99] If they had serious worries about federal intervention, they would not be entering these public dissents.

3.4.2 Takeovers and the Federal Threat

Now we backtrack to Delaware's response to the instability precipitated by the takeover wars of the 1980s. Six months after *CTS*, 34 other states had enacted antitakeover legislation. Management was pressuring Delaware to do the same.[100] However, actors in the Reagan administration were pressuring Delaware not to do the same, threatening to preempt its take-

96 It has been suggested (see Kamar 1998) that Delaware cases' indeterminacy stems from strategic concerns and amounts to an abuse of the state's dominant position in the charter market. We are unpersuaded, see Bratton (2000, p. 469-72).

97 For a contrary view, see Jones (2004, p. 654-62). Professor Jones sees the Delaware courts making a belated, but still preemptive response to SOX in recent cases. We have no quarrels with her description of the operative judicial behavior pattern. But, in our view, such decisions amount to small scale interventions that impact on corporate practice in only marginal ways.

98 This point can be restated from an institutional perspective: federal state relations are a function of socially constructed roles and institutional roles; actors have mutable preferences that change due to socialization, learning or persuasion, see Pollack (2003. p. 57-59. Institutions are points of communicative interaction among actors socialized within common norms. They discover their preferences through processes of deliberation within these institutional frameworks. Given deliberations about corporate governance and compliance in the wake of an external shock, Delaware's new respectability makes it much less likely that actors at the federal level will change their inherited preferences respecting the federal-state allocation so as to disturb the state equilibrium.

99 See Former Del. Supreme Court Chief Justice: Federal Power Threatens Role of Del. Law, 36 BNA Sec. Reg. & L. Rep. 1493 (2004)(describing a speech by Norman Veasey at the ABA annual meeting); SEC Official, Delaware Chief Justice Don't See Eye-to-Eye on Federalism Issues, 36 BNA Sec. Reg. & L. Rep. 1478 (2004)(describing back and forth between Chief Justice Myron Steele and SEC Director of Corporation Finance Alan Beller at the ABA annual meeting).

100 See Roe (2003, p. 625) (noting that Martin Lipton was recommending reincorporation out of Delaware).

over regulation if it did.[101] Delaware finally enacted a weak statute.[102] Commentators put contrasting glosses on these events. One view emphasizes that Delaware's weak response reflected shareholder side demands unique to the national chartering state. In other states the statutes followed from the influence of local firms; all potential targets. Delaware, in contrast, is home to bidders as well as targets and the countervailing capital market interest also registers there (see Romano 1988, p. 467). The other view emphasizes the federal threat.[103] Under this view, the events of the era stand as an exemplar of constructive back and forth within the federation, with threatened federal intervention curbing Delaware's structural preference for the management interest.

Both perspectives figure into the overall picture. But we emphasize a third aspect. Under Delaware's evolutionarily stable strategy, it sometimes has to make concessions to management in the teeth of opposition at the national level. Even as Delaware enacted a weak statute on a slow timetable, it did enact a statute. Delaware thereby signaled its fidelity to the management interest and a determination to maintain state law's equilibrium tilt to management. The federal threat imported credibility to the signal, to the extent there really was a federal threat.

But the Washington actors who tried to protect the hostile takeover in the 1980s lacked the political wherewithal to follow through. As we have seen, Congress was gridlocked on the subject. Moreover, even given Congressional support for takeover protection, it is not at all clear that federal intervention would have disturbed the state equilibrium. The takeover protection legislation introduced in the House in 1987[104] would have given the SEC authority to promulgate rules prohibiting defensive tactics and to create 'standards for the fair conduct of contests for corporate control,' subject to a shareholder 'opt in' privilege.[105] The provision would have terminated Delaware's takeover case law under *Unocal* and *Revlon*, but otherwise would have left things in place. That result might even have benefited Delaware by removing the competitive threat posed by tighter antitakeover provisions enacted in other states.

The greater threat already had passed, the threat posed in the 1970s by the cases that would have federalized much of fiduciary law and the 1980 federal fiduciary standards bill. But the 1980 bill ended the long series federal chartering threats with more of a whimper than a shot across Delaware's bow. To look at the longer history is to see federal chartering as a reform initiative that fell lower and lower on legislative agendas as the twentieth century

101 See Roe (2003, p. 626-27) (noting that the White House Counsel of Economic Advisors opposed the Delaware statute, that an SEC Commissioner threatened to preempt, and that SEC Chair David Ruder said the same in a speech and also warned the statute's drafter that enactment would be imprudent).

102 See Del. Gen. Corp. L. § 203, Del. Code Ann., tit. 8 (2001).

103 See Roe (2003, p. 629-30). See also Bebchuk (1992, p. 1455), Eisenberg (1989, p. 1512); Cary (1974, p. 688). Anecdotal evidence shows that Delaware lawmakers keep federal intervention in mind when they take politically sensitive steps.

104 H.R. 2172, 100th Cong. 1st Sess. (proposed April 27, 1987).

105 Id.§14. The statute also imposed a one share/one vote rule, id. § 3, prohibited greenmail, id. § 5; accorded shareholders access to the proxy statement to nominate directors, id. § 6; prohibited street sweeps, id. § 11, prohibited golden parachutes, id. § 12; and amended the Williams Act in numerous ways. Id. §§ 4, 7, 8, 9, 10, 13.

unfolded. It lay at the top of the Taft administration's agenda. It dropped to the second tier of the second Roosevelt administration's agenda. By the 1970s, it remained alive only in the offices of a handful of congressmen. After 1980, it disappeared. Even as actors in the Reagan administration threatened to preempt defensive tactics, they were committed to a cooperative federal-state equilibrium and had no truck with federal chartering. By 2002 popular demands completed the transformation of federal corporate politics. Now shareholder value triggers political emergencies.

None of this should be taken to deny the fact that Delaware's agents are averse to any exercise of federal preemptive power (see Chandler and Strine 2003). Moreover, federal rumblings certainly affected their behavior in the mid 1970s and mid 1980s. But, similar rumblings have not been heard since, even as Congress made a significant intervention in SOX. But because the Enron crisis concerned compliance, the state equilibrium gave Delaware no room for maneuver.[106]

Federal chartering does remain in Kingdon's bottom drawer, ready to be revived if Delaware ever steps out of line. A federal threat accordingly figures into Delaware's strategy at a deep structural level. To the extent it actively impacts Delaware's play, it presumably imports risk aversion respecting any state law innovation that disrupts the equilibrium in management's favor. This shows in the historical pattern. The last time Delaware initiated *sua sponte* a legislative process designed to catch management's eye by providing it new benefits was in the 1960s. Significantly, deteriorating market share made Delaware feel compelled to act. We also see such risk aversion in the historical pattern that ties legislative innovation to rising stock markets. Management favorable innovation is less likely to raise eyebrows in prosperous conditions. It follows that whatever the bottom is, Delaware will not go there, just as it will never tilt markedly in the shareholders favor. Finally, note that barriers to entry into the charter market have imported stability since Delaware regained market share after 1967. The barriers provide shareholders an incidental systemic benefit even as they block the analogy to a first best product market. If entry were easy, the competitor could cater to management, enervating the fiduciary regime or otherwise curbing litigation.

3.4.3 Delaware in the Era of Shareholder Capitalism

The shareholder interest only nominally lost the takeover wars of the 1980s. Although legal innovations during the 1980s made tender offers more expensive and less likely to occur, the normative agenda of the hostile offerors and their proponents in policy discussions did win the day. The offerors demanded shareholder value maximization and the managers and state legislatures resisted. In the 1990s, management did an about face and assimilated the norm. Incentivized by stock options, managers began building their careers by maximizing value. Disinvestment and conglomerate unbundling, which came by force in the 1980s, became an ordinary business agenda item. At the same time, institutional shareholders, outraged by the antitakeover triumph of the 1980s, learned to ameliorate the shareholder collec-

106 Congress in any event acted so quickly as to leave any window of opportunity closed.

tive action problem by organizing and making their voice heard at in boardrooms and at the annual meetings.[107] Performance pressures on executives intensified. So did conversations about items on the governance agenda, leading to apparent improvements in practice

Many question the depth of these changes, now that the shareholder value era has given way to the Enron era. Whatever the quality of the change in the practice, there can be no question that the changes worked to Delaware's advantage. The diffusion of the shareholder value norm and the shift of interest group influence toward a more even balance between management and an emerging class of shareholders, taken together, meant a better protected shareholder interest. There resulted a lessening in intensity of the ongoing debate over the separation of ownership and control. Where thirty years ago there prevailed a managerialist model of corporate governance that endorsed the delegation of substantial discretion to managers, today the absolutist view represents a minority perspective.[108] The deflation of managerialism implies a concomitant diminution of antimanagerialism. As a result, corporate governance debates have lost much of their ideological coloration and corporate federalism has become depoliticized. Today debates tend to devolve on functional questions about value creation and agency costs, a context in which Delaware often comes up looking very good.

The federal threat accordingly recedes further into the deep structure of corporate federalism. The state enabling regime still remains vulnerable to federal mandates, perhaps even more vulnerable. Shareholder capitalism has brought the conduct of business and stock market results forward in the national consciousness, making negative shocks politically salient in Washington. Yet, despite the notable incursion on internal affairs in SOX, it holds out no apparent disruption of the state equilibrium. Delaware being a business, only a threat to the state equilibrium matters to its bottom line. As to this, the federal government has proved surprisingly cooperative.

Shareholder activism also helps Delaware by reducing the threat of potential competition. Through much of the 1980s it remained conceivable that Delaware could suffer a significant number of outbound reincorporations to the stronger antitakeover states. To the extent shareholders rubber stamped shark repellant charter amendments, they also would rubber stamp a management protective reincorporation. That assumption has not been safe for some time (Daines and Klausner 2001). Shareholders now vote 'no' on such proposals. It follows that even as management retains agenda control over reincorporation, the shareholder veto has become meaningful. The exit door from Delaware to a neo charter monger would certainly be sticky, and very well may be locked in most cases.[109] And even if an exit-seeking management could get the votes, it still might hesitate – the reincorporation process might send a bad signal to the financial markets. It follows that the only competitive threat to Dela-

107 Ironically, Delaware's position is enhanced only because the primary avenue for shareholder intervention – the proxy rules – already has been federalized.

108 Steve Bainbridge (2002, 2003) is the leading proponent.

109 Here we note that a negative inference arises from Bebchuk, Cohen and Ferrell (2002), which surveys reincorporation activity to find that competition does tend to reward the antitakeover states.

ware would come from a state that devised a superior strategy addressed to issues as to which management and shareholder interests stand aligned. That seems an unlikely event, given Delaware's ability to learn and modify its approach in response to changes in practice.

The foregoing points, taken together, also imply increased slack for the Delaware courts respecting the ongoing mediation between the management and shareholder interests. Widespread acceptance of the shareholder value norm frees the Delaware bench to intervene for the shareholders with less worry about the result disrupting the equilibrium. Such interventions have lost any public interest coloration. In any event, the genius of Delaware lawmakers lies in their ability to generate a thick fiduciary law without at the same time imposing a significant compliance burden.

Hostile takeovers are the sticking point in this description. Delaware remains an antitakeover state, with its poison pills, classified boards, and cooperative judiciary more than making up for the weakness of its antitakeover statute. Its continued adherence to the management side and rejection of short-term value maximization continues to occupy a top spot on the agendas of shareholder activists and academic commentators (see e.g., Bebchuk, Coates and Subramanian 2002).

But this appears to be another case of a narrow, elite political network fighting a rearguard action against a stable equilibrium. Takeovers have disappeared from the federal political agenda. Between 1987 and 1990, 32 bills concerning hostile takeovers and defensive tactics were introduced in the Congress. Between 1991 and 1994, there were seven such bills, and after 1994, only one. With the Congress quiescent, the states' antitakeover equilibrium stays in place. This political result is easily explained. Takeover protection never had much political traction in Washington, due to management opposition and public indifference or hostility (see Romano 1988, p. 490-503). The newly vocal shareholder interest apparently still makes for an insufficient counter. Nor is it clear that it would make sense for the lead institutions to direct their political energies to takeovers. Other governance matters, like committee practice and access to the proxy statement, take precedence today.

Other structural factors also can be cited. Federal intervention in internal affairs tends to follow stock market reverses, because losses trigger political demands. Merger and acquisition activity, including hostile offers, tends to coincide with rising stock markets, a time when the management interest registers especially effectively. Red ink may speak more loudly than opportunity costs in any event. While the 1990s did yield clear cut cases of opportunity costs to shareholders due to tough management defensive play, the cases were sporadic. The prevailing picture was one of free flowing premiums incident to friendly deals.[110] Hostile takeovers were politically salient during the 1980s, when they provided the shareholder interest a stick to yield against suboptimal earnings retention practices and conglom-

110 See Bratton (5th ed. 2003). Even as the absolute number of hostile offers stay constant, see Coates (1999), the percentage of overall activity involving a hostile bid dropped significantly, from 14 percent of all transactions in then1980s to 3 percent in the 1990s, see Andrade, Mitchell and Stafford (2001, p. 104-09).

erate structures (see Holmstron and Kaplan 2001, p. 127-32). By the 1990s, norms and incentive structures had shifted. Managers in industries experiencing external shocks voluntarily responded by entering into restructuring transactions

3.4.4 Delaware as a National Agency

Several commentators,[111] including us (Bratton and McCahery 1995), have suggested that corporate federalism be understood by analogy to the relationship between the legislature and an administrative agency. This delegation analogy has attractive aspects. The spread of Delaware charters nationwide makes Delaware a de facto national lawmaker. As such it serves a harmonisation function in the national marketplace. It also can be noted that Delaware owes its national impact to the Supreme Court's interpretation of the constitution to require states to admit firms chartered elsewhere, and accordingly collects rents only as a result of a federal dispensation of grace. Congress has the authority to federalize the subject matter in any event. It follows that even though Congress never formally delegated lawmaking authority to Delaware, it fairly may be viewed as an arm of the national government. Arguably, to the extent the analogy succeeds, the federal allocation is justified and with it Delaware's national role. We think that the analogy is descriptively robust, but that it has limited justificatory impact for federalism discussions.

Political theorists posit a menu of functions that agencies serve for legislative principals. Two stand out as candidates for describing Delaware. The first is substantive credibility. Sometimes the legislature cannot credibly commit to stick to policy choices, due to the vagaries of elective politics and constituent demands.[112] The legislature delegates to an agent that can establish the desired credible commitment and develop the necessary expertise. The more insulated the agency from external political pressures the better it serves this function. The delegation of monetary policy to a central bank is the classic case.[113] Extending the point to Delaware, we see a need for a credible commitment from government in order to induce investment and can identify just that credible commitment in Delaware's evolutionarily stable strategy.

Does the analogy, thus drawn, carry through to import presumptive immunity from federal interference in internal affairs? We do not think so. The central bank analogy is descriptively problematic because the delegation's objective is the vesting of political property rights in the agency (see Majone 2001). Delaware has no such rights and has steadily seen its regulatory turf contained. Worse, we can go to back to the credibility concept and apply it to the SEC: The SEC vests a voice for the shareholders and insulates the mandatory disclosure system from compromise due to management influence, importing credibility for the purpose

111 See Macey (1990, p. 267-68) (using the agency analogy as the basis for a public choice explanation of the existence of state regulation), Roe (2005, p. 2534) (comparing Delaware to a central bank and noting limitations on the analogy).

112 See Pollack (2003). The legislature may want the agency to take the blame for unpopular policies, see Fiorina (1982)

113 See Majone (2001) (discussing Kenneth Rogoff's theory that governments tend to delegate 'monetary policy to a central banker who is more "conservative" (i.e. more inflation averse) than the government' and commenting on the high level of independence bestowed upon the European Central Bank by the Maastricht Treaty); see also Rogoff (1985).

of encouraging investment. That the SEC was created in order to correct state level results bespeaks a state level adverse selection problem.

At this point, the analogy's proponent can fall back a step and restate the point, addressing the system as modified by the federal securities laws. Like all principal-agent relationships, those between legislatures and agencies implicate agency costs, and ex post legislative overruling is a standard disciplinary device. Congress did just this in enacting the securities laws. To the extent that Delaware is easily overruled and a threat of additional incursions imposes ongoing discipline Delaware (see Weingast and Moran 1983),the agency analogy holds well.[114] It thereby comes to bear against those who argue for total preemption. But, politically speaking, that argument has fallen off the agenda. Today's federalism discussion concerns the magnitude of the presumption against nonintervention. At this point the agency analogy works against charter market advocates, who argue for a strong restraint against federal incursions into internal affairs. Delegation analysis legitimizes such federal incursions on the ground that the principal's preferences should prevail. We are left to judge the federal intervention in cost-benefit terms, with no special presumption skewing the analysis, at least so long as the intervention does not disrupt the state level equilibrium,[115] a result that federal authorities do not appear to prefer.

Now let us try a second line of political theory. Under this scenario, the agency serves a function analogous to that of a Congressional committee: It sets the agenda, avoiding cycling, perhaps also skewing the agenda in a desired direction (see Kiewiet and McCubbins 1991, Pollack 2003). Mark Roe (2005) draws this analogy forcefully, pointing out that the delegation to Delaware orders the agenda and limits the players to the management and shareholder interests, relegating public interest advocates to secondary influence at the federal level. This too is descriptively accurate. But its justificatory impact on the federalism discussion is similarly narrow. It provides an argument against total preemption, but it does not, for example, support an argument against federal intervention to preempt antitakeover legislation or invalidate corporate defensive devices. We also would add an historical caveat. The description works better and better as one goes back in time, and federal chartering motivated by a public interest agenda becomes an active agenda item under the trust paradigm. As one moves forward in time, the overall federal regulatory scheme more and more instantiates the strategy of contract and outside regulation for outside constituents and the public interest, with federal corporate law politics becoming more shareholder value oriented. To the extent federal corporate politics focuses only on the governance agenda, and it has been

114 See Lupia and McCubbins (1998), which evaluates the success of a delegation in terms of two factors – knowledge and incentives. If the principal either knows what the agent is doing or the agent's action makes the principal better off than would the status quo. Delaware is transparent, making oversight easy; often Delaware's actions make the federation better off. Lupia and MCubbins offer a tougher standard in the alternative. Under this the delegation succeeds only when the agent takes action that improves the principal's welfare. Viewed this way, the Delaware delegation fails in some instances.

115 At this point the proponent of state discretion can argue that Delaware should be insulated as if it were a central bank. But now the description has failed and the point merely restates the normative claim made in the federalism discussion.

thus focused for 25 years, the structural importance of agenda control at the state level matters less and less for shareholder capitalism.

3.5 Conclusion

Federal intervention that interferes with the state equilibrium could be justified if done for the purpose of encouraging keener charter competition and a more even-handed strategic balance between the shareholder and management interests. But we perceive no political incentives that might encourage federal micromanagement of the charter market. Failing that, corporate federalism remains robust, so long as the federal government and stock exchanges continue to refrain from allocating to themselves so much subject matter as to cause Delaware's customers to question the efficacy of their rent payments. Those who would prefer to see no further expansion of federal territory are likely to be frustrated. The shareholder class having risen, corporate law is hardwired into national politics. Only two developments could change the pattern: Either managers assimilate a strong norm of financial truth telling and compliance with law, or shareholders assimilate the precepts of fundamental value investment. We predict no change.

Meanwhile, Delaware is safe in the present context. It would take a dramatic shift in federal policy preferences to threaten it. Such a development seems unlikely. We have seen striking changes in political preferences since 1888, yet these have given rise to few if any serious attempts to transfer corporate lawmaking in whole to the federal government. Positive political economy suggests that once an institutional structure has run in one direction for a long period, one is unlikely to see new constraints that alter the original understanding.

4 The Role Of Specialized Courts In Resolving Corporate Governance Disputes In The United States And In The Eu: An American Judges Perspective

Jack B. Jacobs

4.1 Introduction

I am greatly honored to be invited to speak at this important conference on corporate governance dispute resolution, co-sponsored by the OECD, the Stockholm Centre for Commercial Law, and the Government of Japan. To be included in this highly distinguished international group of policymakers, scholars, lawyers and judges is especially flattering.

I have been asked to speak on the role of specialized courts in resolving corporate governance-related disputes. In the interest of candor, I should disclose at the outset what expertise I do – and do not – bring to the table on this subject. Before my appointment to the Delaware Supreme Court, where I have served for almost three years, I served for eighteen years as a Vice Chancellor on the Delaware Court of Chancery, a specialized court with an expertise in corporate and business law matters, including issues involving corporate governance. I also have taught, and currently lecture, on corporate governance matters at various law schools in my own country.

From that somewhat narrow platform, I have been able to develop with modest confidence a few insights into this subject, at least as far as the American experience is concerned. But, what insights that experience may offer those of you who are pondering whether specialized courts are a useful tool to resolve corporate governance-related disputes in the EU, is a topic on which I speak with somewhat less confidence. Indeed, on that important question, I view myself as more of a student than a professor, but for what they may be worth, I offer my views on that issue as well.

In the few minutes allotted to me, what I propose to do is discuss three related topics. First, I start with the historical experience of the Delaware courts in the area of corporate governance. That experience shows, I submit, that specialized courts have proved themselves capable of influencing the direction of corporate governance in the United States, although such courts are not the only or even the most important factor in shaping that highly complex enterprise. Second, I turn to the EU, and discuss one of its premier specialized courts that has come to influence corporate governance on a national level: the Enterprise Chamber of the Amsterdam Court of Appeals. Third, and finally, I ask whether the success of the Delaware and Dutch experience might prompt other EU member nations to create their own indigenous tribunals that specialize in corporate governance-related disputes, and conclude with some speculations about the prospects of that happening on the supranational EU level.

4.2 The American Experience: The Delaware Court Of Chancery

The experience I am most knowledgeable about is that of American business courts. Viewed from a nationwide perspective, even that experience base is relatively thin, because to date only a handful of American States have established courts that specialize in business and corporate related matters. Except for Delaware, these courts are administratively created, specialized divisions of already-existing courts of general jurisdiction, which must be distinguished from independent courts of specialized jurisdiction.[1] The few states that have created specialized business courts did so because their business communities were dissatisfied by the inability of their local courts of general jurisdiction to resolve business disputes in an expeditious manner, due largely to those courts' large backlogs of criminal and other non-business cases. I am informed that in some of those states the specialized courts have performed quite satisfactorily, but not in all. In all those communities, though, the judges of those specialized courts have been afforded the opportunity to develop expertise in business and corporate governance issues, and to create processes for resolving complex business disputes more quickly and knowledgeably.

You should be aware that many American states have declined to create business courts, primarily for two reasons. First, specialized courts are perceived as elitist, i.e., as affording better justice to business than to ordinary individual citizens. Second, it was feared that specialized courts would further burden the budgets of state governments that are experiencing significant financial crises. Because all but one of the specialized business courts are relatively new, and because their jurisdiction encompasses more than corporate governance matters, the data is insufficient, as least as far as those courts are concerned, to generalize broadly about the impact of specialized courts upon corporate governance in America nationally. Indeed, the only specialized court whose experience is extensive enough to be reliable is the Delaware Court of Chancery. That court, ironically, was created over 200 years ago not as a business court, but as a traditional, constitutionally separate court of equity in what was then a small rural state. Only during the 20th century did that court develop an expertise in business and corporate law matters, including governance issues. That was not because any formal decision was made to specialize, but rather because of the convergence of two circumstances: (1) a very significant number of public U.S. companies (over half of the NYSE-listed and of the Fortune 500 companies) were and still are incorporated in Delaware, and hence are subject to the application of Delaware law, and (2) over time the Delaware

1 In New York, for example, the Chief Judge of New York's highest court, the Court of Appeals, created a Commercial Division of the New York Supreme Court, which is New York's trial court of general jurisdiction. New Jersey assigns to its Chancery Division cases that are denominated as 'complex litigation.' North Carolina has created a Business Court for complex business cases, whose presiding judge is a separate Superior Court Judge. Maryland has created a Business and Technology Court Management Program, to which currently sitting trial judges are specially assigned. Massachusetts has created a Business Litigation Session of the Massachusetts Superior Court, which hears complex commercial and business cases including cases involving governance issues. See University of Maryland School of Law (2005); see Junge, (1998); Report of ABA Ad Hoc Committee on Business Courts (1992).

Court of Chancery came to be the tribunal of choice for resolving intra-corporate disputes in those public companies.[2]

Underlying the first of these circumstances is the critical fact that almost all U.S. courts observe the internal affairs doctrine, which requires that the law of the state where the company is incorporated be applied to resolve internal governance disputes. I am aware that in the EU that is not necessarily the case: some member states apply their equivalent of the American internal affairs doctrine, but other states apply the 'real seat' doctrine, under which corporations whose activities are centered in a member state are subject to the laws of that state, even if the company is incorporated elsewhere.[3] In my country, however, because of the internal affairs doctrine, governance disputes involving Delaware corporations are governed by Delaware corporate and fiduciary law. Over time, each Delaware court decision in that area becomes a part of what is now the most developed body of corporate and business law precedent in the United States. Because over half of the major public companies are incorporated in Delaware but do business nationally and in many cases multinationally, the effect of Delaware court precedents extends far beyond the borders of that state. For these reasons, in the area of corporate and business law, the Delaware Court of Chancery, and the Delaware Supreme Court (which is the appellate court that reviews Chancery decisions) became influential in developing corporate governance law not only in Delaware, but also in other American jurisdictions whose courts have chosen to follow Delaware case law in resolving governance disputes in companies incorporated in those states.

I recite this as background to make a single point, which is that the decisions of Delaware's Court of Chancery and the Delaware Supreme Court in resolving corporate governance disputes, have been influential in shaping the development of corporate governance law and policy in my country. The evidentiary support for that proposition may be found in some of the more important Delaware cases decided over the past two decades, and the impact those cases have had on corporate practices outside the courtroom.

One of the more controversial Delaware governance cases was the 1985 Delaware Supreme Court decision in *Smith v. Van Gorkom*.[4] There, the board of a publicly held Delaware corporation was found liable for money damages for approving a sale of their company, which was arranged by the CEO without board knowledge or authorization, at a price that was never negotiated or validated by a reliable financial valuation of the company. The board approved the acquisition at a short meeting at which no documents were provided to the directors, and at which the directors made no critical inquiry about the merits of the transaction, relying instead upon a brief oral presentation by the CEO. The Supreme Court held the directors liable for breaching their fiduciary duty of care.

2 Report of ABA Ad Hoc Committee on Business Courts (1992: 956).
3 See McCahery and Vermeulen (2004: 9).
4 488 A.2d 858 (Del. 1985).

Van Gorkom sent shock waves throughout the American corporate community, and profoundly affected American corporate governance practices. At that point in time, corporate boards were regarded as essentially passive advisors, with the CEO being completely dominant and the board having no prescribed role other than to give advice when asked and to approve executive proposals when made. *Van Gorkom* changed the corporate culture of American public company boards, by sending a strong message that corporate boards, including non-employee, outside directors, had an affirmative duty to be skeptical, to act with due care, and to make an careful, informed decision, independent of management, that any transaction to which they commit their company is in the best interests of the company and its stockholders.

A later, similarly influential, case was the 1996 *Caremark*[5] decision, in which the Delaware Court of Chancery announced that Delaware corporate boards must exercise their duty of care not only in making decisions affecting the corporation, but also in overseeing decisions made by management. Caremark was a settlement of a derivative action brought against the board of a public company. A multimillion dollar criminal fine had been assessed against the company for violating certain federal laws, and a derivative suit on behalf of the company was brought against the directors for damages. The claim was that the directors failed to exercise proper oversight over management, and had they done so, management's illegal behavior would have been uncovered in a timely way. The Chancellor held that although corporate boards are not required to micromanage decisions made by corporate managers, they must attempt in good faith to implement a system that will keep the directors informed about whether management's decisions and practices are in compliance with the laws – criminal and civil – that regulate the company's business.

Caremark, like *Van Gorkom*, also profoundly affected the governance of American corporations far beyond the borders of Delaware. Almost immediately after Caremark was decided, many public companies began taking steps, including hiring expert consultants, to institute compliance systems to assure that their boards would be properly informed about the risks created by their managements' decisions in running the business. So pervasive was this reaction that many large American law firms developed subspecialties in this field. Six years later, the *Caremark* doctrine became part of federal law in the Sarbanes-Oxley Act of 2002, which was enacted in response to the recent scandals involving companies such as Enron, Global Crossing, and Worldcom. Sarbanes Oxley requires (among other things) that companies covered by the Act must put in place risk management systems, and that the CEO must publicly certify whether those control systems are properly functioning and if not, why not. Thus, the board's duty of oversight, first recognized in the *Caremark* case, has now become a permanent statutory fixture in the American corporate governance landscape.

Perhaps the most publicized area of corporate governance shaped by Delaware decisions has been the area of corporate takeovers. In the U.S., it was the Delaware courts that first de-

5 *In re Caremark Intern., Inc. Derivative Litigation*, 658 A.2d 959 (Del. Ch. 1996).

veloped the legal standards that dictate what corporate boards can and cannot do in response to a hostile bid for control. Until the mid-1980s, those standards were not well developed in our law. To fill that gap, the Delaware courts developed new standards in a series of decisions, including *Unocal*,[6] *Revlon*,[7] and its progeny,[8] including *Macmillan*.[9] The doctrine announced in those cases has been adopted by courts of many other States, and have been followed even by boards of many companies that are not incorporated in Delaware. It is noteworthy that in 2005, a significant body of the Delaware jurisprudence governing what corporate directors may permissibly do to take defensive measures against a hostile takeover bid, was adopted by the Japanese Ministry of Justice and the Japanese Ministry of Economy, Trade and Industry, in fashioning Takeover Guidelines for corporations in Japan, where hostile takeovers have recently become a phenomenon.

For those of you who may not be familiar with the Delaware takeover jurisprudence, in *Unocal*, the Delaware Supreme Court held that a target company board may lawfully oppose a hostile takeover bid, but only if the board concludes in good faith and after a reasonable investigation that the hostile bid poses a threat to corporate interests and policy, and only if the board implements defensive measures that are not disproportionate to the threat. In *Revlon* and its progeny, the Delaware Supreme Court held that once a target company board commits the company to a sale or a change of control transaction, the board's duty is to obtain the maximum available value for the shareholders, and not to interpose any obstacles to their receiving that value, even if the result is that the company is sold to a bidder the directors personally oppose. In the *MacMillan* takeover case, which involved the target company board resisting a takeover attempt by Sir Robert Maxwell, the Delaware Supreme Court held that in conducting an auction to sell the company for the highest available value, the board had a fiduciary duty to oversee actively the fairness of that auction – a duty that the MacMillan board was found to have violated by abdicating that responsibility to a senior officer whose personal interests were in conflict with that objective.

The corporate governance jurisprudence of the Delaware courts continues both to evolve and to be an important factor in shaping American corporate governance practices. I briefly mention three more recent examples: the *Hollinger International*,[10] *Walt Disney Company*,[11] and *News Corporation*[12] cases.

Hollinger involved a dispute between Hollinger International ('Hollinger') and its ultimate controlling stockholder, Lord Conrad Black. The Company owned, among other things, The London Daily Telegraph and The Jerusalem Post. The dispute concerned over

6 *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).
7 *MacAndrews & Forbes v. Revlon, Inc.*, 506 A.2d 173 (Del. 1986).
8 *QVC Network v. Paramount Communications, Inc.*, 637 A.2d 34 (Del. 1994).
9 *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1988).
10 *Hollinger Intern., Inc. v. Black*, 844 A.2d 1022 (Del. Ch. 2004); aff'd, 872 A.2d 559 (Del. 2005).
11 *In re The Walt Disney Co. Derivative Litig.*, 2005 WL 2056651 (Del. Ch.); 2005 Del. Ch. LEXIS 113, appeal pending, No. 411, 2005 (Del.).
12 *Unisuper, Ltd. v. News Corporation*, 2005 WL 3529317 (Del. Ch.).

who – the Company's board or Lord Black – would control Hollinger and the opportunity to sell one of its major assets, The Daily Telegraph. After an expedited trial, the Court of Chancery invalidated certain by-laws that Lord Black had caused to be adopted, which would have given Lord Black a veto power over any merger involving Hollinger and any sale of its assets. The Court found that the by-laws were inequitable and violated a prior agreement by Lord Black to cooperate with the board and management of Hollinger, who were engaged in a strategic process to develop a value-maximizing transaction for the Company. The Court also upheld a poison pill that the Hollinger board had adopted, as a highly unusual step, to prevent the Company's controlling stockholder (Lord Black) from selling control of the Company to the Barclay Brothers over the opposition of the board.

Putting to one side the publicity generated because of the prominence of the businesses and persons involved, the corporate governance rulings of the Court of Chancery in *Hollinger* have helped clarify several corporate governance issues involving companies that do business worldwide and that are controlled by a single person or cohesive small group.

A second recent case that attained 'celebrity' status is the Disney case that was the subject of a two month long trial in 2005. There, a shareholder of the Walt Disney Company filed a derivative action against the Disney board for breaching its fiduciary duties for having agreed to an executive compensation arrangement with Michael Ovitz, and then permitting that agreement to be terminated without cause after only one year, resulting in a severance payment to Ovitz of $130 million. In a 170 page post-trial opinion, the Chancellor held that the Disney directors had breached no fiduciary duty for which they could be found liable. Equally important, the court pointedly criticized the Disney board for engaging in executive compensation processes that fell far short of the best practices expected of the board of an American public company. Because that decision is currently on appeal before my Court, I am constrained in what I can say about it, but I am able to report that whatever may be the ultimate outcome of the case, the Chancery opinion has been widely discussed as a roadmap for guiding how executive compensation decisions in U.S. companies should – and should not – be made.

The third, and most recent, governance decision, which also involved a corporation having multinational business operations, is *Unisuper, Ltd. v. News Corporation.*[13] In that case, News Corporation, then an Australian corporation controlled by Rupert Murdoch, announced that the company would be reorganized and reincorporated in Delaware. That reorganization would be contingent upon obtaining the approval of each class of shareholders. Because the shares owned by the Murdoch family voted as their own class, the public shareholders, which included several institutions including Australian pension funds, could veto the reorganization if they voted against it. Those institutions were concerned that their shareholder rights could be adversely affected if the company were reincorporated in Delaware. More specifically, they were concerned that under Delaware law, the board of direc-

13 See, *supra*, n.12.

tors could institute a poison pill without shareholder approval, whereas under Australian law shareholder approval would be required.

As a result of negotiations between the company and the institutions' representatives, most of the institutions' governance concerns were worked out by agreement to add protective provisions to the company's Delaware certificate of incorporation.[14] The poison pill issue was not the subject of an agreed-upon charter provision, however, because there was insufficient time to draft a provision of such complexity. News Corp.'s board did agree – and approved a policy that was announced in a press release and in a letter to shareholders – that if a poison pill were adopted following reincorporation, the rights plan would expire after one year unless the shareholders approved an extension. Based on that agreement, the institutions voted for the reincorporation and did not oppose the reorganization.

One month later, Liberty Media acquired 17% of News Corporation's outstanding stock. Fearing a hostile takeover, News Corp. adopted a poison pill in response. One year expired, and the board extended the pills but without obtaining shareholder approval. Moreover, the board announced that in the future, it might or might not implement its policy of obtaining shareholder approval of further extensions of the pill.

The Australian institutional investors sued the company in the Delaware Court of Chancery for an order declaring the pill invalid. Denying a motion to dismiss, and rejecting the Company's argument that the board policy was not binding as a matter of law, the Court of Chancery found that the complaint stated a claim for breach of contract. The Court stated that '[I]f a board enters into a contract to adopt and keep in place a resolution (or a policy) that others justifiably rely on to their detriment, that contract may be enforceable, without regard to whether resolutions (or policies) are typically revocable by the board at will.'[15]

I submit that these decisions, emanating from one American jurisdiction – Delaware – demonstrate that a specialized tribunal that is capable of resolving internal governance disputes competently and quickly can play an important role in fostering good corporate governance. In this connection I underscore the word 'quickly,' because the experience has shown that in addition to having expertise in the subject matter, it is important that the tribunal be capable and willing to reach a decision, and to express that decision in a well-reasoned written opinion within a relatively short time frame. In many of the hostile takeover cases, for example, litigation that would ordinarily require one or two years is customarily compressed into a matter of weeks, and the Court of Chancery (and on appeal the Supreme Court) will typically issue a decision, often lengthy and complex, within a week to ten days from the date the case is submitted. The reason is that hostile takeover cases usually arise

14 For example, News Corp. agreed to insert a provision into its Delaware charter that the company would not issue new shares having more than one vote per share, and would retain a listing on the Australian Stock Exchange; and Murdoch agreed not to sell his stock if after the sale the purchaser owned more than 19.9% of the stock, unless the purchaser agreed to purchase all the remaining shares of the company on the same terms.

15 *News Corp.*, *supra*, 2005 WL 3529317 at *5.

on motions for preliminary injunction that must be decided quickly, while the financing for the contested transaction is still in place. Even in those cases that required a live trial (putting the Disney case to one side), the trial was expedited, and the opinion deciding the governance disputes was issued within days or weeks after the completion of briefing.[16]

Two factors have contributed to the Court of Chancery's ability to decide complex corporate governance disputes quickly. The first is that Chancery is a court of limited jurisdiction: there are no juries, it hears no criminal, personal injury, or traditional family law cases. As a consequence, the number of cases per judge is considerably less than in the Superior Court, which is Delaware's trial court of general jurisdiction. That enables the Chancery Court judges to move a particular case to the proverbial 'head of the line' if the circumstances so require. The second factor is, for want of a better term, I call culture, or esprit de corps. Over the decades a tradition has developed where it is expected that the Chancery Court judges will hear and decide matters on an expedited basis, when necessary, and express their decision in an opinion that is typically of appellate quality. The value system that generates that kind of professional pride and work ethic is a psychic reward for a public position that does not and cannot offer the level of remuneration that is available in private practice.

Having discussed how Delaware's specialized tribunal has influenced the development of good corporate governance practices in the United States, I turn to the next question, which is whether that experience has lessons for the member states in the EU. In my view, the Dutch Enterprise Chamber is a specialized court that promises to have a similar influence in the Netherlands.

4.3 The Experience with the Dutch Companies and Business Court

At least one EU member state, the Netherlands, has a specialized court that, like the Delaware Court of Chancery, has developed a record of success in resolving corporate governance disputes and contributing to corporate governance practices in that nation. I refer to the Enterprise Chamber, which is a division of the Amsterdam Court of Appeals, specializing in corporate and commercial matters related to legal entities incorporated in the Netherlands. The Enterprise Chamber[17] has exclusive jurisdiction over claims arising out of financial reporting, disputes between a company's management and its works council relating to proposed management actions, and disputes respecting the composition of supervisory boards in specified kinds of large companies. In addition, the Enterprise Chamber is authorized to institute 'investigation proceedings' to resolve conflicts between a company and its shareholders.[18]

16 The Court of Chancery also has a formal program in which it will mediate corporate, business and even technology-related disputes, upon request of the parties. To avoid issues of disqualification, when mediation is requested, the mediator is a Court of Chancery judge other than the judge who is presiding over the case.

17 See Willems, *et al.* (2004).

18 See Simpson (2003: 1084).

Established in 1971, the Enterprise Chamber initially resolved disputes arising in the context of bankruptcy proceedings, and developed a substantial body of case law with respect to the personal liability of directors based upon improper management resulting in their company's bankruptcy. In recent years, shareholders and Dutch companies have availed themselves of the Court's ability to act quickly and decisively, and as a result the Enterprise Chamber has become the forum of choice for litigating a growing number of cases outside the bankruptcy area. Included among those areas are contests for corporate control, and in particular, challenges to takeover defenses implemented by Dutch companies.

An important reason for this development is that the Enterprise Chamber is empowered to conduct an investigation proceeding. Upon the written request of shareholders representing at least 10% of a company's share capital, or such lesser amount as is provided by the company's articles of association, the Enterprise Chamber may order an investigation into the management policies and conduct of business at a company, if there are 'justified reasons to question the correctness' of the company's management policies. Examples of 'justified reasons' include allegations of violations of law, financial reporting or accounting irregularities, potential insolvency, insufficient provision of information to shareholders or other stakeholders, and conflicts of interest involving the company, its management and/or its shareholders. This procedure is authorized because no formal discovery procedure (such as under the American Federal Rules of Civil Procedure) is allowed in Enterprise Chamber proceedings.

The investigation is generally carried out by one or more court-appointed investigators, who interview the company's management, review its files and relevant documents, and present their conclusions in a report submitted to the court. If the report establishes that corporate misconduct took place, the court can order permanent measures such as suspending or nullifying board or shareholder resolutions, suspending or dismissing board members, appointing temporary managing directors, deviating from specified provisions of the company's articles of association, and ordering a temporary transfer of shares. The Chamber is also empowered to order temporary measures during the pendency of the investigation proceeding, not unlike the preliminary injunction proceedings conducted in the Delaware Court of Chancery.[19]

The broad power of the Enterprise Chamber to impose remedies has been a major reason why corporate litigants have brought claims and commence investigation proceedings in the Chamber, especially in takeover contests. In several takeover cases, a bidder requested an investigation into a target company's management practices in order to level the playing field, by obtaining provisional rulings aimed at suspending defensive actions taken by the company. Like the Delaware Court of Chancery, the Enterprise Chamber has been responsive and expeditious in considering requests for provisional relief by convening initial hearings in many cases within days, and ordering provisional measures directly after those hear-

19 Simpson (2003: 1085-1086).

ings are concluded. That is what occurred in the highly publicized Gucci takeover case in 1999, and in the Rodamco and HBG takeover cases in 2001.[20] Because the Enterprise Chamber is not the court of last resort, a party that is aggrieved by its rulings has the right of appeal to the Supreme Court of the Netherlands, which performs appellate review functions analogous to the review of Court of Chancery rulings by the Delaware Supreme Court.[21]

The experience with the Enterprise Chamber, which has existed for only 35 years, evidences that a specialized court that has the expertise, resources, and mandate to resolve corporate governance disputes, can have a similar impact on corporate governance practices in an EU member state, as the Delaware Court of Chancery has had in the U.S.[22]

One important difference between the Dutch Enterprise Chamber and the Delaware Court of Chancery merits discussion. Although the Delaware Court of Chancery has formal jurisdiction only over Delaware corporations, its influence over corporate governance has been far broader, primarily because of the national operations of many of the companies that are incorporated in Delaware and whose internal governance affairs are, therefore, governed by Delaware corporate law. The Dutch Enterprise Chamber which, it appears, is doing an equally admirable job, also has formal jurisdiction only over Netherlands corporations. Unlike Delaware, however, the Netherlands is not where a majority of the listed companies, or the largest firms in the EU, are incorporated. Therefore, the Dutch Enterprise Chamber does not function, at least at present, as the business court for the EU.[23] Nor, at the present time is any court of any member EU state in a position to assume that role, because of structural barriers.

A critical reason why a specialized court of one State (Delaware) has come to have influence over corporate governance law and practice in the U.S., is that corporations in the U.S. are free to change their state of incorporation on a comparatively cost-free basis – a fact that has contributed to regulatory competition for corporate charters among the States in the U.S. To this point, Delaware has won that competition. Within the E.U., however, there are legal and procedural barriers to such jurisdictional competition. Those barriers include: (i) imposing exit taxes on companies that are incorporated in one member state and later choose to reincorporate in a different member state, and (ii) uncertainty as to whether the courts of member states will apply to foreign companies litigating in those courts, the corporate governance law of the foreign company's country of incorporation.[24] As a result, the regulatory competition that exists in the U.S., and that has driven the creation of specialized

20 Simpson (2003: 1086-1096).
21 See Willems *et al.* (2004: 34-36).
22 Several Dutch legal scholars have reportedly noted the activist role taken by the Enterprise Chamber in recent years. One corporate takeover specialist has observed that that activist role can be contrasted with the approach of the Dutch District Court, which has the ability to hear similar cases but may not have the same background and experience, and generally has not tended to act as quickly or decisively. See Simpson (2003: 1086, fn 10).
23 '[A]lthough one might speculate that the Enterprise Chamber could become Europe's equivalent to the Delaware Chancery Court . . . it is premature to reach any such conclusion about the impact of Enterprise Chamber decisions in European jurisdictions other than the Netherlands.' Simpson (2003: 1098).
24 McCahery and Vermeulen (2004).

business courts there, is not present (or is far less present) in the E.U. The available literature suggests that without changes that would promote regulatory competition and corporate mobility within the EU, there are fewer incentives to develop specialized business courts within the EU.

Whether that is good or bad is for the E.U. policymakers, not for me, to say. But because this segment of the Conference is devoted to specialized tribunals, I infer that a respectable body of opinion makers believe that the E.U. should consider fostering the creation such tribunals. On that assumption, I will conclude on a subject about which I confess being least knowledgeable – the prospect that specialized courts to resolve governance disputes will be created on a more widespread basis within the E.U. On this subject, my comments will be brief.

4.4 Some Speculations About the Prospects For Specialized Business Courts In The EU

If it is thought desirable to foster the development of specialized courts along the lines of the Dutch Enterprise Chamber in the E.U., that could occur in one of two ways. The first is by each member state encouraging that development within its own borders. The second is by the centralized E.U. authorities creating s specialized business court at the supranational level. At present I am not aware that the former development has occurred in any member state other than the Netherlands. As for the latter, there are developments, none definitive, that in the view of some scholars, might serve as a framework for developing specialized courts at the E.U. supranational level.

In a very thoughtful article,[25] Professor Luca Enriques of the University of Bologna Faculty of Law argues that good corporate law is necessary for the development of financial markets, and that what makes good corporate law are good corporate law judges. The essential prerequisites for a good corporate law judge, Professor Enriques argues, are: (1) honesty, rapidity and expertise, (2) no deference to controllers in conflict of interest cases, (3) the ability to identify the real rights and wrongs and to deal with them directly, (4) an unwillingness to be formalistic, and (5) concern for how their decisions mold the behavior of corporate actors.[26] For our purposes the import of the Enriques article is to confirm our intuitive, common sense notion that national legal culture, and how judges are educated and selected, play a major role in determining the quality of a nation's judiciary. Critical to this concept is Professor Enriques' view that changing national legal culture so as to develop a highly qualified judiciary takes time and will most likely be the product of globalization and competitive forces.[27] I personally agree with this view, and would amplify it by suggesting that (i) one of the more important competitive forces will be driven by the need and desire of individual EU member states to attract foreign investment capital for its local firms, and that (ii)

25 See Enriques (this volume, ch. 9).
26 Enriques (this volume, ch. 9:181).
27 Enriques (this volume, ch. 9:207-208).

foreign investment tends to be attracted to jurisdictions that offer investor protection in the form of enforcement agencies like the S.E.C. in the U.S., and the courts.

What this tells us is that although high quality business courts can be created from the bottom up (i.e., on a member state level), this will happen only if the member state has an incentive to do so. Whether or not those incentives exist will be influenced, if not determined, by what happens not only at the national, but also at the E.U. level. Some have suggested that barriers would have to be removed to foster the regulatory competition among member E.U. states, as one step towards creating the economic incentives for specialized courts to evolve at the member state level.

What of the prospects for the central E.U. authorities establishing a specialized court or courts to resolve corporate governance disputes on a supranational level? There have been developments that could serve as a framework for this to happen. The first is the SE statute that became effective in 2004, and that authorizes the European Company or Societas Europea. Some have argued, however, until the problem of uniform taxation is addressed, firms will not choose to incorporate as European Companies in great numbers.[28] A second development consists of reform measures that have been recommended by a group of experts commissioned by the European Commission to simplify existing rules and improve freedom of choice between alternative forms of organization. A third development are decisions of the European Court of Justice (ECJ) in *Centros*, *Überseering*, and *Inspire Art*[29] – decisions that, in the view of some, could eventually trigger the development of competitive lawmaking within the E.U. In *Centros*, the ECJ recognized the right of a Danish firm to incorporate in the United Kingdom to circumvent cumbersome Danish minimum capital rules, without the intention of conducting business operations in the country of incorporation. The European Court held that for Denmark to refuse to register that company to do business there violated the EC Treaty. Some scholars view *Centros* and its progeny as renewing the discussion about regulatory arbitrage in Europe, because those cases enable firms to migrate to countries that offer internal processes and legal regimes that lower their costs, regardless of where the firm's assets, employees and investors are located.[30]

These developments could represent important steps towards creating a framework for fostering the creation of a specialized tribunal at the E.U. level to resolve corporate governance disputes. But whether that will happen, and how long it would take for that to occur, are subjects about which I am not qualified to speculate. What I can say with confidence is that if there develops within the E.U. the economic incentives and political will to foster the creation of national, or supranational, specialized courts, the Delaware Court of Chancery and the Dutch Enterprise Chamber are two tribunals that could serve as useful models.

28 McCahery and Vermeulen (2004:16-18).
29 Case C-212/97 *Centros Ltd. v. Erhvervs-og Selskabsstryelsen*[1999] ECR I-1459; Case C-208/00 *Übersering BV v. Nordic Construction Co. Baumanagement GmbH*; Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amerstam v. Inspire Art Ltd.*.
30 McCahery and Vermeulen (2004: 27-28).

5 'Good Faith' and The Ability Of Directors To Assert § 102(b)(7) Of The Delaware General Corporation Law AS A Defense To Claims Alleging Abdication, Lack Of Oversight, And Similar Breaches Of Fiduciary Duty

John L. Reed[1]

5.1 Introduction

Recent high-profile corporate scandals have brought to the forefront investor and public concerns about the manner in which corporate fiduciaries carry out their duties. Along with this concern has come a rising tide of lawsuits seeking to hold directors and other fiduciaries personally accountable for corporate misdeeds, including failures to properly oversee companies' affairs. With nearly sixty percent of the Fortune 500 and a majority of all public companies incorporated in Delaware[2], Delaware remains front and center in the current climate of corporate cynicism and the desire to hold directors personally liable for corporate losses.

Section 102(b)(7) of the Delaware General Corporation Law (the DGCL)[3] allows Delaware corporations to include in their certificates of incorporation a provision limiting or eliminating the liability of their directors for breaches of fiduciary duty. The statute, however, expressly excludes and prohibits exculpation for (1) breaches of the duty of loyalty, (2) actions not taken in good faith, and (3) transactions or other conduct where a director derives an improper personal benefit. While the procedural manner in which a § 102(b)(7) provision must be raised and certain other discrete aspects of the statute have been squarely addressed by the Delaware Supreme Court,[4] little else is clear.

Especially pertinent, in light of recent corporate scandals are questions concerning the availability of protection from liability for directors in cases involving abdication of duty/lack of oversight claims. As recent cases in Delaware and other jurisdictions make clear, such questions include the meaning of 'good faith' as it appears in § 102(b)(7) and what, if any, claims alleging abdication of duty or lack of oversight constitute a breach of the duty of good faith or loyalty as opposed to or in addition to a breach of the duty of care. To address these questions, this article provides a brief history and background of § 102(b)(7), discusses the meaning of 'good faith' for purposes of § 102(b)(7), and reviews cases involving abdication of duty or lack of oversight claims, with particular emphasis on recent cases suggesting

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2 See Why Choose Delaware as Your Corporate Home?, State of Delaware, Department of State: Division of Corporations, at http://www.state.de.us/corp/default.shtml (last visited Apr. 15, 2004).

3 Del. Code Ann. tit. 6, § 102(b)(7) (2003).

4 See, e.g., *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001).

that such claims may implicate a director's duty of good faith and/or loyalty, rendering a § 102(b)(7) defense inapplicable.

5.2 Brief History and Background of § 102(b)(7)

Section 102(b)(7) first appeared in the DGCL in 1986, in response to the declining availability of adequate directors' and officers' liability insurance[5] created in the wake of *Smith v. Van Gorkom*,[6] a case where the Delaware Supreme Court upheld a finding that directors breached their fiduciary duty of care in connection with the approval of an acquisition. The case later settled for $23 million. Even though the D&O insurer contributed the full policy limits, the directors had only a total of $10 million in coverage. To help alleviate the consequences and concerns of directors following *Van Gorkom*, § 102(b)(7), as enacted, permits Delaware corporations to authorize provisions in their certificates of incorporation limiting or eliminating the personal liability of directors for breaches of fiduciary duty, excepting, however, four specific categories of conduct. The statute states that a certificate of incorporation may contain:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.[7]

As drafted – or some would say, misdrafted – § 102(b)(7) has often been described in general terms as authorizing charter provisions limiting or eliminating director liability for 'duty of care' violations.[8] As discussed more fully below, however, § 102(b)(7) might more accurately be described as limiting or eliminating director liability for either (1) *pure* duty of care violations or (2) *some* duty of care violations. The latter being stated as such to accommodate those who maintain the view that a *knowing* or *egregious* violation of the duty of care (i.e. a violation

5 See 1 Ward *et al.* (2003: § 102.15) (citing unavailability of insurance and corresponding concerns about companies' ability to attract qualified directors and encourage entrepreneurial decision making as reasons prompting enactment of 102(b)(7)).

6 488 A.2d 858 (Del. 1985). See 1 Drexler *et al.* (2002: § 6.02[7] n.54), (pointing to *Van Gorkom* as a case 'widely cited as contributing to directors' concerns with personal liability' and prompting the enactment of § 102(b)(7)). See also 65 Del. Laws, ch. 289, §§ 1-2 (1986) (official synopsis concerning enactment of § 102(b)(7)).

7 Del. Code Ann. tit. 8, § 102(b)(7) (2003).

8 See Drexler *et al.*, *supra* note 6, § 6.02[7]; See 1 Balotti & Finkelstein (2004) § 4.29. ('In essence, Section 102(b)(7) permits a corporation . . . to protect its directors from monetary liability for duty of care violations, i.e., liability for gross negligence.'). Accord *Rothenberg v. Santa Fe Pac. Corp.*, No. 11,749, 1992 Del. Ch. LEXIS 106, at *10 (Del. Ch. May 18, 1992), reprinted in 18 *Del. J. Corp. L.* 743, 751 (1993). Such a description is gleaned from the cumulative exceptions, as § 102(b)(7) does not explicitly mention the 'duty of care.'

that has especially egregious consequences or amounts to more than gross negligence) is still a duty of care violation as opposed to a violation of the duty of loyalty or the duty of good faith.

Since its enactment, many aspects of § 102(b)(7) have been the subject of litigation and, consequently, judicial clarification. One of the more frequently litigated aspects of § 102(b)(7) is the procedural posture in which it arises. The Delaware Court of Chancery has long held that, when raised by a director as a protection from personal liability, a charter provision authorized by § 102(b)(7) is in the nature of an affirmative defense.[9] Procedurally, however, questions have been raised by the Delaware Supreme Court as to whether a § 102(b)(7) defense may properly be considered by a court deciding a motion to dismiss. In *Malpiede v. Townson*,[10] for instance, the supreme court expressed concerns about the court of chancery's consideration of an exculpatory charter provision on a Rule 12(b)(6) motion to dismiss, because the provision was neither referred to nor incorporated into the complaint. While not expressly addressed in the opinion below, it would appear that the court of chancery, in accordance with established practice, took judicial notice of the relevant corporate charter,[11] a document filed with the Delaware Secretary of State and, absent rare circumstances, a document whose authenticity is not typically subject to reasonable debate. Although it ultimately upheld the court of chancery's consideration of the provision under the circumstances, the Delaware Supreme Court advised that it would have been preferable for the court of chancery to treat 'the motion as one for summary judgment once the Section 102(b)(7) charter provision was interposed by the director defendants.'[12]

Another issue related to § 102(b)(7) that has received considerable attention is the effect that the invocation of an exculpatory charter provision has on claims which are subject, *ab initio*, to review under the entire fairness standard as opposed to the business judgment rule. As explained by the Delaware Supreme Court in *Emerald Partners v. Berlin*:[13]

9 See, e.g., *Boeing Co. v. Shrontz*, No. 11,273, 1992 Del. Ch. LEXIS 84, at *10 (Del. Ch. Apr. 20, 1992), reprinted in 18 *Del. J. Corp. L.*225, 234 (1993).

10 780 A.2d 1075 (Del. 2001).

11 The established practice of taking judicial notice of exculpatory charter provisions in deciding a motion to dismiss was recognized by the court of chancery only weeks before the supreme court released its opinion in *Malpiede*:

> Because the Section 102(b)(7) provision cannot be found in the Complaint, there may be doubt as to whether the Court may consider the exculpatory provision in the Certificate of Incorporation in the context of a motion to dismiss. The established Chancery practice, which I will follow until instructed otherwise, is to address the Section 102(b)(7) defense in resolving motions to dismiss through the taking of judicial notice of the applicable provision in the certificate of incorporation. I do so because it promotes the efficient allocation of the court's and the parties' resources.

In re Ply Gem. Indus., S'holders Litig., No. 15, 779-NC, 2001 Del. Ch. L6XIS 84 at *38-*39 (Del. Ch. June 26, 2001), reprinted in 27 Del. J. Corp. L. 937, 953 (2002).

12 *Malpiede*, 780 A.2d at 1092. The court noted that converting a Rule 12(b)(6) motion to one for summary judgment, thus permitting the non-moving party to engage in very limited discovery relating to issues such as the authenticity and validity of the § 102(b)(7) charter provision, would have been a preferable approach. *Id.* at 1091-92.

13 787 A.2d 85 (Del. 2001) (*Emerald Partners III*). This case had a lengthy history. It spanned nearly fifteen years, resulting in twenty separate court opinions and orders, and the case only recently concluded with an order from the Delaware Supreme court affirming the chancery court's findings. See *Emerald Partners v. Berlin*, 840 A.2d 641 (Del. 2003).

> [A]lthough a Section 102(b)(7) charter provision may provide exculpation for directors against the payment of monetary damages that is attributed exclusively to violating the duty of care, even in a transaction that requires the entire fairness review standard *ab initio*, it cannot eliminate an entire fairness analysis by the Court of Chancery.[14]

Thus, in all instances where the entire fairness standard applies *ab initio*, a reviewing court must undertake an entire fairness analysis even for claims that might otherwise be subject to dismissal under a § 102(b)(7) clause, being careful to thereby 'identify the breach or breaches of fiduciary duty upon which liability [for damages] will be predicated in the *ratio decidendi* of its determination.'[15] Because an exculpatory charter provision shields monetary liability only for duty of care violations, 'the breach or breaches of fiduciary duty upon which substantive liability for monetary damages is based become outcome determinative.'[16]

Perhaps the most widely litigated aspect of § 102(b)(7) is the scope of director misconduct that may be exonerated by an exculpatory charter provision. Despite the frequency with which it has been addressed, this topic remains relatively unclear. Although courts and commentators seem to agree that an exculpatory charter provision precludes monetary liability for pure 'duty of care' claims and not for duty of loyalty or 'good faith' claims, the assignment

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14 *Emerald Partners*, 787 A.2d at 93. As further explained by the court, 'The category of transactions that require judicial review pursuant to the entire fairness standard ab initio do so because, by definition, the inherently interested nature of those transactions are inextricably intertwined with issues of loyalty.' *Id.* (citations omitted).

15 *Id.*at 94.

16 *Id.* As to independent directors, a literal reading of this holding in *Emerald Partners III* is difficult to understand, unless independent directors are guarantors of fairness and strictly liable for an unfair transaction. As one scholar/practitioner has pointed out:

> If disinterested directors are strictly liable for approving an unfair transaction, the conclusion in *Emerald Partners III* that a fairness determination must be made before the affirmative defense of exculpation can be decided seems to be the better reasoned result. However, if disinterested and independent directors who approve a self-dealing transaction which is not fair are only liable if they have acted without the requisite care or have acted in bad faith, the decision in *Emerald Partners III*, and one of the prior opinions in that case, seems inconsistent with the prior opinions of the Delaware Supreme Court. While resolution of this issue seems to be a necessary, if unstated, predicate to the entire analysis in *Emerald Partners III*, it is not expressly addressed by the Court in its decision, and it does not appear to have been raised by the defendants in their defense of the action. Nor does it appear that this issue has been definitively resolved by any prior Delaware Supreme Court decision.
>
> A strict liability standard makes the disinterested and independent directors liable as 'guarantors' of the fairness of the transaction.

David C. McBride, Emerald Partners v. Berlin: Are Disinterested Directors the Guarantors of Fairness? 3, available at http;//www.yest.com (on file with the Delaware of Corporate Law), The author later stated:

> To this commentator, an analysis of fairness, if not the actual resolution of the issue, probably is necessary in most cases before exculpation can ben resolved if the disinterested directors are strictly liable for approving an unfair transaction with a controlling fiduciary. However, if the liability of the disinterested directors also requires a determination that they acted in bad faith or breached their duty of care, evidence of whether the transaction was or was not entirely fair may be relevant to that determination, but it is unclear why actual resolution of the fairness issue, as opposed to evaluation of the evidence is necessary.

Id at 33. See also William T. Allen et al. (2001) (debating the standard of judicial scrutiny that should apply to self-dealing transactions when approved by disinterested directors or shareholders).

of various claims to one or more of these categories has proved to be anything but arithmetical.[17]

Delaware cases involving the effect of a § 102(b)(7) charter provision on allegations of waste have held that some, but not all, claims for monetary damages based on a theory of waste may be subject to dismissal in light of an exculpatory provision. For instance, in *Emerald Partners v. Berlin*,[18] the court of chancery considered the director defendants' motion for partial judgment on the pleadings seeking, among other things, dismissal of the plaintiff's waste claim. In the complaint, the plaintiff alleged that the director defendants committed waste by approving a transfer of assets to a fellow director to secure that director's personal loans in exchange for little or no consideration. In their motion, the directors raised the company's exculpatory charter provision, claiming that they could not be personally liable for monetary damages stemming from the alleged waste even if such allegations were true, and that they therefore would have been disinterested in considering a pre-suit demand with respect to the waste claim. In disagreeing with the defendants and holding that pre-suit demand was excused, the court of chancery stated that '[i]f the defendant-directors knowingly approved a transaction in which the corporation received no consideration in return for the pledge of valuable corporate assets to secure the personal loans of its Chief Executive Officer, . . . § 102(b)(7) would not protect them from personal liability because they would have acted in *bad faith*.'[19]

Two years later, in *Green v. Phillips*,[20] the court of chancery again was confronted with an exculpatory charter provision in the waste context. There, the plaintiff alleged that the director defendants of a company (Van-Heusen) committed waste by entering into an employment agreement with a former director and ten percent stockholder of Van Heusen (Phillips) in an attempt to terminate Phillips' relationship with the company. Under the agreement, Phillips was to receive an annual salary in exchange for consulting services and a covenant not to compete. In addition, the agreement provided various other benefits, such as insurance and a company car, to Phillips, and the plaintiff argued the company had failed to receive any consideration for these additional benefits. Accordingly, the plaintiff claimed that the agreement constituted waste, for which the director defendants should be held personally liable. In ruling that the company's exculpatory charter provision shielded the director defendants other than Phillips from personal liability, the court disagreed that the waste claim '[drew] into question the good faith of all defendants,' holding instead that there were no

17 A potentially important subject concerning the scope of the exculpation afforded by § 102(b)(7) which has yet to be addressed by Delaware courts is whether directors may be exempted from personal liability for breaches of the duty of care when such duties are owed to a corporation's creditors. As drafted, § 102(b)(7) appears to preclude director exculpation in such circumstances. Section 102(b)(7) states that a charter provision may eliminate or limit the personal liability of a director 'to the corporation or its stockholders.' The statute makes no mention, however, of creditors. See *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 789 (Del. Ch. 1992) (noting that defendant pointed to the potential 'anomaly' in attempting to argue that he should not owe duties to the corporation's directors). See also *Pereira v. Cogan*, No. 00 Cir. 619, 2001 U.S. Dist. LEXIS 2461, at *30-*38 (S.D.N.Y. Mar. 13, 2001) (holding that company's 102(b)(7) provision did not bar duty of care claims brought on behalf of company's creditors).

18 No. 9700, 1993 Del. Ch. LEXIS 273 (Del. Ch. Dec. 23, 1993).

19 *Id.*at *21-*22 (emphasis added).

20 No. 14436, 1996 Del. Ch. LEXIS 76 (Del. Ch. June 19, 1996), reprinted in 22 *Del. J. Corp. L.*360 (1997).

well-pleaded allegations that '(i) the defendants (other than Phillips) were financially interested, or that (ii) the other defendants acted in other than good faith in approving the ... Agreement.'[21] The court thus distinguished the case from *Emerald Partners*, noting that 'the waste claim alleged there did bring the directors' loyalty and good faith into question.'[22]

Delaware cases discussing the applicability of § 102(b)(7) to claims involving disclosure violations likewise indicate that the availability of exculpation depends on the nature of a given claim, with particular focus on the alleged motivation underlying a disclosure claim. In *Arnold v. Society for Savings Bancorp, Inc.*,[23] for instance, the plaintiff alleged that the directors breached their fiduciary duties by failing properly to disclose information concerning the sale of the company. In their defense, the directors argued that the company's exculpatory charter provision precluded the disclosure claims. The court agreed, first proclaiming the general applicability of § 102(b)(7) to disclosure claims: 'Given that the fiduciary disclosure requirements were well-established when Section 102(b)(7) was enacted ... there is no reason to go beyond the text of the statute ....'[24] The court further explained that, 'claims alleging disclosure violations that do not otherwise fall within any exception are protected by Section 102(b)(7).'[25] The court went on to find that the disclosure violations alleged by the plaintiff were at best omissions of material fact made in good faith.[26] Other disclosure cases have reached similar results.[27]

5.3 The Meaning of 'Good Faith' for Purposes of § 102(b)(7)

As explained, actions or omissions 'not in good faith' are expressly excluded from exculpation under § 102(b)(7). As addressed more fully below, many of the cases involving oversight/abdication claims involve allegations that directorial conduct, or lack thereof, rises to the level of bad faith and, hence, that such conduct or inaction is unprotected by a corporation's exculpatory charter provision. Accordingly, the answer to the question of what is meant by 'not in good faith' for purposes of § 102(b)(7) may be of paramount significance in defining the scope of exoneration allowed by § 102(b)(7).

As with any question of statutory construction, the proper starting point for discerning the meaning of 'good faith' for purposes of § 102(b)(7) is the language of the statute itself. Unfortunately, however, 'good faith' is not defined anywhere in the DGCL. Nor does the framing of § 102(b)(7) provide any helpful insight. Although one might be led to believe that, because they appear disjunctively as two separate exceptions under § 102(b)(7), 'not in good faith' and 'any breach of the director's duty of loyalty' are mutually exclusive categories

21 *Id.* at *21-*22.
22 *Id.* at *22.
23 650 A.2d 1270 (Del. 1994).
24 *Id.* at 1287.
25 *Id.*
26 *Id.* at 1288.
27 See, e.g., *Johnson v. Shapiro*, No. 17,651, 2002 Del. Ch. LEXIS 122, at *30-*31 (Del. Ch. Oct. 18, 2002), reprinted in 28 *Del. J. Corp. L.* 361, 374 (2003).

of conduct or omissions, this is not necessarily the case. For example, as Vice Chancellor Strine observed in *In re Gaylord Container Corp. Shareholders Litig.*,[28] the 'fundamental' duties are 'care and loyalty.'[29] Pointing to two Delaware Supreme Court decisions – *Cede & Co. v. Technicolor, Inc.* (*Cede II*)[30] and *Barkan v. Amsted Industries, Inc.*[31] – the Vice Chancellor went on to suggest that the notion of 'good faith' being part of a 'triad' of independent fiduciary duties – that is, the concept of good faith as a third, succinct type of fiduciary duty – may well have its origin in a semantical misunderstanding:

> Indeed, the very Supreme Court opinion that refers to a board's 'triads [sic] of fiduciary duty [sic] – good faith, loyalty, [and] due care,' *Cede II*, equates good faith with loyalty. In the following sentence from *Cede II*, the Supreme Court quotes its earlier opinion in *Barkan v. Amsted Industries, Inc.*, but adds bracketed text to clarify meaning. The sentence, with the bracketed text emphasized, reads as follows:
>
> [A] board's actions must be evaluated in light of relevant circumstances to determine if they were undertaken with due diligence [*care*] and good faith [*loyalty*]. If no breach of duty is found, the board's actions are entitled to the protections of the business judgment rule.
>
> In *Barkan* itself, it is clear that the Supreme Court used the terms 'due diligence' and 'good faith' as a fresh way of referring to the 'fundamental duties of care and loyalty' it discussed three sentences earlier in the same paragraph. Moreover, *Cede II* contains two lengthy sections focusing on the duties of loyalty and care but has no comparable section on good faith, despite its putative equality in the triad.[32]

As elaborated upon by then-Vice Chancellor (now Justice) Jacobs in *Emerald Partners v. Berlin*,[33] some of the categories set forth in § 102(b)(7) appear to be, or are, superfluous, thus adding to the confusion as to their respective meanings:

> Good faith is a fundamental component of the duty of loyalty, as the Supreme Court recognized in *[Cede & Co. v.] Technicolor*,

28 753 A.2d 462 (Del. Ch. 2000).
29 *Id.*at 476 n.41.
30 634 A.2d 345 (Del. 1993).
31 567 A.2d 1279 (Del. 1989).
32 *In re Gaylord Container Corp.*, 753 A.2d at 476 n.41 (internal citations omitted). See also *Guttman v. Huang*, 823 A.2d 492, 506 n. 34 (Del. Ch. 2003) (revisiting observations made in *Gaylord*). Accord *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (noting that business judgment rule is presumption that directors acted on an informed basis, 'in good faith and in the honest belief that' an action was in best interests of company).
33 No. 9700, 2003 Del. Ch. LEXIS 42 (Del. Ch. Apr. 28, 2003), reprinted in 28 *Del. J. Corp. L.*1027 (2003).

> 634 A.2d [345,] 368, n.6 (*citing Barkan v. Amsted Industries, Inc.*, 567 A.2d 1279, 1286 (Del. 1989). Confusion about the relationship between the fiduciary duty of loyalty and its good faith component is attributable in part (in my view and the view of other members of this Court) to the way that Section 102(b)(7) is drafted. The structure of Section 102(b)(7) balkanizes the fiduciary duty of loyalty into various fragments, thereby creating unnecessary conceptual confusion. For example, subsection (i) of Section 102(b)(7) excludes conduct violative of the 'duty of loyalty' from exculpatory protection, but then goes on, in other subsections, to carve out conduct that amounts to different examples of quintessentially disloyal conduct. One such example of disloyal conduct is unfair self-dealing, which subsection (iv) describes as a director's receipt of 'an improper personal benefit' from a transaction. 8 *Del. C.* § 102(b)(7)(iv).[34]

Because the statute itself is unhelpful in determining the meaning of 'good faith,' the meaning of the term must be gleaned from its judicial application. As Delaware cases and authorities addressing the meaning of 'good faith' make clear, however, the term cannot be generally defined, but is instead a creature of context.[35]

Consistent with the Delaware Supreme Court's decisions in *Cede II* and *Barkan*, the court of chancery has, on more than one occasion, equated the duty of good faith with the duty of loyalty. In *Citron v. Fairchild Camera and Instrument Corp.*,[36] while considering claims that director defendants violated their fiduciary duties in recommending a merger and failing to undertake an auction of the company, the court of chancery explained that 'the absence of significant financial adverse interest creates a presumption of good faith, or a *prima facie* showing of it.'[37] Not only did the *Fairchild* court equate good faith with the traditional concept of loyalty (i.e., the existence, or lack thereof, of an adverse financial interest), it also suggested that a good faith inquiry concerns a director's state of mind:

> This inquiry into a subjective state of mind necessarily will require inferences to be drawn from overt conduct – the quality

34 *Id.*at *139 n.133, reprinted in 28 *Del. J. Corp. L.*at 1089 n.133.

35 For instance, in the commercial context, the Delaware Supreme Court has described good faith for purposes of the implied contractual duty as a non-specific excluder:

> [Good faith] is an excluder. It is a phrase without general meaning (or meanings) of its own and serves to exclude a wide range of heterogenous forms of bad faith. In a particular context the phrase takes on specific meaning, but usually this is only by way of contrast with the specific form of bad faith actually or hypothetically excluded.

E.I. Du Pont de Nemours & Co. v. Pressman, 679A.2d 436, 443 (Del. 1996) (citing Robert S. Summers, 'Good faith in General Contract Law and The Sales Provisions of the Uniform Commercial Code,' 54 *Va. L. Rev.* 195, 201 (1908).

36 No. 6085, 1988 Del. Ch. LEXIS 67 (Del. Ch. May 19, 1988), reprinted in 14 *Del. J. Corp. L.*273 (1989). Accord *Goodwin v. Live Entertainment, Inc.*, No. 15,765, 1999 Del. Ch. LEXIS 5, at *19 n.4 (Del. Ch. Jan. 22, 1999) (explaining that 'a finding that a majority of the Board was disinterested is strong evidence that the Board was "motivated by a good faith desire to achieve the best available transaction"' (citation omitted)).

37 Citron, 1988 Del. Ch. LEXIS 67, at *46 (emphasis added).

> of the decision made being one notable possible source of such an inference ... the evidence in this case establishes that the Fairchild board was properly *motivated* in all that it did in response to the Gould interest in acquiring control of the Company. It acted in good faith.[38]

Thus, following the reasoning of *Citron*, misconduct otherwise implicating due care could be so egregious as to create an inference of bad faith, even absent an improper financial benefit.

As later explained by the court of chancery in *Nagy v. Bistricer*,[39] '[by] definition, a director cannot simultaneously act in bad faith and loyally towards the corporation and its stockholders.'[40] Thus, any utility of 'good faith' as a concept independent of loyalty, according to the court of chancery's reasoning, rests in its constant reminder (1) that a fiduciary may act disloyally for a variety of reasons other than personal pecuniary interest; and (2) that, regardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes.[41]

As is made clear by *Nagy*, although good faith is a component of loyalty,[42] the concepts of bad faith and adverse pecuniary interest or motive are not necessarily the same, as disloyalty may take many forms.[43]

The 'good faith' standard, especially in the abdication context (as set forth more fully below), acts almost as a bridge between the concepts of due care and loyalty, transforming what might otherwise be deemed certain violations of the former into violations of the latter, even in the absence of an adverse pecuniary interest. Indeed, as noted by the authors of one

38 *Id.*at *46-*47 (emphasis added).
39 770 A.2d 43 (Del. Ch. 2000).
40 *Id.*at 49 n.2. See also Allen *et al.*, at 1319 n.124 (noting that notwithstanding the statue's separate delineation of the duties of loyalty, good faith and improper personal benefit, conduct qualifying for any of the exceptions set forth under § 102(b)(7) also constitutes a breach of the duty of loyalty, the first exception listed in the statute).
41 Nagy, 770 A.2d at 49.
42 The author of one recent article has suggested that good faith is not necessarily a component of loyalty or due care and that 'confining' good faith to one of those two situations 'would diminish its power as a prophylactic tool or incentive for good fiduciary conduct.' See Sale (2004). Of course, for the director concerned about personal liability, far more significant than an academic categorization or debate about the semantics of good faith is a practical understanding of what conduct or lack thereof will be deemed to constitute bad faith for both pleading and evidentiary purposes. As explained in this article, Delaware courts have not attempted to confine good faith to either due care or traditional concepts of loyalty (i.e., conflicting pecuniary interests) for procedural or substantive purposes, rather they have utilized good faith as a flexible, catch-all standard. With respect to the loyalty analysis, Delaware courts have also acknowledged the need to move beyond a traditional 'pecuniary interest' approach to a broader approach which recognizes that disloyalty may take many forms.
43 *Id.*at 49 n.2. See also *In re Oracle Corp. Deriv. Litig.*, 824 A.2d 917, 938 (Del. Ch. 2003) ('Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. Homo sapiens is not merely homo economicus. We may be thankful that an array of other motivations exist that influence human behavior . . . .').

treatise, the duty of good faith is an 'overarching element' of a director's baseline duties of due care and loyalty.[44] Whether a given due care violation presents a question of bad faith and, in some cases, loyalty, appears to depend on the magnitude and/or ongoing nature of the violation. It is the magnitude or ongoing nature of the action(s) or inaction(s) that provides the indicia of what ultimately needs to be proven – i.e., the director's good faith or bad faith motivation ('state of mind').[45] In *In re J.P. Stevens & Co. Inc. Shareholders Litigation*,[46] the court of chancery held, in the business judgment context, that bad faith may be inferred in cases where a decision is 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.'[47] What this has to mean is that if such a determination is made, the court has concluded that if the facts as pleaded are true, the directors had to have *known* (i.e. had the requisite culpable 'state of mind') that they were violating their fiduciary duties or had an ill motive. As reflected in the cases discussed below, the 'inexplicable on any other ground' definition of 'bad faith' appears to be the best embodiment of the various usages of the standard as it relates to allegations of directorial misconduct.

With respect to abdication, the authors of another treatise have pointed out that recklessness – conduct or inaction 'somewhere in between ordinary negligence and intentional wrongdoing' – may constitute bad faith, stating that '[t]o the extent that recklessness involves a conscious disregard of a known risk, it could be argued that such an approach is not one taken in good faith and thus could not be liability exempted' under § 102(b)(7).[48] Consistently, in *Mills Acquisition Co. v. MacMillan, Inc.*,[49] the Delaware Supreme Court recognized, in *dicta*, that abdication may constitute a breach of the duty of loyalty under certain egregious circumstances. As the court declared in that case, the 'board's virtual abandonment of its oversight functions . . . was a breach of its fundamental duties of loyalty and care in the conduct of [an] auction.'[50]

44 Block *et al.* (1988) (citing Proposed Model Bus. Corp. Act § 8.31 Official Comment, in, Committee on Corporate Laws, Changes in the Model Business Corporation Act – Amendments Pertaining to Electronic Filings/Standards of Conduct and Standards of Liability for Directors, 53 Bus. Law. 157, 180 (1997)).

45 It is worth noting here that, in the fee shifting context, Delaware courts have required a showing that the defendant acted with scienter in order to justify a finding of bad faith. See, e.g., *Ryan v. Tad's Enterprises, Inc.*, 709 A.2d 682, 706 (Del. Ch. 1996):

> Although the defendants have failed to carry their burden of showing entire fairness, that does not necessarily establish that the defendants acted in bad faith as that term is defined for fee-shifting purposes. The plaintiffs must carry the burden of persuading the court that the defendants acted with scienter sufficient to warrant a finding of bad faith.

The *Ryan* court also defined bad faith as conduct constituting a 'high degree of egregiousness' Id. (quoting *Abex, Inc. v. Kohl Real Estate Group, Inc.* No. 13, 462, 1994 Del Ch. Lexis 213 (Del. Ch. Dec. 22, 1994) reprinted in 20 *Del. I. Corp. L.* 703 (1995)).

46 52 A.2d 770 (Del. Ch. 1988).

47 *Id.*at 780-81. See also *In re Rexene Corp. S'holders Litig.*, Nos. 10,897 & 11,300, 1991 Del. Ch. LEXIS 81, at *11 (Del. Ch. May 8, 1991), reprinted in 17 *Del. J. Corp. L.*342, 350 (1992) ('Bad faith will be inferred where the decision is so beyond the bounds of reasonable judgment that it seems essentially inexplicable on any [other] ground . . . .') (internal quotations omitted) (emphasis added)).

48 Balotti & Finkelstein, *supra* note 8, § 4.29 (Supp. 2004).

49 559 A.2d 1261, 1284 n.32 (Del. 1988).

50 *Id.* See also *Bomarko, Inc. v. International Telecharge, Inc.*, 794 A.2d 1161, 1178 (Del. Ch. 1999) (noting abdication of directorial duty rebuts the business judgment rule).

In sum, the definition of 'good faith' for purposes of § 102(b)(7) is necessarily broad and flexible, acting as a component of loyalty, while also implicated by certain due care violations.[51] The evolution and interplay of the relationship among the triad of directorial duties – due care, good faith and loyalty – is perhaps best seen in, and may be most greatly impacted by, cases in Delaware and other jurisdictions involving abdication/oversight claims.

5.4 The Effect of an Exculpatory Provision on Abdication of Duty,Sustained Lack of Oversight, and Similar Claims

Although not directly addressed by the Delaware Supreme Court to date, the issue likely to be of the most significance to directors of Delaware corporations in the coming years is the availability of exculpation under a § 102(b)(7) charter provision as a basis for obtaining the dismissal of claims of abdication of duty and/or systematic or sustained lack of oversight. Cases from Delaware and from other jurisdictions addressing abdication/oversight claims strongly indicate that exculpation is not, under certain circumstances, available for liability stemming from such claims, even where adverse pecuniary interests are not at issue.

6.4.1 Delaware Cases

Delaware cases dealing with abdication of duty and lack of oversight claims in the non-§ 102(b)(7) context suggest that such claims may implicate a director's duty of good faith under certain circumstances. In a 1963 case predating the enactment of § 102(b)(7) but dealing with the topic of director liability for failure of oversight, the court in *Graham v. Allis-Chalmers Manufacturing Co.*,[52] refused to hold board members liable for harm done to the company by certain of the company's employees.[53] The plaintiff in *Graham* alleged that the director defendants were grossly negligent in failing to actively supervise and manage the corporation's affairs. The court disagreed, explaining that directors cannot be expected to detect employee wrongdoing where there are no obvious signs that any exists:

> In the last analysis, the question of whether a corporate director has become liable for losses to the corporation through neglect of duty is determined by the circumstances. *If he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected*cavalierly *to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him.* This is not the case at bar, however, for as soon as it became evident that

51 In a recent article, Chief Justice E. Norman Veasey of the Supreme Court of Delaware noted the importance of good faith as a guide to director conduct. As stated by the Chief Justice, 'That standard of conduct – good faith – is key to director conduct, and it must be considered when one looks at the directors' processes and motivations to be certain they are honest and not disingenuous or reckless.' See Veasey (2003) (emphasis added).

52 188 A.2d 125 (Del. 1963).

53 Specifically, the employees had created liability for the company under federal antitrust laws by conspiring with other companies to fix prices and rig bids. *Id.*at 129.

> there were grounds for suspicion, the Board acted promptly to end it and prevent its recurrence.[54]

By its explicit language and by negative implication, the court's holding in *Graham* made clear that lack of oversight or inattention to obvious warning signs may constitute a breach of a director's fiduciary duties, however, the court did not address which of a director's fiduciary duties would be implicated by such a claim.[55] Moreover, *Graham* seemed to suggest that while repeated inattention to 'red flags' might constitute a breach of fiduciary duty, it imposed no requirement that directors take proactive steps to detect wrongdoing.[56] Although *Graham* seemed to set the bar high for plaintiffs hoping to prevail on lack of oversight/abdication claims, subsequent cases created questions about how high the bar in fact is. Those cases also provided some clarification as to the particular duties implicated by such claims.

Again addressing lack of oversight claims outside of the § 102(b)(7) context, the court in *Rabkin v. Philip A. Hunt Chemical Corp.*[57] considered the claims of minority stockholders against the corporation's directors related to a cash-out merger. The plaintiffs alleged, in part, that the directors were grossly negligent by failing adequately to inform themselves in responding to a merger proposal and by failing to take any action with respect to the merger for a year prior to its consummation. In addressing the claims related to the directors' affirmative response to the merger proposal, the *Rabkin* court applied a relatively forgiving definition of gross negligence: 'In the corporate area, gross negligence would appear to mean, "reckless indifference to or a deliberate disregard of the stockholders," or actions which are "without the bounds of reason."'[58] The court then found that the plaintiffs had not adequately alleged any such conduct.

Turning to the plaintiffs' claims of inaction or director neglect, the court first noted that 'the business judgment rule may apply to a deliberate decision not to act, but it has no bearing on a claim that directors' inaction was the result of ignorance.'[59] Instead, explained the court, '[d]irectors will be held liable for injuries caused as a result of their neglect where they fail to use "that amount of care which ordinarily careful and prudent men would use in similar circumstances."'[60] The court further explained that it would be inappropriate to

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54 *Id.*at 130 (emphasis added).

55 In 1963, when the Graham opinion was issued, § 102(b)(7) did not exist. The explicit language of Graham should have been as ominous to directors at that time as the explicit language today in some non-Delaware cases (discussed *infra*) purporting to define the scope of a § 102(b)(7) provision.

56 See Veasey, *supra* note, 51 at 446 (explaining that, as a result of *Graham*, 'directors could escape liability if there were no red flags, and they were not expected to "ferret out wrongdoing"').

57 547 A.2d 963 (Del. Ch. 1986).

58 *Id.*at 970 (quoting *Allaun v. Consolidated Oil Co.*, 147 A. 257, 261 (Del. Ch. 1929); *Gimbel v. Signal Cos.*, 316 A.2d 599, 615 (Del. Ch.), aff'd, 316 A.2d 619 (Del. 1974)). This definition of 'gross negligence' – with phrases such as 'deliberate disregard' and 'without the bounds of reason' – would appear to be one that would apply to conduct beyond gross negligence. This definition could be equated with a culpable state of mind, and one that, if met, would establish the type of bad faith excluded from § 102(b)(7) protection.

59 *Id.*at 972.

60 *Id.* (citing *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963)).

accord the same deference to directors who abdicate their managerial responsibilities.[61] Applying this more exacting standard, the court held that the plaintiffs stated a claim for neglect and denied the defendants' motion to dismiss.[62]

Although the court of chancery's opinion in *Rabkin* created some concern and confusion about the applicable standard of review for oversight claims, the opinion had little practical impact on directorial liability under § 102(b)(7). If, following *Rabkin*, the standard of review

for oversight claims was in fact simple negligence rather than gross negligence, any additional concern for directors would have arisen from claims based on conduct that was more than simple negligence, but not gross negligence. For directors of companies with valid exculpatory charter provisions, however, such distinctions would be largely academic, as less egregious conduct constituting simple negligence but not gross negligence most likely would fall within the provision's scope of protection.[63]

In 1991, the court of chancery provided important insight into the relationship between the scope of § 102(b)(7) and abdication claims in *In re Dataproducts Corp. Shareholders Litigation*.[64] There, the stockholder plaintiffs alleged, among other things, that the directors of Dataproducts abdicated their duties by turning over to the company's CEO and Vice President of Finance primary responsibility for negotiating a proposed takeover by another company. In their defense, the directors invoked the company's exculpatory charter provision, arguing that the plaintiffs' complaint at best stated a claim for negligence, thus precluding monetary liability for the directors. The plaintiffs countered by arguing that the directors' alleged abdication of their oversight obligations was 'not in good faith' and constituted 'intentional misconduct' within the meaning of § 102(b)(7).[65]

61 *Rabkin*, 547 A.2d at 972. The *Rabkin* court's explanation for the application of a more exacting standard of review in cases involving allegations of director inaction seems, to some degree, to put the cart before the horse. To say that directors who have abdicated their duties should be afforded less deference assumes the fact of abdication before judicial review of the alleged inaction has occurred. In other words, until alleged inaction has been judicially reviewed, how can it be determined whether such inaction amounts to abdication? In any analysis here, one should be mindful of the fact that allocation of resources is often a business decision as it relates to monitoring.

62 The reference to the word 'neglect' in this standard certainly warrants some comment. In this context, 'neglect' must be understood to mean neglect in the extreme sense and something much more than simple negligence. By way of analogy – an analogy often utilized by Vice Chancellor Strine in academic discussions on the topic of director conduct, see, e.g, Strine (2004) – the use of the word 'neglect' in Graham must be akin to the type of neglect that would result in a parent losing custody of a child (i.e., sustained and conscious or knowing misconduct or inaction) as distinguished from a situation where a child wanders into the road because a parent is momentarily distracted. In the latter situation, the parent 'neglected' to keep an eye on the child, but it is not the type of neglect that would evidence a culpable state of mind. Compare this with the standards for negligence and recklessness under Delaware criminal and tort laws. See, e.g., Del. Code Ann. tit. 11, § 231(c) (2001) (defining criminal recklessness as being 'aware of and consciously disregard[ing] a substantial and unjustifiable risk'); *Jardel Co. v. Hughes*, 523 A.2d 518, 530 (Del. 1987) (stating that criminal negligence is functionally the same as tort gross negligence and noting that tort recklessness requires knowledge of substantial and unjustifiable risk).

63 A concern may have existed under *Rabkin*, however, if sustained or systematic instances of conduct amounting to simple negligence could collectively be deemed to rise to the level of bad faith. As set forth below, a recent decision by the Seventh Circuit has been described as presenting just such a scenario.

64 No. 11,164, 1991 Del. Ch. LEXIS 149 (Del. Ch. Aug. 22, 1991), reprinted in 17 *Del. J. Corp. L.*1159 (1992).

65 *Id.*at *15-*16, reprinted in 17 *Del. J. Corp. L.* at 1168-69.

Disagreeing with the plaintiffs and dismissing the oversight claim, the *Dataproducts* court held that the complaint did not even inferentially suggest bad faith or improper motive on the part of the defendants.[66] Providing insight as to the proper classification of abdication claims, the court further held that both because the plaintiffs' allegations were lacking and 'because the "director abdication" claim is *equally consistent with director gross negligence as with conduct that was intentional or in bad faith*,' the plaintiffs failed to establish that the claim was not precluded by the company's exculpatory charter provision.[67] Although far from definitive on the topic, the court's opinion in *Dataproducts* suggested that while some abdication claims implicate only the duty of care, other claims may rise to the level of bad faith or intentional misconduct and thus be excepted from exculpation under § 102(b)(7).

Providing significant insight into the types of oversight claims that may rise to the level of bad faith, and apparently retreating from *Rabkin's* introduction of the simple negligence standard into the corporate fiduciary context, was the court of chancery's 1996 decision in *In re Caremark International Inc. Derivative Litigation*.[68] In *Caremark*, the plaintiffs alleged that the directors breached their fiduciary duties by failing adequately to monitor certain of Caremark's employees who violated state and federal regulations, resulting in the payment by Caremark of fines totaling approximately $250 million. After the parties to *Caremark* settled the lawsuit for minimal consideration, the court assessed the adequacy of the settlement, thereby reviewing the viability of the plaintiffs' claims.

In finding that the plaintiffs' oversight claims likely would have been 'susceptible to a motion to dismiss,' the court explained that, in order to succeed, the plaintiffs would have been required to prove four elements: '(1) that the directors knew or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in the losses complained of.'[69] In addition, the court provided important instruction as to the level to which failure of oversight must rise in order to be considered bad faith:

> Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, as in *Graham* or in this case, in my opinion only a sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exi[s]ts – will establish *the lack of good faith* that is a necessary condition to liabili-

66 *Id.*at *16, reprinted in 17 *Del. J. Corp. L.*at 1168-69.

67 *Id.*at *17, reprinted in 17 *Del. J. Corp. L.* at 1169 (emphasis added). Viewed in isolation, this statement in Dataproducts could be misinterpreted or even misrepresented as a statement of law. Obviously, a well-pleaded claim that is consistent with 'conduct that [is] intentional or in bad faith' cannot result in a Rule 12(b)(6) dismissal. Thus, the outcome of the case is more easily understood by reference to the court's conclusion that the complaint did not inferentially suggest bad faith or improper motive on the part of the directors. *Id.*at *16, reprinted in 17 *Del. J. Corp. L.*at 1168-69.

68 698 A.2d 959 (Del. Ch. 1996).

69 *Id.*at 971.

> ty. Such a test of liability – lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight – is quite high. But, a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to *good faith performance of duty* by such directors.[70]

Although the issue of liability for lack of oversight was not squarely before it, the *Caremark* decision was important in at least three regards: first, without specifically referring to the word 'negligence,' the *Caremark* court suggested that the standard of review applicable to oversight claims seeking money damages is more than simple negligence and even more than gross negligence. The court's use of the phrases 'knew or should have known' and 'good faith performance of duty' suggests that to be actionable, the conduct must rise to the level of a conscious failure to perform.[71] Importantly, the *Caremark* court also suggested that when a director's lack of oversight is 'sustained and systematic,' such conduct leaves the realm of due care and encroaches upon bad faith. As such, a sustained or systematic lack of oversight would fall outside of the scope of conduct protected by an exculpatory charter provision.[72] Finally, *Caremark* is especially significant in its suggestion that a bad faith claim may be predicated not only upon a director's alleged lack of attention to red flags, but also upon a director's failure to assure implementation of an oversight system.

Most recently, the court of chancery addressed the affect of an exculpatory charter provision on oversight claims in *In re Walt Disney Co. Derivative Litigation.*[73] There, stockholders of Walt Disney Company filed a derivative lawsuit against Disney's directors, alleging that the directors breached their fiduciary duties by blindly approving an employment agreement with a former President of Disney and by failing in their oversight of the treatment of the former President's termination. The defendants moved to dismiss the complaint, arguing that the plaintiffs' claims were barred by Disney's § 102(b)(7) charter provision and that the plaintiffs failed adequately to plead demand futility. After converting the defendants' motion into one for summary judgment, the court of chancery turned to the viability of the oversight claims. With respect to the termination of the employment agreement, the plaintiffs claimed that certain of the defendants:

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70 *Id.* (emphasis added).

71 This conclusion about *Caremark* finds support in *Guttman*:
Although the *Caremark* decision is rightly seen as a prod towards the greater exercise of care by directors in monitoring their corporations' compliance with legal standards, by its plain and intentional terms, the opinion articulates a standard for liability for failures of oversight that requires a showing that the directors breached their duty of loyalty by failing to attend to their duties in good faith. Put otherwise, the decision premises liability on a showing that the directors were conscious of the fact that they were not doing their jobs.

72 *Guttman,* 823 A2d at 506. As described by Vice Chancellor Strine, *Caremark* 'suggests that directors should only be held personally liable for a failure to monitor if their laxity in oversight was so persistent and substantial that it evidences bad faith.' See Strine (2002).

73 825 A.2d 275 (Del. Ch. 2003).

> (1) failed to ask why [they] had not been informed; (2) failed to inquire about the conditions and terms of the agreement; and (3) failed even to attempt to stop or delay the termination until more information could be collected. . . . [T]he facts alleged [that the defendants] *consciously and intentionally disregarded their responsibilities*, adopting a 'we don't care about the risks' attitude concerning a material corporate decision.[74]

Refusing to dismiss the complaint on demand futility grounds, the court of chancery first explained that demand was excused because the facts alleged gave rise to a doubt that the business judgment rule applied:

> Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct, in my opinion, that may not have been taken honestly and in *good faith* to advance the best interests of the company. Put differently, all of the alleged facts, if true, imply that the defendant directors *knew* that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss. Viewed in this light, plaintiffs' new complaint sufficiently alleges a breach of the directors' obligation to act honestly and in good faith in the corporation's best interests for a Court to conclude, if the facts are true, that the defendant directors' conduct fell outside the protection of the business judgment rule.[75]

Then, turning to the defendants' § 102(b)(7) argument, the court held that the plaintiffs' claims fell outside the scope of the liability waiver provide by § 102(b)(7):

> [P]laintiffs' claims are based on an alleged knowing and deliberate indifference to a potential risk of harm to the corporation. Where a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the director's actions are either 'not in good faith' or 'involve intentional misconduct.' Thus, plaintiffs' allegations support claims that fall *outside* the liability waiver provided under Disney's certificate of incorporation.[76]

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74 *Id.*at 289.
75 *Id.* (emphasis added).
76 *Id.*at 290.

The court's opinion in *Disney* is significant in that it engaged in a due care analysis, and then held that the same facts giving rise to a 'reason to doubt business judgment protection' may also amount to a 'lack of good faith' for purposes of § 102(b)(7), even where an improper pecuniary interest is not involved. *Disney* is thus consistent with the notion that, in addition to *sustained* or *systematic* oversight cases, oversight or abdication cases, though not involving sustained violations, may simply be so egregious in nature that they implicate the duty of good faith and therefore fall outside the waiver of liability provided by § 102(b)(7).[77] This notion is further supported by cases from other jurisdictions, some of which involve far less egregious allegations of conduct than those of *Disney*, but which nevertheless reach similar results.

5.4.2 Cases from Other Jurisdictions

Purporting to follow the principles laid down in cases such as *Rabkin* and *Caremark*, courts in other jurisdictions have rendered opinions discussing the relationship between oversight claims and § 102(b)(7). Some of these decisions suggest that oversight claims may represent a significant source of director liability in the future.

In *McCall v. Scott*,[78] several stockholder derivative actions were filed in response to investigations of health care fraud instituted against Columbia/HCA Healthcare Corporation (Columbia). The district court had dismissed the action below on the basis that plaintiffs had failed to sufficiently allege demand futility under Delaware law to excuse the failure to make a pre-suit demand on the board of directors.[79] On appeal, the director defendants filed a joint brief arguing the dismissal was proper both for failure to allege demand futility and for failure to state a claim against them as directors.[80] The Sixth Circuit reversed, ultimately recognizing the viability of an action for intentional or reckless breach of the duty of due care under Delaware law.

Although the Sixth Circuit did not determine finally any issues on the merits, it overruled the district court and held that demand futility was adequately pleaded against five directors based upon allegations that presented a substantial likelihood of director liability for 'intentional or reckless breach of the duty of care.'[81] Most importantly, the Sixth Circuit rejected the argument that only intentional conduct would escape the protection of § 102(b)(7). The Sixth Circuit noted that while it was unclear under Delaware law whether some reckless acts or omissions may be excluded under § 102(b)(7) provisions, it did not believe that only intentional conduct escaped the prohibition created under the rule.

77 In the oversight context, the court of chancery's recent opinion in *Guttman v. Jen-Hsun Huang*, 823 A.2d 492 (Del. Ch. 2003), is instructive. There, the court dismissed the plaintiff's derivative claim that former directors were culpable, under *Caremark*, for failing to prevent accounting irregularities that resulted in the company's restatement of certain financial statements for failure to comply with the demand pleading requirements of court of chancery Rule 23.1. In so doing, the court explained that a *Caremark* claim is a difficult one to prove, as it requires a 'showing that directors were conscious of the fact that they were not doing their jobs.' *Id.* at 506 (emphasis added).

78 239 F.3d 808 (6th Cir. 2001).

79 *Id.* at 813.

80 *Id.*

81 *Id.* at 824.

McCall thus provides persuasive support for the conclusion that rejection of claims because of a § 102(b)(7) provision is inappropriate where the conduct of the board has been challenged by particularized allegations constituting unconsidered inaction, sustained and systemic failure to exercise minimal oversight over critical affairs, and such a severe degree of gross recklessness that the board decision cannot be explained away as an exercise of good faith. To hold otherwise would be to create a new and overbroad rule of law wherein only intentional conduct would give rise to the risk of liability for directors whose grossly negligent, bad faith conduct results in financial loss.

Following receipt of three petitions for rehearing en banc, the Sixth Circuit panel that decided *McCall* revisited its decision and reaffirmed the finding that shareholder complaints concerning actions that could not have been undertaken in good faith would not be protected by provisions in the corporation's certificate of incorporation which protected directors against claims for gross negligence. In particular, the court held that '[u]nconsidered inaction can be the basis for director liability because, even though most corporate decisions are not subject to director attention, ordinary business decisions of officers and employees deeper in the corporation can significantly injure the corporation.'[82] The Sixth Circuit based this ruling in part on the Delaware Supreme Court's opinion in *Graham v. Allis-Chalmers Manufacturing Co.*,[83] reciting *Graham*'s teaching that where a director 'neglect[s] cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him.'[84]

The defendants in *McCall* did not resist that logic, rather, they again argued that allegations of gross negligence, however framed, are protected against under the waiver-of-liability provision contained in Columbia's corporate charter.[85] Columbia had adopted that provision pursuant to § 102(b)(7).[86] The defendants argued 'that they must be held harmless under Columbia's waiver provision for claims based on breach of the duty of care.'[87] The plaintiffs responded that 'their duty of care claims [were] based not on gross negligence, but rather on reckless and intentional acts or omissions, and thus are not precluded by the waiver provision.'[88] Not surprisingly, the Sixth Circuit found that '[p]laintiffs' claims of 'reckless or intentional breach of the duty of care' do not fit easily into the terminology of Delaware corporate law.'[89] The appellate court further noted:

> Delaware courts do not discuss a breach of the duty of care in terms of a mental state more culpable than gross negligence. Rather, allegations of intentional or reckless director miscon-

82 *McCall v. Scott*, 250 F.3d 977, 999 (6th Cir. 2001).
83 188 A.2d 125 (Del. 1963).
84 McCall, 250 F.3d at 999.
85 *Id.*at 999-1000.
86 *Id.*at 1000.
87 *Id.*
88 McCall, 250 F.3d at 1000.
89 *Id.*

> duct are more commonly characterized as either a breach of the duty of loyalty or a breach of the duty of good faith.[90]

This led the Sixth Circuit to observe that 'while it is true that duty of care claims alleging only grossly negligent conduct are precluded by a § 102(b)(7) waiver provision, it appears that duty of care claims based on reckless or intentional misconduct are not.'[91]

The Sixth Circuit concluded that '[u]nder Delaware law, the duty of good faith may be breached where a director consciously disregards his duties to the corporation, thereby causing its stockholders to suffer.'[92] Because the plaintiffs in *McCall* accused the directors not merely of 'sustained inattention' to their management obligations, but rather of 'intentional ignorance of' and 'willful blindness' to 'red flags' ... regardless of how plaintiffs style their duty of care claims, [the court found] that they have alleged a conscious disregard of known risks, which conduct, if proven, cannot have been undertaken in good faith.[93] The Sixth Circuit therefore ruled that the plaintiff's claims were not precluded by Columbia's § 102(b)(7) charter provision.

Shortly after the Sixth Circuit's ruling, the Eastern District of Michigan distinguished *McCall* while granting a motion to dismiss for failure to adequately plead demand futility. In *Salsitz v. Nasser*,[94] the plaintiff asserted a derivative action alleging that certain directors of Ford Motor Company recklessly or intentionally breached their fiduciary duties by, among other things, failing for a prolonged period of time to oversee and monitor the purchase of palladium, a precious metal used in some Ford vehicles, and in failing to respond to problems with certain tires installed on some Ford vehicles. Addressing the allegations concerning the directors' response to the tire problems, the court noted that the plaintiff focused extensively on *McCall v. Scott* and *In re Abbott Laboratories Derivative Shareholders Litigation*.'[95] The court found, however, that both cases were '*distinguishable based on the specific allegations of wrongdoing set forth in those cases*.'[96]

The specific allegations of wrongdoing set forth in *McCall* and *Abbott Laboratories* upon which the *Salsitz* court based its distinction involved primarily allegations of criminal investigations or other formal government action. With respect to *McCall*, the *Salsitz* court noted that the complaint alleged

90 *Id.*
91 *Id.*
92 McCall, 250 F.3d at 1001.
93 *Id.*
94 208 F.R.D. 589 (E.D. Mich. 2002).
95 *Id.*at 598. The Seventh Circuit's decision distinguished by the Salsitz court was a panel opinion reported at *In re Abbott Laboratories Derivative S'holders Litig.*, 293 F.3d 378 (7th Cir. 2002). The Seventh Circuit panel issued an order vacating that opinion on August 2, 2002, and the panel issued a new opinion on March 28, 2003. The latter decision is discussed in more detail below.
96 Salsitz, 208 F.R.D. at 598 (emphasis added).

> (1) audit discrepancies between cost reports submitted to the government and secret reserve reports; (2) improper acquisition practices in which at least one of the directors personally was involved; (3) a *qui tam* action alleging a widespread strategy to engage in violations of federal law; and (4) an extensive criminal investigation that included raids on thirty-five Columbia facilities in six different states.[97]

Regarding *Abbott Laboratories*, the court noted allegations of 'similarly . . . clear violations of federal law,' including 'thirteen separate inspections of Abbot's [sic] facilities' by the FDA over a six-year period and FDA warning letters, some of which were sent directly to Abbott's chairman.[98] Distinguishing the facts of *McCall* and *Abbott*, the court in *Salsitz* explained that there were 'no allegations of criminal or civil investigations that plainly put the Board on notice of illegal behavior,'[99] nor were there allegations that Ford was ever officially warned or sanctioned by a government agency 'for any of its conduct in reaction to the tire debacle.'[100] The court thus held that there were insufficient facts alleged in the complaint 'to indicate that Defendants ought to be personally liable for the resulting damages.'[101]

Relying heavily on the language concerning good faith in *McCall*, the Seventh Circuit reached a similar conclusion in *In re Abbott Laboratories Derivative Shareholders Litig.*[102] There, the stockholder plaintiffs alleged that the directors of *Abbott* breached their fiduciary duties by, among other things, failing to oversee and take action to prevent violations of FDA regulations resulting in the requirement that Abbott Laboratories pay a civil fine to the FDA of $100 million. After the trial court dismissed the complaint for failure adequately to plead demand futility, the plaintiffs appealed. On appeal, the Seventh Circuit reversed the trial court, holding that the plaintiffs had sufficiently alleged demand futility based on 'the directors' conscious inaction.'[103] Having so held, the Seventh Circuit addressed the directors' contention that they were not liable under Abbott's exculpatory charter provision.

First noting that a § 102(b)(7) charter provision does not protect directors 'when a complaint alleges facts that infer a breach of loyalty or good faith,' the Seventh Circuit found that the plaintiffs' complaint alleged not only breaches of the duty of care, but also 'omissions not in good faith.'[104] Then, citing *McCall*, the Seventh Circuit observed that 'although "duty of care claims alleging grossly negligent conduct are precluded by § 102(b)(7), it

97 *Id.* (citing McCall, 239 F.3d at 820-24).
98 *Id.* (citing Abbott, 293 F.3d at 388).
99 *Id.*at 599.
100 Salsitz, 208 F.R.D. at 599.
101 Id.
102 325 F.3d 795 (7th Cir. 2003).
103 *Id.*at 809.
104 *Id.*at 811.

appears that duty of care claims based on *reckless* or intentional misconduct are not.'"[105] Accordingly, the Seventh Circuit held that because the plaintiffs accused the directors not only of gross negligence, but also of intentionally failing to address federal violation problems, such allegations amounted to 'a conscious disregard of a known risks,' which conduct, if proven, cannot have been undertaken in good faith.[106]

Although it appears to be reasonably well-settled in Delaware[107] and other jurisdictions that, under certain egregious or sustained circumstances, abdication or oversight claims may implicate the duty of good faith (and/or loyalty) and therefore be excepted from the protections of § 102(b)(7) charter provisions, the facts of *Abbott Laboratories* indicate that such claims may be a source of significant additional directorial liability in the future. Unlike cases such as *McCall*and *Disney*, the 'conduct' the directors allegedly failed to oversee in *Abbott Laboratories* involved problems in the production of the company's product, which resulted in regulatory investigations as opposed to criminal liability. Also, important to the court's holding in *McCall* was the fact that the directors in that case possessed a specialized knowledge and background suggesting that they should have been aware of the employee misconduct. No such allegations were made in *Abbott Laboratories*. Pointing to these and other distinctions between *McCall* and *Abbott Laboratories*, the authors of one corporate law treatise have characterized *Abbott Laboratories*as a potentially substantial source of director liability.[108] Given the factual distinctions from *McCall*, one can make a strong case that, in order to bypass a charter provision, the Court in *Abbott Laboratories* applied the 'bad faith' exception to lapses of oversight which arguably did not even rise to the level of gross negligence.[109] Neither *McCall* nor *Abbott Laboratories* is a decision of the Delaware Supreme Court, but, nonetheless, until that Court confronts the issue of what is required to be pleaded to convert an apparent duty of care breach into disloyal or bad faith conduct, these federal authorities, especially *Abbott Laboratories*, represent a potentially significant inroad into the protections intended by the enactment of § 102(b)(7).[110]

105 *Id.* (emphasis added). The court's inclusion of the word 'reckless' in this portion of its holding is not – even though it purports to be – in accord with Delaware law. No Delaware case has expressly held that 'recklessness' is the equivalent of 'bad faith.' A fair reading of the Delaware cases suggests that to be beyond the exculpatory purview of a § 102(b)(7) provision, the conduct of a director must be so egregious as to evidence a culpable state of mind – i.e., a director made a conscious decision to violate his or her fiduciary duties or had to have known he or she was committing or likely to be committing a violation.

106 Abbott, 325 F.3d at 811 (quoting McCall, 250 F.3d at 1000-01). See also *Pereira v. Cogan*, 294 B.R. 449, 528-30 (S.D.N.Y. 2003). In Pereira, the Southern District of New York considered claims brought on behalf of a company's creditors against, among others, the company's former directors for failure to monitor and prevent a number of challenged transactions shortly before the company's eventual bankruptcy. In reviewing the entire fairness of the transactions, the court held that the same inaction/failure of oversight by the directors which constituted a breach of the duty of care also constituted a breach of the duty of loyalty. *Id.*at 532 ('such failure to do anything but let the contract of the controlling shareholder (and one's superior) renew is a violation of the duty of loyalty and due care').

107 The topic remains somewhat nebulous in Delaware, as it has yet to be squarely presented to or addressed by the Delaware Supreme Court.

108 Drexler *et al.*, *supra* note 193, § 6.02[7]. Indeed, one could argue that Abbott actually disincentivizes directors from establishing sophisticated oversight systems for fear of being imputed with almost universal knowledge of the company's affairs – good and bad. As the Abbott court concluded, 'Where there is a corporate governance structure in place, [a court] must then assume the corporate governance procedures were followed and that the board knew of the problems and decided no action was required.' Abbott, 325 F.3d at 806 (emphasis added).

109 Drexler *et al.*, *supra* note 193, § 6.02[7].

110 *Id.*

Most recently, the District of Kansas, in a case not involving oversight or abdication of duty claims, addressed the definition of good faith for purposes of § 102(b)(7). In *Grogan v. O'Neil*,[111] a stockholder plaintiff brought an action asserting direct and derivative claims against former directors and the former CEO of TransFinancial Holdings, Inc. (TransFinancial), a Delaware corporation. The plaintiff in *Grogan* alleged in part that the defendants breached their fiduciary duties to TransFinancial and its stockholders in negotiating and agreeing to a proposed buyout of TransFinancial by a Management Buyout Group, which ultimately was not consummated, thus leading to the eventual liquidation of TransFinancial's assets.

Specifically, the plaintiff alleged that the director defendants failed in their obligation, as recognized in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[112] to maximize shareholder value in the proposed sale of TransFinancial, and that the defendants engaged in waste by liquidating certain TransFinancial assets for a fraction of their value when an alterna-tive transaction would have yielded a much greater value. In their defense, the defendants in *Grogan* filed a motion to dismiss the claims against them, arguing, with respect to the waste claim, that the plaintiff's allegations failed to state a claim, and that they were, in any event, shielded from personal liability resulting from such a claim due to TransFinancial's exculpatory charter provision enacted under § 102(b)(7).[113]

In the portion of its opinion addressing the waste claim, the *Grogan* court first found that the plaintiff's allegations stated a claim for waste, noting thereby that although a waste claim must fail 'if "there is *any substantial* consideration received by the corporation, and . . . there is a *good faith judgment* that in the circumstances the transaction is worthwhile,"' it was not unreasonable to assume, from allegations that directors received only one half the fair value of the assets at issue, that no reasonable businessperson would have engaged in the transaction.[114] Deeming the waste claim viable, the court turned to the issue of whether the waste claim was nevertheless barred by TransFinancial's certificate of incorporation.

Regarding the exculpatory charter provision, the court found, as an initial matter, that the defendants had failed to submit an authenticated version of TransFinancial's certificate of incorporation and had failed to request that the court convert the motion into one for summary judgment to consider a matter outside of the pleadings (the charter), and the court therefore held that it would deny the defendants' motion to dismiss on that basis. Continuing with its analysis, however, the court stated that even if it took judicial notice of the unauthenticated certificate of incorporation, 'it would overrule defendants' motion to dismiss.'[115] As the court explained, the plaintiff's complaint stated a claim for waste, and '[t]he standards

111 292 F. Supp. 2d 1282 (D. Kan. 2003).
112 506 A.2d 173 (Del. 1986).
113 Grogan, 292 F. Supp. 2d at 1290-91. The defendants also argued that the waste claim should be dismissed because the plaintiffs failed make a demand on the board to pursue the claim or to adequately allege that demand would have been futile. *Id.*at 1291.
114 *Id.*at 1291 (citing *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000)).
115 *Id.*at 1291-92.

for corporate waste and bad faith are similar: to prevail on either claim, plaintiff must show that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests.'[116] As the court further explained, the defendants did not 'dispute that bad faith may be inferred where the board's decision is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any other ground.'[117] Noting that on a motion to dismiss it was obligated to accept the plaintiff's allegations as true, the court found that, in a transaction where directors sold assets for only half of their value, when an alternative transaction would have yielded as much as ninety percent of market value, the plaintiff's allegations created a strong inference that the defendants 'acted in bad faith.'[118]

Unlike *McCall* and *Abbott Laboratories*, *Grogan* involved affirmative actions alleged by the plaintiff to constitute waste and, hence, bad faith. Indeed, the court's holding in *Grogan* strongly suggests that in any case in which the plaintiff is able to state a claim for waste, a § 102(b)(7) will not bar such a claim.[119] Thus, good faith may have increasing significance not only in lack of oversight or abdication cases, but also in cases involving affirmative business decisions so egregious in nature that they cannot be explained on any other grounds. In other words, directors' business decisions may be so patently bad and/or the results thereof so harmful, that bad faith will be inferred due to a lack of any other reasonable explanation.

5.5 Conclusion

Unless and until the Delaware Supreme Court is presented with a case in which it can clarify the standard or threshold required for allegations of abdication or lack of oversight to either implicate the duty of good faith (assuming good faith is and should be discussed as a separate duty) or call into question the good faith of director action and/or inaction, the issue will continue to be debated and pursued at all levels. One thing that does seem clear, however, is that courts and legislators are headed in a direction of greater accountability for directors in the oversight of their corporations, and the duty of good faith is likely to play a pivotal role in an environment of increased accountability.[120]

116 *Id.*at 1293 (citing *White v. Panic*, 783 A.2d 543, 554 n.36 (Del. 2001)).

117 Grogan, 292 F. Supp. 2d at 1293 (internal quotations and citations omitted).

118 *Id.*

119 Because of the exacting nature of the relevant standard, cases in which plaintiffs successfully state claims for waste are rare. See *Telxon Corp. v. Bogomolny*, 792 A.2d 964, 975-76 (Del. Ch. 2001).

> Waste is an extremely difficult claim to prove: the waste theory represents a theoretical exception . . . very rarely encountered in the world of real transactions. There surely are cases of fraud; of unfair self-dealing and, much more rarely negligence. But rarest of all – and indeed, like Nessie, possibly non-existent – would be the case of disinterested business people making non-fraudulent deals (non-negligently) that meet the legal standard of waste!

Id. (citation omitted).

120 Regulators also appear to be headed in a direction of greater director oversight. In a complaint filed in the District of Massachusetts, the SEC has asserted civil claims against a former outside director of the Chancellor Corporation – a company embroiled in a corporate accounting scandal not unlike that of Enron. In the complaint, the SEC names the former outside director in several counts of alleged securities law violations, claiming that he 'knew, or was reckless in not knowing, that Chancellor's conduct was improper,' without alleging that he actively participated in any of the allegedly violative conduct. See *SEC v. Chancellor Corp.*, No. 03-10762 (D. Mass. Apr. 24, 2003). The lawsuit represented the first time the SEC brought charges against an outside board member not directly involved in alleged fraud, as a model for enforcement actions against directors who ignore misconduct.

Enron, WorldCom, Adelphia, Tyco,[121] HealthSouth, and the collapse of Arthur Anderson, to name a few, have all led to an increased degree of cynicism in the investing public. Whether the perception is worse than the actual problem is something that can be debated, but what is less debatable is whether corporate governance will be the subject of increasing scrutiny and reform. Many of the recent, high-profile corporate scandals and failures might have been prevented if their boards of directors had been more actively or proactively involved in establishing oversight, reporting, and accountability mechanisms within their companies and in the actual oversight process. By way of example, a report titled 'The Role of the Board of Directors in Enron's Collapse,' issued by the Permanent Subcommittee on Investigations, stated that:

> the Subcommittee identified more than a dozen red flags that should have caused the Enron Board to ask hard questions, examine Enron policies, and consider changing course. Those red flags were not heeded. In too many instances, . . . the Enron Board failed to provide the prudent oversight and checks and balances that its fiduciary obligations required and a company like Enron needed. By failing to provide sufficient oversight and restraint to stop management excess, the Enron Board contributed to the company's collapse . . . .' [122]

Initial steps towards reforming corporate governance have already been taken by Congress with the passage of the Sarbanes-Oxley Act of 2002, which imposes requirements with regard to auditor oversight, approval of non-audit work, the engagement of professionals, 'whistle blower' policies, the disclosure of information in accounting firm reports, responsibilities of attorneys, and CEO and CFO certifications.[123] The NYSE and NASDAQ have also followed with reforms of their own. Of course, courts and legislators alike must be careful to avoid short-sighted reactionary measures and attempt to strike a sensible balance in imposing oversight standards and apportioning liability for corporate scandals. Companies will have increasing difficulty attracting and retaining talented directors if directors are expected to be omniscient and are strapped with liability when they are not. On the other hand, a heightened and more hands-on system of director oversight can and should be achieved, because if directors are not steering the corporate ship, who is? As has been painfully learned, financially-interested officers, auditors and other advisors cannot be counted on to police themselves. More legislation may follow if there is a perception that courts have not created standards of conduct sufficient to ensure that directors will be accountable for willful ignorance or lack of oversight. Whether courts need to go so far as to hold that it is a breach of fiduciary duty per se if a board fails to comply with Sarbanes-Oxley and other

121 It is worth noting that Enron, WorldCom, Adelphia, and Tyco are not Delaware corporations.

122 Permanent Subcommittee on Investigations of the Committee on Governmental Affairs of the United States Senate, The Role of the Board of Directors in Enron's Collapse, 107th Cong., 2d Sess., Report 107-70, at 59 (July 8, 2002), available at http://www.broadbandc-span.org/downloads/070702enronreport.pdf.

123 Pub. L. No. 107-204, 116 Stat. 745 (2002).

reforms is also something that can be debated,[124] however, it is likely that the evolution in American corporate jurisprudence of what constitutes 'good faith' conduct on the part of a director will play a key role in these rapidly-emerging issues of corporate governance.[125] As a result, it will be increasingly important for corporate fiduciaries to understand the 'good faith' standard and how best to conform their conduct to that standard.

Central to all of this is striking a balance to ensure that (1) directors are independent, yet not so detached from the company that they are not the best people to be governing the company, and (2) qualified people are encouraged to serve as directors and are not scared off by the threat of liability from standards that cannot reasonably be met. This balancing is better left to courts than to politicians. To avoid action by the latter, the enforcement by the courts of 'best practices' in corporate governance needs to get better. How, is a topic for another day.

124 See Chandler & Strine (2003) (noting that future cases may involve claims that directors are breaching their fiduciary duties by not complying with Sarbanes-Oxley and recent NYSE and NASDAQ reforms).

125 Indeed, building on the suggestion of the *Caremark* court that directors may be liable for failures to implement a 'reasonable information and reporting system,' it could be argued that Sarbanes-Oxley and other recent reforms represent just such a 'reasonable' system. See Veasey, *supra* note XX50, at 448 (noting the possibility 'that the issue of good faith may be measured, not only by the evolving expectations of directors in the context of Delaware common law fiduciary duty, but also against the backdrop of Sarbanes-Oxley and the SRO requirements, even though there may be no express private right of action').

PART III: THE ROLE OF SPECIALIZED COURTS IN THE NETHERLANDS AND ITALY

6 Company Law and the Dutch Supreme Court

Levinus Timmerman

6.1 Contextualism

Recently I read a speech by the former Chancellor William T. Allen on ambiguity in corporation law.[1] In his wonderful essay, Chancellor Allen gives us an impression of the way he wrote his opinions in cases regarding the corporation law of Delaware. One of his confessions is that, when writing opinions in matters of company law, he often applied a technique which he called: 'contextualism'. Contextualism refers to a kind of judicial reasoning in which the circumstances of a case play a prominent role. It assumes that there is not in principle one right answer to all legal problems. A feature of contextualism is that the 'teachings' of the contextualized opinions cannot easily be summarized and restated. The contextualized approach to questions of law discourages grand generalizations and stimulates judicial modesty and self restraint which are in my view not the worst qualities for a judge. It also underlines the specific responsibilities of a judge in our legal order, such as the weighing of divergent interests and viewpoints.

Although the method of contextualism may be, to the taste of some of you, no method at all and not really law at all, contextualism is in my opinion for some judges a sensible way to make judgments. Doctrinal instruments, which are the opposite of contextualism, have the danger of abstracting from the facts of a case thereby foregoing some information which may be relevant for deciding a case. Moreover, often judges do not avail themselves of the necessary instruments to oversee and fully understand all human activities. Therefore, it may be a risky proposition for a judge to propound rules for all these wide variety of activities. I am familiar with some judgments by courts containing firm general rules. In my experience, these judgments are the ones which often need to be differentiated within a rather short period. This need for revision of a rule shortly after a decision has been made, does not reinforce the prestige of the judiciary. This can be avoided by sticking to the circumstances of a case and rendering a judgment based on these circumstances. This approach seems to me in particular recommendable when applied in an unbiased, open and fair minded manner and when the decision has been written down in clear and fine prose.

When I try to characterize the decisions of the Dutch Supreme Court in the field of company law – and you expect me to do that – in my opinion contextualism is an appropriate characterization. It is my impression the Dutch Supreme Court acts in matters of company law as a prudent court which tries to avoid firm rules which may give rise to unrest in the complicated business world. In company law cases, our Supreme Court often resorts to what I just referred to as contextualism. The very differentiated business world is one reason

1 William T. Allen, Ambiguity in corporation law, 22 Delaware Journal of Corparate Law 1997, p. 894-903.

why judges in company law cases are inclined to contextualism. I sympathize with this tendency. There is also a more particular Dutch justification to endorse contextualism in practice. This has to do with the rather particular character of Dutch legislation on company law. Let me start with making some remarks on the Dutch legislation on companies.

6.2 Reasonableness and fairness

In the Dutch statutes on companies, reasonableness and fairness play a prominent role. In my opinion, one of the most important sections of Book 2 of our Civil Code is section 8. It reads as follows: 'Everyone who is involved in the organization of a company by virtue of the legislation or the articles of association should, in acting towards one another, observe the requirements of reasonableness and fairness'. In my opinion this prescription is the principal standard of Dutch company law. Our legislator has elaborated this standard in several other provisions of our Code. For instance: A court may deviate from a statute or from the articles of association, if the observance of the statute or the articles of association will be unacceptable according to the requirements of reasonableness and fairness. A consequence of this provision is that reasonableness and fairness can render a statutory provision ineffective. In my view it is a very peculiar trait of Dutch company law that reasonableness and fairness can set aside statutes and articles of association. Our judges do this sometimes. For instance, the Supreme Court has decided that, although our Civil Code provides that it is compulsory to designate an expert to establish the value of shares which are the subject of a mandatory transfer, it is not necessary to comply with the statutory obligation in case such a designation serves no useful purpose (for instance: the articles of association already solve this problem in a balanced way). Let me return to the reasonableness and fairness in general. I do not have to underline that the standards of reasonableness and fairness refer the judge basically to the particulars of a case and give him room for taking into consideration the particular circumstances of a case. In my opinion one may assume that the requirements of reasonableness and fairness, which are laid down in our Civil Code force Dutch judges in matters of company law to contextualism.

Apart from these provisions of reasonableness and fairness, our Civil Code has still another characteristic which stimulates contextualism. Our Code contains many vague, open norms. For instance, section 9 of the Code states that each board member is obligated to perform properly his duties. The meaning of the term 'properly' is determined according to the circumstances of the case. If one of the board members does not perform properly his duties towards the company assigned to him, each of the board members is jointly and severally liable with respect to the shortcoming. Every board member may show that the shortcoming is not attributable to him. The joint and several liability of the board members, which is rather stringent can be explained from the idea of the Dutch legislator that managing a company is a collective responsibility of all the board members. In theory, Dutch company law does not allow CEO's to act like a omnipotent sun king. Moreover, Dutch company law distinguishes, just as German company law, between members of the managing board and members of the supervisory board. This creates a formal distinction between executive and non-executive officers. The joint and several liability for shortcomings in the management of a company only rests on the members of the managing board and not on the members of supervisory board.

6.3 Liability of board members

How does the Dutch Supreme Court apply section 9 regarding the liability of board members in its decisions? The answer is in a very contextualistic way. Our Supreme Court gave a leading decision in 1997.[2] The details are not very interesting. The Dutch Supreme Court developed in this decision a kind of roadmap for determining cases of directors liability. It ruled as follows: Serious negligence of a board member is required in order to vest liability. Whether a shortcoming of a managing director qualifies as 'serious negligence' is determined by the circumstances of the case. So: the individual facts are crucial. The Supreme Court mentions some of the circumstances which may be relevant, such as: the nature of the activities conducted by the company, risks which may generally follow from those activities, the division of tasks among the members of the managing board, guidelines which may be applicable to the managing board, information known or which should have been known by a managing director at the time of his reproached decision, as well as the carefulness which may be required of a managing director who is apt for and diligent in performing his tasks.

Naturally my view is very clear: more contextualistic than this is impossible. In future cases our Supreme Court can decide rather freely, taking into consideration all relevant facts of a case and can do justice to all the relevant circumstances. I may make another observation with respect to this decision on the liability of board members towards their company. As a general rule, the Dutch Supreme Court is hesitant to second guess substantive management decisions. Courts have to review a business decision in the light of the circumstances at the time the decision was taken without the benefit of hindsight. But what Dutch company law and the cited decision of the Supreme Court lack is the American business judgment rule. The absence of a business judgment rule has important consequences for business partners, including, for instance, the former board member who is sued by his company or by the receiver in case his company has gone bankrupt. The sued board member has, after the company or the receiver has stated and has made plausible improper management, to prove that he has performed his duties on an informed basis, in good faith and in the honest belief that the decision was taken in the best interest of the company. In my view this can easily make it tricky for a sued board member, subject to suit, to escape liability. To be sure, board members of Dutch companies may derive a certain degree of protection against civil liability due to the fact that Dutch law does not generally allow derivative actions. Dutch law in general only grants the company or the receiver a legal title to claim damages from a managing director for negligent behavior. This fact may be viewed as one of the major reasons for the fact that there have been only a limited number of director liability cases for an alleged breach of section 2:9 BW in the Netherlands. I should immediately add: we do have a lot of

2 Hoge Raad 10 januari 1997, Nederlandse Jurisprudentie 1997, 360.

managing directors's liability cases in the Netherlands. However most of these cases are about liability of directors *vis à vis* unpaid creditors of the company and tend to be predominantly in the field of insolvency law. Typically, managing directors are held liable in such cases for the company's deficit according to sections in the Dutch civil code, which shift the burden of proof to managing directors in case for example no adequate accounting books are available. In such cases cases directors can only escape liability by showing that the company's bankruptcy must be ascribed to some important factor other than mismanagement (sections 138/248 of Book 2 of our Civil Code).

6.4 Inquiry proceeding

How are directors' duties enforced under Dutch company law in view of the fact that we do not have an instrument like a derivative action? In answering this question, I need to explain a bit about a very Dutch phenomenon: the Dutch inquiry procedure.[3] The inquiry procedure provides shareholders with an effective instrument to enforce directors duties. If there is good reason to doubt the proper management of a company (this is again a very contextualized concept), shareholders representing 10% of the nominal capital or at least 225.000 euro of the nominal capital may initiate proceedings of inquiry before the Companies and Business Chamber of the Court of Appeal in Amsterdam. The conduct of business by the managing board may be subject to such inquiry. If this court finds that there is a prima facie case of mismanagement, it will order an inquiry and appoint experts who will conduct the inquiry. The company which becomes the subject of such inquiry is required to provide the experts with relevant information and – in principle – bears the costs of the inquiry. How long the inquiry will take cannot be predicted. It depends very much on the complexity of the case. In larger complex cases it will take many months. The investigators are free to determine the form of their report. The only requirement is that it should be in writing. In the report the investigators may criticize the manner in which the company has been managed. When listed companies are involved, the Companies and Business Court will always order publication of the report. If, on the basis of the report, the Court finds mismanagement (here again we have a contextualist notion), it may, at the request of the initiators of the proceedings, for example:

a) suspend or annul resolutions of the board;
b) suspend or dismiss board members; and
c) temporary appoint new board members.

The only possibility of appeal for decisions by the Companies and Business Chamber taken in the framework of the inquiry-proceedings is an appeal to the Supreme Court. It should be noted that the review by the Supreme Court is under Dutch law limited to questions of law. The Supreme Court may only review whether the law has been correctly applied

3 See on the Dutch inquiry proceeding: Marius Josephus Jittta, Procedural aspects of the right of inquiry and Vino Timmerman, Review of management decisions by the courts, seen partly from a comparative legal perspective, in The Companies and Business Court from a comparative perspective, p. 1-58 (Uitgave vanwege het Instituut voor Ondernemingsrecht Rijksuniversiteit Groningen, nr. 41) and on the Italian inquiry proceeding as regulated in section 2409 and described by Luca Henriquez, Do corporate law judges matter? Some evidence from Milan, under 4 of his essay.

and the decision has been properly reasoned. The Companies and Business Chamber may declare most of its decisions to be enforceable notwithstanding the appeal to the Supreme Court. This does not stimulate appeals in cassation with the Supreme Court.

For American lawyers it may be somewhat strange to learn that the inquiry proceeding itself does not deal with the liability of board members. In this respect I should note that the Companies and Business Chamber does not have the authority to determine the civil liability of a managing director, as this Chamber has been especially set up to decide in matters of company law. The civil liability of a managing director can only be established in civil proceedings, for which separate proceedings should be started. This for American lawyers somewhat strange limitation of the inquiry proceeding can traced back to two factors:

It was the original intention of the Dutch legislator to use the inquiry proceedings to solve problems in a company in the interest of the company by way of measures to be ordered by Companies and Business Chamber. The principle aim of the inquiry proceedings is to get a company back on track by restoring the sound relations within a company. In my opinion we observe here a somewhat idealistic trait of Dutch company law. The future will indicate whether this idealistic trait of the inquiry proceeeding will be able to cope with the more and more antagonistic business world.

There is also another point: in an inquiry proceeding facts are established in a rather informal way by the investigators. In order to avoid the disruption of business the least as possible, the Dutch legislator has chosen for a relative informal and quick procedure, with limited appeal possibilities. Facts are only judged in one instance by the Companies and Business Chamber. In the field of civil liability however, it is generally accepted in the Netherlands, that it should be possible to discuss the facts on which liability of, for instance, board members will be based, in two instances and with ample opportunities for the sued person to give his views on the matter. As noted earlier, the Companies and Business Chamber is in an inquiry proceeding the only instance which deals with the establishment of facts. As in other jurisdictions, Our Supreme Court is not authorized to review the facts of a case.

As I already indicated, the inquiry proceedings are of great importance for the enforcement of board members'duties. Within the framework of the inquiry proceeding shareholders can complain about the way board members performed their duties. Standards for the proper performance of the duties of board members can be derived from the relevant case law by the Companies and Business Chamber and the Supreme Court. The Supreme Court stated in one of its decisions that mismanagement should be understood as 'a violation of basic principles of responsible conduct of a business'. Typically, mismanagement arises in cases where there is an insufficient separation of the private interests of a boardmember as for instance a seller of real estate projects from the interests of the company as buyer of such a project; the failure to inform the supervisory board of certain transactions; and the failure to inform the shareholders meeting in full about changes in shareholders ownership. In general, one may say that the Supreme Court requires the Companies and Business Chamber to exercise restraint, reserve and caution in establishing mismanagement. A general principle of Dutch company law is that a court must not 'step into the shoes' of management of a company.

6.5 Takeover battles

Within the framework of the inquiry proceedings some interesting takeover battles have been taken to the Business and Companies Chamber and the Supreme Court. These cases shared the same key question: did the implementation of an anti-takeover measure constitute mismanagement of the board. A famous case concerns a shareholder who obtained a controlling interest in the shareholders meeting (he got about 30% of the votes at the shareholders meeting; the attendance at the meeting was not above 20%) and who had the intention to force the board to adopt policies which differed from previous ones devised by that board. The board installed an anti-takeover measure which neutralized the votes of the hostile shareholder. The Companies and Business Chamber ruled in this case that the implementation of the anti-takeover measure constituted mismanagement. Our Supreme Court quashed this decision: In the circumstances of the case the anti-takeover measure fell within the scope of a reasonable balancing of interests and was an adequate and reasonable response to the circumstances of the case. In other words: The Companies and Business Chamber had not been sufficiently contextual minded in the view of the Supreme Court. However, the Supreme Court noted that it is in general not legitimate to maintain such an anti-takeover measure during an unlimited period in time.[4] Clearly, what we see here, is in my opinion the application by the Supreme Court of a proportionality test. The Dutch Supreme Court determined whether the anti-take over measures taken by the managing board in this case were proportionate in view of the circumstances. This judgment is from 2003. Do we hear in this Dutch judgment the echo of the famous *Revlon*-case, decided by the Supreme Court of Delaware?

Let me finish with making some remarks on what Vice Chancellor Leo Strine has called, in a beautiful essay, open minded traditionalism in company law.[5] The gist of his argument is that important social institutions like public companies should not have their policies dictated by transient shareholders whose interests might be inconsistent with the long term investors concerned with the sound accretion of wealth through fundamental economic growth. In his view a company is more than simply a means to make investors rich. Seen from this perspective managers should be vested with a great of authority to pursue business strategies, which should be subject to only a few constraints, such as the approval by the shareholders of important business transactions and the monitoring of business strategies by independent directors. These constraints should prevent boardmembers making abuse of their powers. The key element of the traditionalist approach to company law is that the management of a company should have a strong hand to make and pursue difficult and often ris-

4 Hoge Raad 18 april 2003, Nederlandse Jurisprudentie 2003, 486

5 L.E. Strine jr., Towards a true corporate republic: a traditionalist response to Lucian'solution for improving corporate America, see Harvard International Law Review 2006 (forthcoming).

ky business decisions. I fully agree with the views of Vice Chancellor Strine: the primary goal of company law is not to prevent failure, but to facilitate the maximum creation of societal wealth, to stimulate creativity of boardmembers and to give them leeway to pusue a course of action they believe in good faith to be in the longterm best interests of the shareholders.

6.6 Conclusion

In the foregoing I touched upon two subjects: the liability of boardmembers towards their company and the establishment of a defensive barrier by the board of a company which gets under attack of investors. Concerning the liability of boardmembers I am in favor of an approach in which a sharp distinction is made between bad results by the management of a company and decisions made in bad faith. Liability questions may in my view only been thrown up with a chance of succes in bad faith cases. As I explained in the forgoing, the Dutch Supreme Court is contextualized minded. I consider this as a great achievement of the Dutch legal system. However, how contextualized our Supreme Court may be, I hope that it will stand by the view that liability can only be assumed in cases of acting in bad faith, even in these times of very critical reporting in the newspapers on the performances by boardmembers. Defensive barriers are all over the world controversial parts of company law. In this period of aggressive institutional, short term investors, such as hedge funds, I, as a tradionalist, prefer a rather permissive attitude *vis à vis* these measures. Thank you for your attention.

7 The Companies and Business Court as a specialized court

Maarten J. Kroeze

7.1 Introduction

The Netherlands and Delaware have some things in common. Not only is milk the national Dutch beverage as it is officially in Delaware according to Section 312 of the Delaware State Code; the Netherlands is also a small state in a federation of larger states.[1] Before large parts of the state company laws in the European Union were harmonized the Netherlands was sometimes characterized as the 'Delaware of Europe'. Dutch company law was flexible, there were no capital requirements and the Netherlands was one of the very few states in Europe to adhere at a certain moment to the internal affairs doctrine.[2] One of the hidden objectives of the European company law harmonisation program initiated in the 1960s, was to prevent competition between state company laws. Such competition was especially feared by the larger states in Europe. At this moment this competition is less feared in the European Union and even stimulated by recent case law of the European Court of Justice.[3] The idea that the competitiveness of Europe as a whole is not enhanced by harmonizing all company law rules, but by harmonizing some key rules and by stimulating flexibility and facilitating cross-border entrepreneurial activities has gained ground.

Another remarkable resemblance is that both Delaware and the Netherlands have a court that is specialized in company law issues. This feature of the Dutch and Delaware law system is unique in the world.[4] Both specialized business courts are – each on its own scale – successful and have made – and still make – important contributions to the development of corporate governance in their jurisdictions. The aim of this contribution is to find an explanation for the success of the Dutch specialized business court. In the first part of this contribution I will focus on specialized courts and the pros and cons of specialized courts on a more abstract level (Sections 7.2 to 7.4). In the second part I will address the question of how these pros en cons have worked out for the Dutch specialized business court (Sections 7.5 to 7.8). In the Dutch language the Dutch specialized business court is called 'De Ondernemingskamer'. In this contribution I will not use the literal translation 'Enterprise Chamber', but the functional translation 'Companies and Business Court'.[5]

1 § 312 State Code: 'Milk shall be the official beverage of the State.' (64 Del. Laws, c. 41, § 1).

2 The internal affairs doctrine was officially adopted in 1959. At this moment the internal affairs doctrine is laid down in the *Wet conflictenrecht corporaties* (Corporations (Conflict of Laws) Act).

3 HvJEG (European Court of Justice) 9 March 1999, *NJ* 2000, 48 (Centros); HvJEG (European Court of Justice) 5 November 2002, *NJ* 2003, 58 (Überseering); HvJEG (European Court of Justice) 30 September 2003, *NJ* 2004, 394 (Inspire Art Ltd).

4 There are some specialized courts that have some resemblance with the Delaware Chancery Court and the Companies and Business Court. As of January 1, 1993, the State of New York established four specialized commercial departments to hear complex commercial and business cases. The State of Maryland created a Business and Technology Court in 2002. In Thailand the Thai Central Intellectual Property and International Trade Court was established at the end of 1997.

5 See for a justification of this functional translation: Willems (2004: 182-183).

7.2 What is a specialized court?

What is a specialized court? A specialized court can be described as a court with limited and usually exclusive jurisdiction in one or more specific fields of the law. Judges who serve in a specialized court are experts in the fields of law that fall within the court's jurisdiction.[6] A specialized court can either be set up as an independently functioning court or as an administratively created specialized division of an already existing general court.[7] The way a specialized court is organized is not essential as long as there are safeguards for its proper and independent functioning. Most jurisdictions in the world have specialized courts. Fields of law that are frequently assigned to specialized courts are juvenile cases and tax cases. But specialized courts for cases on bankruptcy law, labor law, patent law, commercial law and anti-corruption law are also not uncommon. There is a good deal of literature on the advantages and disadvantages of specialized courts.[8] I will give an overview of these advantages and disadvantages.

7.3 Advantages of specialized courts

There are strong arguments in favor of establishing specialized courts.

a) Specialized courts can resolve questions of law more efficiently and effectively. The judges in a specialized court are experts in their field with experience in handling matters in that field.[9]
b) Specialized courts give decisions with better quality leading to more predictability.
c) Specialized courts can devote more time to individual matters, without having to give priority to other cases, such as criminal cases.
d) Specialized courts tend to adopt an informal approach to procedural matters. They are therefore better equipped to adjust the procedure to individual aspects of a case.
e) Specialized courts have a significantly higher percentage of settlements.[10] The reason is probably because specialist judges can give better directions with more authority.
f) An argument that was especially raised in the U.S. is that general courts and other litigants can also benefit from transferring highly complex litigation to specialized courts, because the dockets of general courts are not drained by complex business cases.

These arguments are traditional arguments. They were already brought forward when competition was almost completely national. In today's world with a global economy and opportunities to invest in whichever country or economy, there has evolved a very important argument in favor of establishing a specialized court for commercial and business matters.

6 Central European and Eurasian Law Initiative (1996).
7 Jacobs (2003: 10).
8 For example: Dreyfuss (1990); Dreyfuss (1995); Central European and Eurasian Law Initiative (1996); Ad Hoc Committee on Business Courts (1997); Drabbe (1963). Very useful for the preparation of section 7.3 was Jordan (1981).
9 The result of establishing four specialized commercial departments in the State of New York to hear complex commercial and business cases was a 35 percent productivity increase in complex business cases in the first year. See: Haig (1998).
10 This was for example the case in the State of New York where a commercial division was established in 1993.

g) A business court can play an important role in the economic development of regions or countries. It can be used as a tool to attract companies, businesses, investors and investments to a given jurisdiction or to prevent them from leaving. A prerequisite is that the specialized court gives added value to companies and investors. The argument of competitive advantages from specialized courts is of special importance for courts that specialize in business law and fields of law that are related to business, such as patent law, bankruptcy law or labor law.

7.4 Disadvantages of specialized courts

Strong and valid objections have been raised against specialized courts. I will sum up the most important.

a) In 1951 the American Judge Rifkind expressed the view that in time the body of law that is addressed by a specialized court, secluded from the rest, 'develops a jargon of its own, thought-patterns that are unique, internal policies which it subserves and which are different from and sometimes at odds with the policies pursued by the general law'. Specialization 'intensifies the seclusiveness of that branch of the law and that further immunizes it against the refreshment of new ideas, suggestions, adjustments and compromises which constitute the very tissue of any living system in law'. In a fundamental statement he asserts that '[t]he very essence of the judicial function' is not close familiarity, but 'a detachment from, a dispassionateness about the activity under scrutiny'.[11] To this day this well formulated argument is put forward against specialized courts.

b) An objection that is somewhat connected to the objection of Judge Rifkind is that forcing specialist advocates to argue before generalist judges ensures that the law will remain intelligible, at least to the average lawyer. Basic assumptions will not be taken for granted, and questions will be seen in a context broader than that of the specialist narrow concerns.[12] It is also argued that legal thought may benefit if legal issues are considered by different courts. A specialized court is often the only one of its kind.

c) Another serious concern that has been put forward in American legal literature – and that is probably connected to the electoral system of state judges in the United States – is that a specialized court is under greater pressure to be influenced by special interest groups than general courts are. This is because there are usually more general courts and it is not worthwhile for special interest groups to lobby if there are only a few cases in every single general court.[13]

d) An argument that was recently raised with success to oppose the institution of business courts in Pennsylvania and California is that a specialized court gives a higher quality judicial resource to certain categories of cases at the expense of other cases. No litigants should have 'better' justice than others.[14]

11 Rifkind (1951). See also Jordan (1981: 745).
12 Jordan (1981: 748).
13 Central European and Eurasian Law Initiative (1996: 15); France (1996).
14 Ad Hoc Committee on Business Courts (1997); Central European and Eurasian Law Initiative (1996).

7.5 The Dutch Companies and Business Court

I will now turn to the Dutch Companies and Business Court. In this section I will explain some main features of the Court.[15] In the following sections I will examine whether the pros and cons of specialized courts also apply to the Companies and Business Court as a specialized business court.

The Dutch Companies and Business Court is a specialized and independent section of the general court of appeal in Amsterdam. The Court has exclusive jurisdiction in some fields of company law. This exclusive jurisdiction is attributed to the Court in specific statutes like the Dutch Civil Code, the Works Council Code and the Dutch Code of Civil Procedure. The Companies and Business Court is for example the competent court in disputes on reporting rules and in disputes between the company and the works council. The Court does not adjudicate all company law matters. Directors' liability cases are left to the civil or commercial divisions of general courts. As a generalization one could say that the Companies and Business Court has jurisdiction over conflicts within companies.

The Companies and Business Court acts as an appellate court in some procedures: for example in the expulsion and exit procedures that allow shareholders to sell other shareholders out or to be sold out by other shareholders. In most procedures the Companies and Business Court is the first and only factual instance. Parties are allowed to address the Supreme Court. But this is a cassation court that does not have the power to review facts (or at least to review facts openly). Its review is limited to questions of law and questions of reasoning.

The important role that the Companies and Business Court has in shaping corporate governance rules in Dutch company law, however, is connected with the so-called 'inquiry procedure'. Labor unions, the public prosecutor and – the most important category – shareholders with – alone or together - 10% of the shares or shares with a nominal value of 225,000 euros have a right to initiate the inquiry procedure by an application addressed to the Companies and Business Court. The Court may order an inquiry if there appear to be well-founded reasons to doubt the correctness of the policies or the conduct of a company. If there are well-founded reasons to doubt the correctness of the policies or the conduct of the company, the Court will appoint one or more investigators. These investigators are usually independent scholars, lawyers or auditors. The inquiry will lead to a report. This report brings the first part of the proceedings to an end. The objective of this first part is to disclose the policies and conduct of the company and – if relevant – to disclose who has been responsible for incorrectness of these policies and for misconduct of the company.[16] Sometimes parties are satisfied with this first part and everything ends there. This is the case when, for example, the company has gone bankrupt.

15 See in general: Josephus Jitta (2004).

16 HR (Supreme Court) 10 January 1990, *NJ* 1990, 466 (Ogem II).

The second part of the proceedings is again initiated with an application. In this second stage the applicant asks the Companies and Business Court to establish whether there has been misconduct on the basis of the report, to establish who has been responsible for misconduct and if appropriate to order measures. The Companies and Business Court has broad authority in ordering measures: for example the annulment of resolutions, the suspension or dismissal of board members, the temporary appointment of board members, the temporary derogation of the articles of association, the temporary transfer of shares to a nominee and the dissolution of the company. The objective of this second part of the proceedings is to reorganize the company, to restore the company to a healthy state and to state who has been responsible for the misconduct of the company.[17]

I would like to emphasize that the Companies and Business Court does not address all company law issues. In fact, there are many company law issues that are assigned to general courts of first instance. The Companies and Business Court can establish the individual responsibility of board members for misconduct and this will damage their reputation. But it is not competent in liability cases and cannot award damages. A judgment by the Companies and Business Court on individual responsibility is not binding in liability proceedings, although it is not surprising that such a judgment will be of great help in such proceedings.[18]

Initially, the inquiry procedure was directed at companies, cooperative societies and mutual funds. When it proved successful it was extended to associations and foundations that run businesses. As of January 2006 there is a special provision that allows a representative body of the patients of a hospital with the legal form of an association or foundation to start inquiry proceedings.[19] What we see is an extension of the jurisdiction of the Companies and Business Court from the for-profit sector to the nonprofit sector. There is no experience yet with this new task.

What contribution did the Companies and Business Court make to the development of Dutch company law? I will give a brief outline of the importance of the Companies and Business Court. The Court has established standards for conflicts of interest, for the protection of minority shareholders, for takeover measures, for decision-making by the top level in groups of companies, for the disclosure of information by executive directors to supervisory board members, for the disclosure of information to shareholders, for the way directors should behave (active, loyal and with due care), for aspects of remuneration of directors (for example for poison pills) and for the way the company and its directors should operate vis-à-vis the works council. In the recent Versatel case the Companies and Business Court set new standards for conflict of interest situations in takeover and squeeze-out merger settings.[20] To illustrate the approach of the Companies and Business Court and the far-reaching

17 HR (Supreme Court) 10 January 1990, *NJ* 1990, 466 (Ogem II).
18 HR (Supreme Court) 8 April 2005, *JOR* 2005/49 (Laurus).
19 According to Art. 6.2 of the Uitvoeringsbesluit WTZi (Care Institutions (Eligibility) Act Implementation Decree), a hospital has to include an article in the bylaws that authorizes a representative body of the patients to start inquiry proceedings.
20 OK (Companies and Business Court) 14 December 2005, *JOR* 2006/7, *Ondernemingsrecht* 2006-3.

provisional measures it can take and sometimes takes, I will cover the Versatel case in more detail.

The executive director and three out of four supervisory board members of Versatel were employees of the parent company Tele 2, which had made a successful take over bid. In a subsequent merger with another subsidiary of Tele 2 the minority shareholders of Versatel would be squeezed out. Versatel wanted the general meeting of shareholders to vote on a change in its corporate governance policy. In future a supervisory board member could decide on a squeeze-out merger even if he had a conflict of interest. The Companies and Business Court decided that the interests of the outside minority shareholders were not in good hands with the non-independent board member and supervisory board members (who were all employees of the dominant shareholder Tele 2 which had just made a successful takeover bid), and in December 2005 – as a provisional measure – appointed three independent supervisory board members with exclusive authority to take all decisions and all actions regarding the squeeze-out merger. The appointment of the three independent supervisory board members can be seen as a procedural solution by the Companies and Business Court to the conflicts of interest problem.

In a remarkable decision of 24 March 2006 the Companies and Business Court intervened again in the Versatel squeeze-out merger case.[21] The subsidiary of Tele 2 and Versatel wanted to enter into the merger as soon as possible. The two merging companies would be valued after the merger (the interests of the minority shareholders would be protected by a complex tracking stock structure). The independent supervisory board members had agreed to the conditions of this merger. The minority shareholders of Versatel asked the Companies and Business Court to block the merger. The Companies and Business Court found that the subsidiary of Tele 2 and Versatel did not bring forward facts justifying the necessity of the structure. It also held that the minority shareholders were entitled to a general overview of the facts and figures of the merger before the merger was completed. In these circumstances it was contrary to the requirements of reasonableness and fairness that the minority shareholders should be forced into a merger without specific information. The Companies and Business Court prohibited any decision-making by the shareholders' meeting on the merger. To a certain extent it overruled the independent supervisory board members it had appointed earlier. This decision goes beyond the procedural solution of appointing independent supervisory board members. It is based on a substantive review by the Companies and Business Court of the facts and the conflicts of interest problem. In my opinion the Companies and Business Court should in general rely on the judgement of the independent board members it appointed. Only exceptional circumstances could justify a departure from the business judgement of the court-appointed independent board members. I wonder if these exceptional circumstances were present in this case.

21 OK (Companies and Business Court) 24 March 2006, *Ondernemingsrecht* 2006-8.

7.6 The success of the Companies and Business Court

Why is the Companies and Business Court so successful? As a general remark I would like to mention that there is one important event that boosted the popularity of the Companies and Business Court. Between 1971 and 1994 it had no authority to take provisional measures. In 1994 the company law statute was changed in such a way that the Companies and Business Court could take provisional measures.[22] One could say that this has led to a kind of renaissance for the Court. Disputes that require quick action were now brought before the Companies and Business Court and not before the judge in a general court in interlocutory proceedings. This is one important explanation for the success of the Companies and Business Court. I give another explanation for this success. This explanation is connected to the arguments in favor of specialized courts that I set out in Section 7.3. Let us see which arguments in favor of specialized courts apply to the Companies and Business Court.

7.6.1 1st argument in favor - Specialized courts can resolve questions of law more efficiently and effectively. The judges in a specialized court are experts in their field with experience in handling matters in that field.

In urgent matters – where provisional measures are requested – a party can submit his application to the Companies and Business Court on Monday. The hearing will be held on Thursday. The defendant – that is the company – and other interested parties can submit their written defense and relevant documents in the period between the application and the hearing. If a party does not submit a written defense he is allowed to defend himself, or put forward his opinion on the case in question by oral pleading at the hearing. When necessary, the Companies and Business Court gives a reasoned oral judgment within half an hour after the closing of the hearing.[23] This illustrates the Court's efficiency and effectiveness.

The Companies and Business Court is one of the very few Dutch courts that includes lay people. The bench consists of five people, three of them professional specialized justices. The other two have financial experience as an auditor, a businessman or as a labor union official depending on the issues in the case in question. The main reason for establishing the Companies and Business Court in 1971 was that the Dutch financial statement procedure and the inquiry procedure demanded expert adjudication and an expert insight in the needs of companies and into the relationships within the business community.[24]

7.6.2 2nd argument in favor - Specialized courts give decisions with better quality leading to more predictability.

Although general courts can give high-quality decisions, the overall quality of the decisions of the Companies and Business Court is in my opinion more consistent. The Companies and Business Court has set standards for important company-law issues. An important factor

22 Section 349a of Book 2 of the Dutch Civil Code.
23 In OK (Companies and Business Court) 13 March, *NJ* 2003, 298 the application was submitted on 11 March 2003, the hearing was on 12 March 2003, the written judgment was delivered on 13 March 2003: see Willems (2004: 188).
24 Maeijer (1973, 17). Report of the Verdam Committee 1965, p. 67.

is that general courts tend to be conservative when a decision is needed. It seems as if they are sometimes afraid of the enormous economic consequences of their decisions. The consequence is that lawyers try to mold the facts of the case in such a way that the application for an inquiry procedure is justified. In that event the Companies and Business Court is competent to take provisional measures. The Companies and Business Court can take almost every measure it deems necessary. The president of the Companies and Business Court has stated that this authority comes close to the equitable jurisdiction of the courts of common law countries.[25] When the postponement of the general meeting of Rodamco North America N.V. was requested – which was to decide a few days later on a 6 billion euro takeover – the postponement was given within 15 minutes of the hearings. In my opinion this request for postponement would have had little chance with a general court judge. (I am aware that the party which opposed the postponement would probably say that this is a strong argument in favor of a general court).

7.6.3 3rd argument in favor - Specialized courts can devote more time to individual matters, without having to give priority to other cases, such as criminal cases.

This argument also applies to the Companies and Business Court. Justice Jacobs mentions in his contribution in this book that the Chancery Court judges are able, when required, to take a particular case to the 'head of the line' if circumstances require. The same is true of the Companies and Business Court. Another aspect Justice Jacobs mentions is the culture or esprit de corps within the Chancery Court. The same is in my opinion true of the Companies and Business Court. Justice Willems, who is president of the Companies and Business Court, has brought together a small group of devoted professionals who will not leave the office if the work has not been done. There is a commonly held view in the Netherlands that the Companies and Business Court would not have been as successful – or maybe some would prefer to say influential – as it is now if Justice Willems were not the president of the Court. He is an active, hard-working and innovative justice, who has to a large degree created – by his decisions – his own competence.

7.6.4 4th argument in favor - Specialized courts tend to adopt an informal approach to procedural matters. They are therefore better equipped to adjust the procedure to individual aspects of a case.

Justice Willems likes to compare the approach of the Companies and Business Court to that of the Chancery Court in Delaware. He is not very interested in formal or procedural technicalities and has a strong focus on the substantive issues.[26] In my opinion the most important issue for him is to solve the problem within the company. The Companies and Business Court has discretionary powers to take the provisional measures that it deems necessary, even when the parties did not request certain measures. The approach is – especially for a civil law system with strict procedural law – informal. The application procedure itself is informal. In major cases Justice Willems calls the lawyers to a meeting to agree on the most effi-

25 Willems (2004, 188).
26 Willems (2004: 187-188).

cient procedure. Parties are allowed – if no one objects – to submit memorandums and exhibits in English. The Companies and Business Court has a broad interpretation of the scope of the inquiry procedure. The Court considered itself competent in the recent Unilever case, a dispute that was largely of a contractual nature but had some relationship with the internal policy of the company.[27] Contractual disputes are normally adjudicated by general courts. As I mentioned earlier, general courts are more conservative in ordering provisional measures in company law cases. One of the explanations for this phenomenon is that they have a more formal (and in general correct) approach to civil procedure. General courts will not award something that the plaintiff did not ask for. Parties determine the scope of the subject matter.

7.6.5 *5th argument in favor - Specialized courts have a significantly higher percentage of settlements.*

The Companies and Business Court initiates settlements – especially when smaller business firms are involved – during the hearing. The Companies and Business Court can make these settlements binding on all parties by including them in the records of the hearing. There is some information on settlements that were reached at the hearing.[28] However, it is not possible to answer the question of whether the Companies and Business Court has a significantly higher percentage of settlements than general courts have. There are no reliable data to make a comparison. It would be necessary to have data on the overall settlement rate and not just on those reached at the hearing and in addition the settlement rate in general courts would have to be available. And even if data were available a comparison would inevitably have to be made between settlement rates in different kinds of proceedings. This would lead to an unreliable outcome.

7.6.6 *6th argument in favor - General courts and other litigants can also benefit from transferring highly complex litigation to specialized courts, because the dockets of general courts are not drained by complex business cases.*

This advantage seems to me self-evident and needs no further comment.

7.6.7 *7th argument in favor - A specialized business court can play an important role in the economic development of regions or countries. It can be used as a tool to attract companies, businesses, investors and investments to a given jurisdiction or to prevent them from leaving.*

Global competition between economies has recently been used as an argument in favor of business courts in the United States; for example for the establishment in 2002 of the Mary-

27 OK (Companies and Business Court), 21 December 2004, *JOR* 2005/5 (Unilever); affirmed by the Supreme Court in HR (Supreme Court) 18 November 2005, *JOR* 2005/295.

28 An annual report of the Companies and Business Court is published in the legal journal *Ondernemingsrecht* (see for example *Ondernemingsrecht* 2006-1, pp. 30-32). In 2001 a settlement was reached during the hearing in 11 cases, in 2002 in 3 cases, in 2003 in 4 cases and in 2004 in 3 cases.

land Business and Technology Court.[29] It was also used in 2004 in favor of the Companies and Business Court by the Dutch Minister of Justice in a memorandum on the modernization of Dutch company law that was presented to Parliament.[30] The argument has also been used for developing economies. As an example I quote a paragraph of the OECD White Paper on Corporate Governance in Asia:

> 'Court systems should further strengthen their expertise and capacity to adjudicate corporate-governance disputes efficiently and impartially, including through establishment of specialized commercial courts and promotion of alternative dispute resolution. (…) Areas for active experimentation should include specialized company law courts (…).'[31]

7.7 The disadvantages of specialized courts and the Companies and Business Court

One cannot get away with a one-sided impression. I will therefore make some remarks on the disadvantages of specialized courts I mentioned in section 7.4. There are ways to circumvent the dangers of seclusion from other courts, of immunization against refreshment by new ideas, the development of a jargon of its own, thought-patterns that are unique and internal policies that are different from and sometimes at odds with the policies pursued by the general law. It is striking to see that in practice these disadvantages are circumvented. I will sum up circumstances that counterbalance the specialization of the Companies and Business Court.

a) The Dutch Companies and Business Court has established rules on the responsibility of directors. However, the Court has no authority in liability issues. The general courts decide liability cases. The Companies and Business Court is therefore not exclusively setting standards for the responsibilities of directors (although liability cases regarding directors of a non-bankrupt company are relatively rare because Dutch law does not know the concept of the derivative action and directors do not often (actually: never) sue their colleagues).
b) The Companies and Business Court is competent in totally different company-law-related procedures. In particular the authority to decide codetermination law issues guarantees that the Companies and Business Court does not have exclusive competence in a very narrow part of the law.
c) Two out of the three professional justices are assigned to the Companies and Business Court on a part-time base. They also function as justices in the appellate general court.

29 Ad Hoc Committee on Business Courts (1997) Information technology is Maryland's largest field of economic activity. It has one of the largest concentrations of bioscience and aerospace companies and the highest percentage of technological workers in the U.S. Maryland made a pragmatic and sensible choice by assigning fields of law to the specialized court that would have the largest impact on its economic position.

30 Dutch Parliamentary documents ('Kamerstukken') 2003-2004, 29752, no. 2 (www.overheid.nl). He expressly stated that the existence of the Business Court as a specialized court could enhance the attractiveness of the Netherlands as a place of business.

31 OECD (2003, § 41 and § 138).

In addition to this the Companies and Business Court has four deputy justices, who hear cases on a regular base. These deputy justices are no full-time justices. Three of them have a background as a law professor.

d) The cassation court, which is a general court, has oversight and can set aside the decisions of the Companies and Business Court.

I am not concerned that the Companies and Business Court as a specialized court is under greater pressure to be influenced by special interest groups than general courts would be. Judges in the Netherlands are not elected. They are appointed for life by Royal Decree (in the Dutch situation, for life means that they retire at the age of 70). The justices in the Companies and Business Court are likewise appointed for life. This is not the case for the lay experts who are also members of the Companies and Business Court (the bench consists of three justices and two lay experts). They are appointed by Royal Decree for a period of five years. The justification for this shorter period is that a lay expert is appointed on a personal title, but may lose his expertise (for example if he quits his job as an auditor, director or labor union official). An appointment for life could burden the Companies and Business Court with people who were experts in the past. In my opinion there is no risk in the Dutch situation of undue influence by special interest groups. That there is no indication that corruption has ever occurred in the Dutch judiciary is also relevant in the context of this conclusion.

The ethical argument against a specialized business court is that no litigants should have better justice than others. This argument is too absolute in my opinion. It neglects the fact that there may be valid reasons justifying some litigants getting better justice than others as long as the minimum standards are good enough. This is especially the case if a clear line can be drawn between business cases and other cases. Every potential litigant in an economy may benefit – as a citizen – from the economic development that may be derived from the establishment of a specialized business court.

7.8 Concluding remarks

The aim of this contribution was to find an explanation for the success of the Dutch Companies and Business Court. The competence of the Companies and Business Court to take provisional measures is a prerequisite for this success. One could also argue that the lack of a derivative suit in Dutch law and hence the somewhat inadequate preventive role of behavioral standards set by director liability rules has contributed to the success of the inquiry procedure. Apart from these factors the Companies and Business Court functions with all the advantages that are normally attributed to specialized courts. The fact that these advantages of specialized courts are in reality advantages of the Companies and Business Court contributes in a very important way to its success. Specific features of the Dutch legal system as mentioned in Section 7.7 of this article form a counterbalancing force to some of the disadvantages attributed to specialized courts. Although some criticism is sometimes heard of the active role of the Companies and Business Court, it has no doubt made a very important contribution to the development of Dutch company law and the establishment of rules of corporate behavior in the Netherlands. At a less abstract level – and last but not least – the Companies and Business Court has made a valuable contribution to the resolution of disputes in Dutch companies.

8 Dispute Resolution in the Netherlands: Recent Decisions of the Enterprise Chamber And their Impact on the Corporate Governance of Dutch Companies

Marius W. Josephus Jitta

Disclaimers

I did not have the opportunity to discuss with the other Dutch speakers what they were going to say. There may therefore be a certain overlap between what they have said and what I am going to say. However it is unlikely that I will be telling exactly the same thing as what they have said. The nuances will differ if not the general approach.

As an advocaat I am involved in cases before the Enterprise Chamber and I have some direct or indirect involvement in certain of the cases that I will mention in my speech. I will try to approach the cases in an objective manner without referring to my possible involvement. The Enterprise Chamber is a Division of the Court of Appeal in Amsterdam.

As an advocaat I tend to be an opportunist as all legal advisors: I am looking what is the best for my client in a specific case. That also applies for the possibilities that litigating before the Enterprise Chamber offer. I will try to be more objective today.

A final caveat: I will try to prevent going into excessive detail. This means that by definition what I am saying is incorrect.

8.1 Introduction

Before I can do what I have been asked to do, i.e. make some comments about a few recent decisions of the Enterprise Chamber it is necessary to say something not only about the role of the Enterprise Chamber but also about the position of other Dutch Courts.

8.2 Differences between US Law and Dutch Law

Contrary to US law Dutch law does not know discovery. In a Dutch litigation a party may generally not be forced to make all sorts of documents available.

Compared to the costs of the average litigation in a common law jurisdiction the costs of litigation in the Netherlands is low. A party that looses a case generally only has to pay a fraction of the actual costs incurred by the other side.

8.3 An Unexpected Similarity

It is often taken for granted that there is a considerable difference between common law systems and civil law systems. Although Dutch corporate law is laid down in acts open norms such as the principle of reasonableness and fairness or good faith play an important role and leave it to the courts to apply open norms to specific cases leading to 'court made' law in a manner which is very similar to what happens in a common law jurisdiction.

8.4 Dual Track

Where corporate law matters are concerned Dutch law provides for two different types of litigation: traditional litigation and proceedings before the Enterprise Chamber.

Traditional litigation takes place before the ordinary Courts. Matters are brought in first instance before a District Court. The decisions of a District Court may be appealed with the Court of Appeal and the decisions of the Court of Appeal may be challenged before the Dutch Supreme Court. It is important to note that depending on the grounds of appeal that have been formulated against a decision of the District Court the Courts of Appeal may review the case in its totality and may establish the facts. The review by the Supreme Court is limited to violations of the law. The facts as established by the Court of Appeal can only be challenged to the extent that the arguments of the Court of Appeal are incomprehensible.

In most of the cases in which the Enterprise Chamber has jurisdiction it hears the cases in first instance. Appeals against its decisions are similarly heard by the Supreme Court. The principle that appeals can not directly challenge the factual findings of the Enterprise Chamber applies. Also its factual findings can only be challenged where the arguments of the Enterprise Chamber are given the facts that were established incomprehensible.

8.5 The role of the Enterprise Chamber

The Enterprise Chamber has been designated the competent Court in a number of acts. The Enterprise Chamber has inter alia jurisdiction in cases where (i) there are doubts whether a company is properly managed, (ii) the financial statements of a company are challenged, (iii) provisional decisions of the management of a company are challenged by the works council, (iv) squeeze-out procedures initiated by s shareholder holder at least 95% of the shares and (v) disputes involving the removal of the Supervisory Board of a company to which the so called structure regime applies. This enumeration is incomplete as a number of other laws also give jurisdiction to the Enterprise Chamber.

8.6 The Inquiry Proceedings

The role of the Enterprise Chamber is probably the most important where litigations concerning the way a company is managed are involved. These litigations comprise three different stages. In the first stage the party initiating the litigation has to ask for an inquiry on the ground that there are grounds to fear that the company is not properly managed. If the Enterprise Chamber shares this fear it may order an inquiry, but even if it shares the fears it does not have to do so. Its powers are discretionary in this respect.

If the Enterprise Chamber orders an inquiry it will appoint one or more persons to investigate the issues that the Enterprise Chamber considers that should be investigated. The inquiry may unearth facts that the parties asking for the inquiry could not get access to themselves for lack of the possibility of discovery.

When the investigators have filed their report with the Clerk of the Enterprise Chamber the Enterprise Chamber may be asked to take measures in order to remedy certain aspects of eventual mismanagement if it follows from the report by the investigators that a company has been mismanaged. There is only a limited number of measures that the Enterprise Chamber can order at this stage and the Enterprise Chamber can not order these measures on this basis unless an investigation has been carried out. This was decided by the Supreme Court in the Gucci case.

It is important to note that in the inquiry proceedings the concept of mismanagement is used outside its usual meaning. Not only the management board may be guilty of mismanagement but where a company is found to be mismanaged that may also apply to its Supervisory Board or to its shareholders meeting. This can for instance be the case if the shareholders meeting is consistently deadlocked and such deadlock puts the future of the company at risk.

Where the mismanagement is due to the actions or inactions of the management board of a company, the conclusion that the company is mismanaged does not necessarily imply that the members of the management board are guilty of the sort of mismanagement that results in them having become liable to the company for damages. Whether they have incurred liability is a matter that would have to be litigated in proceedings before the ordinary courts. This would also be the case in the event the liability of other members of the corporate organization is involved.

8.7 Injunctions

When the inquiry proceedings were introduced in 1973 the Enterprise Chamber could only order measures at the end of the third stage. This changed when in 1994 the possibility was introduced for parties to ask injunctive relief from the Enterprise Chamber. This was an important development and nowadays inquiry proceedings are often only started in order that an application for injunctive relief may be filed.

Notwithstanding the fact that the inquiry continues to be at the core of the proceedings it has become less important simply because the majority of the cases ends even without the application for the inquiry having been heard by the Enterprise Chamber.

The Enterprise Chamber has considerable freedom where the type of injunctive relief it orders is concerned and – within the limits of mandatory law – the Court is at liberty to structure injunctive relief in the manner it deems fit. It has often adopted a pragmatic approach. Injunctive relief ordered by the Enterprise Chamber includes inter alia: injunctions forbidding a company tabling or carrying out certain resolutions and the temporary replacement of members of a Supervisory Board or a Management Board, and the appointment of members of such boards with a casting vote.

In the way our law was drafted there is a downside to the freedom of asking injunctive relief in inquiry proceedings: when a party asks for injunctive relief from the ordinary courts and such relief is granted, such party when it enforces the injunction runs the risk that at the end of the day the decision will be reversed and that he may be liable for damages. When the Enterprise Chamber grants injunctive relief the decision does not have to be enforced by the party that made the application because the decision of the Enterprise Chamber does not need enforcement. The result is that there are virtually no risks for the party asking an injunction: apart from a small exposure to costs there is only upside in asking for an injunction.

8.8 Effectiveness of the Enterprise Chamber

The inquiry proceedings before the Enterprise Chamber including the possibility of injunctive relief are generally considered to be an effective way of solving complex situations.

One should however keep in mind that the company and the business operated by it play the central role in the proceedings. The approach is what is best for the company and for its business, how can one solve the problems in the most effective manner and not who is to be blamed.

The manner in which the Enterprise Chamber resolves problems may in certain cases be at odds with a more formal legal approach.

However, there is an inherent contradiction between the purpose of the law – what is best for a company and its business- and the purpose of the parties petitioning the Enterprise Chamber – what is good for me. Of course there are cases in which the two are aligned and as lawyers we will try to convince the Enterprise Chamber that the interest of our clients coincide with the interest of the company. The risks of this contradiction are of course larger in the current practice that focuses very much on whether injunctions should be granted than in the manner in which the proceedings were originally envisaged where the Enterprise

Chamber could only order measures after an inquiry and only if the Court held that the company was mismanaged.

Together with the fact that the financial risks of a litigation are small this results in the inquiry proceedings but rather the possibility of asking injunctions having developed in a major tool on the market for corporate control. At the same time also new types of shareholders have found the way to the Enterprise Chamber. As far as I am aware there have not yet been cases in which the Enterprise Chamber has refused to grant injunctive relief because the parties asking for that relief acquired their shares as part of a struggle for corporate control.

8.9 A Side Effect Of The Success of the Enterprise Chamber

The problem solving capacity of the Enterprise Chamber has as a further indirect side effect: the legislator has recognized proceedings before the Enterprise Chamber as the solution for a variety of complex problems that arise in modern day life where different interests have to be weighed and reconciled.

There are at least two downsides to this development. The first downside is that because there is an institution – the Enterprise Chamber - that will decide the issue there is less need in making new laws to define what interest has to take preference because the easy answer is that that will very much depend on the circumstances in a specific case. This may result – and I think does result - in a sort of law making by proxy. Not only the legislator but also the legal profession and scholars may be criticized for their collective lack of effort in trying to formulate more precise rules.

The second downside is that the legislator while increasing the number of areas in which the Enterprise Chamber may become involved, does as far as I am aware not consider whether the organization of the Enterprise Chamber may cope with the increased workload. Personally I think the current organization of the Enterprise Chamber may already be too small to cope with the ever increasing volume of work coming its way under existing laws: in a number of cases the period between the date of the hearing and the date the Enterprise Chamber renders its decision has become too long.

8.10 The Enterprise Chamber and Corporate Governance

In inquiry proceedings that by their vary nature focus on the way a company through its corporate organs makes its policies, defines the manner in which it will act and implements its policies corporate governance and the checks and balances are ultimately at the very heart. If those checks and balances do not function properly and the internal result of the corporate process leads to a disproportionate result, the Enterprise Chamber may play a role. In many of the decisions rendered by the Enterprise Chamber the protection of minority shareholders whose interest was threatened as a result of a lack of checks and balances were at stake.

Many of the decisions of the Enterprise Chamber therefore have corporate governance implications in a broad sense. Also in a more narrow sense the Enterprise Chamber has rendered decisions in which corporate governance issues play an important role or that give rise to further issues of corporate governance. A number of these decisions have been rendered during the past year. They have in common that they all relate to listed companies that were either the subject of a struggle for corporate control or the business of which was being restructured.

8.11 Recent Decisions

These decisions involved in alphabetical order *Begemann*, *EVC*, *Laurus*, *Sarakreek* and *Versatel* (3x); also the litigation brought in the case of *Shell* could to a certain extent be considered to fall into this category. All cases involved applications for injunctive relief except for *EVC*, in which the decision of the Enterprise Chamber was given on an application for ordering an inquiry and *Laurus* where the Enterprise Chamber was asked to conclude that *Laurus* was mismanaged and the Court was asked to order measures after an inquiry.

8.11.1 EVC[1]

In *EVC* the decision of EVC to transfer the totality of its business to (a company controlled by) its 92,8% shareholder was challenged. This shareholder had in two subsequent tender offers failed to reach the 95% threshold which would allow for the minority shareholders to be squeezed out. When the second offer which was increased to € 4.45 per share failed, EVC decided to sell its business at such a price that when EVC was subsequently liquidated the shareholders would receive a distribution of € 4,45 share. Certain minority shareholders challenged this plan in inquiry proceedings. The Enterprise Chamber refused to order an inquiry because it concluded that the corporate governance of EVC was structured in such a manner that the interest of the minority shareholders was adequately protected. This protection consisted of the presence on the Supervisory Board of EVC of an independent member who supported the proposed transaction in combination with the contractual arrangement that decisions such as the sale of the business could not be taken without his concurrence.

8.11.2 Laurus[2]

This decision is the final stage for the time being of a saga that has kept both the Enterprise Chamber and the Supreme Court busy for a number of years. At the heart of the litigation was a struggle for corporate control which over the years has had a detrimental impact on the development of the company. The decision is one of the relatively few where parties have asked the Court to order measures once the report on the inquiry had become available.

1 Court of Appeal Amsterdam, 21 December 2005, JOR 2006/8
2 Court of Appeal Amsterdam, 18 January 2006, JOR 2006/46.

From a corporate governance perspective the arguments of the Enterprise Chamber are important where the Enterprise Chamber formulated a rule what safeguards a company has to build in when members of their Supervisory Boards have a potential conflict of interest. The Enterprise Chamber held that the question is not whether members of the Supervisory Board are potentially conflicted but whether the company recognized that potential conflicts of interest existed and have build in sufficient safeguards in order to prevent that if such conflicts would arise they could adversely effect the company or if a conflict of interest had arisen, whether they had taken sufficient measures in order to prevent such adverse consequences.

Before the Enterprise Chamber can establish that a company is mismanaged it is not sufficient that potential conflicts of interest exist but also that the company has failed to recognize this fact and has failed to take adequate measures in order to prevent adverse consequences.

8.11.3 Shell[3]

By its background this case definitely falls in this category, but strictly speaking no decision was rendered by the Enterprise Chamber. As part of the restructuring of the Royal Shell Group Shell which inter alia comprised a public offer by a new holding company for the shares of the Dutch holding company, the group decided that the minority shareholders would not be squeezed out by formal squeeze-out proceedings before the Enterprise Chamber but that the former holding company would be merged into its subholding company and the remaining minority shareholders would be cashed out as part of the merger process. This plan was challenged by minority shareholders in inquiry proceedings as far as the compensation that they would receive for there shares was concerned. The case was settled and the parties agreed with the Enterprise Chamber that the case would further effectively be dealt with per analogiam with squeeze-out procedures so that the consideration that the minority shareholders would receive for their shares would be determined by the Enterprise Chamber.

As part of their settlement the parties asked the Enterprise Chamber to decide also whether a legal merger as envisaged by Shell was permissible. The Enterprise Chamber agreed to decide this issue in due course. The question arises whether the Enterprise Chamber in agreeing to do so has not stepped out of bounds.

8.11.4 Versatel[4]

Until now there have been three decisions in *Versatel*. In each of these three cases the same group of minority shareholders asked for injunctive relief. The first application was filed when Tele2 made a tender offer for Versatel and a group minority shareholders asked the Court to order a number of measures that would effectively make the tender offer by Tele2

3 Court of Appeal Amsterdam, 13 December 2005, JOR 2006/64
4 Court of Appeal Amsterdam, 27 September 2005, JOR 2005/272, 14 December 2005, JOR 2006/7 and 24 March 2006

impossible or once the tender offer would be completed forbidding Tele2, a subsidiary of Tele2 and Versatel from entering into a triangular legal merger (juridische driehoeksfusie). Injunctive relief was refused and the Enterprise Chamber held that this type of legal merger was permitted irrespective whether Tele2 would have acquired 95% or more of the Versatel shares (which percentage would have allowed for formal squeeze out proceedings) but also at a level of shareholding of less than 95%. I do not exclude that in retrospect the Enterprise Chamber would have wanted that it had not given an opinion on the permissibility of a triangular legal merger in this case particularly also because the Court could also have refused the injunction because the application was premature.

The second application was filed when the tender offer by Tele2 had been declared unconditional and Tele2 that had acquired some 82.3% of the Versatel shares. Tele2 and its subsidiary then wanted to proceed within the triangular merger and Versatel proposed a draft resolution to its shareholders to amend the manner in which Versatel was applying the Dutch Corporate Governance Code. The Dutch Corporate Governance Code became effective on 1 January 2005 and provides for a number of principles and best practices. Dutch listed companies have to announce to what extent they apply this code which is based on the principle of comply or explain. Versatel had asked its shareholders meeting in Q2 2005 to agree that the company would not apply the Code on a limited number of points. Without removing or suspending the members of the other members of the Supervisory Board that had been appointed in view of the acquisition of Versatel by Tele2 the Enterprise Chamber appointed three independent members on the Supervisory Board of Versatel. These independent members would have the exclusive power to negotiate and agree all transactions between Versatel and Tele2 including the terms of the triangular merger. The Enterprise Chamber further forbade Versatel to deviate in any manner whatsoever from the Dutch Corporate Governance Code as far as exceptions had not already been authorized by the shareholders meeting of Versatel before the tender offer by Tele2.

The third application for an injunction was filed by the same group of shareholders when the independent members of the Supervisory Board had agreed with Tele2 the amended terms of the triangular legal merger. Notwithstanding the fact that the independent members had been appointed by the Enterprise Chamber and had been given the exclusive power to negotiate the terms the Enterprise Chamber considered that the terms that had so been negotiated were inequitable and forbade Versatel to submit this proposal for approval to its shareholders meeting.

8.11.5 Sarakreek[5]

A shareholder of Sarakreek that held in the order of 22% of the shares of Sarakreek had for a number of years been pushing for the liquidation of the company because the company was no longer active and the liquidation of the company would trigger a taxable loss for the shareholder which the shareholder could set off against taxable profits. When the share-

5 Court of Appeal Amsterdam, 13 September 2005, JOR 2005/242.

holder had finally convinced the company that it should put the liquidation of the company on the shareholders meeting, the company entered into an agreement with a third party that was prepared to acquire shares new to be issued by Sarakreek and in that manner preserve a limited value of the existing shares. This value was substantially less than the value of the tax loss that would remain frozen. Both the existing shareholder and the party that had reached agreement with the management of Sarakreek and had acquired the shares they held in the company asked for injunctive relief. Because the existing members of the management board potentially had a conflict of interest with the company, the Enterprise Chamber appointed a further member on the management board with a casting vote particularly in order to ensure that a shareholders meeting of Sarakreek would be properly convened and that the shareholders of Sarakreek would be informed in an adequate manner.

8.11.6 Begemann[6]

A tender offer for the shares of Begemann was announced which tender offer was supported by the Management Board and the Supervisory Board of Begemann. There were at least three peculiar aspects. The offer was in part in cash and in part in the shares of another Dutch listed company Tulip, of which company Begemann was the controlling shareholder, the controlling shareholder of Begemann was controlled by the Chairman of the Supervisory Board of Begemann who was at the same time a member of the Supervisory Board of Tulip. This controlling shareholder of Begemann undertook to tender its shares and there was no fairness opinion or other external objective support in respect of the offer. Minority shareholders filed for an inquiry and asked the Enterprise Chamber injunctive relief because they considered that they had insufficient information to decide whether or not to tender their shares. The Enterprise Chamber was of the opinion that Begemann should have procured that further information than the pubic information on Tulip was included in the Offer Document or that the Boards of Tulip supported the offer and qualified it as fair notwithstanding the fact that these boards purportedly did not have additional information constituted a reason to doubt whether Begemann was properly managed. The Enterprise Chamber appointed an independent member of the Management Board and the Supervisory Board in order to take all necessary decisions in relation to the tender offer and to represent Begemann in the discussions with the offeror.

8.12 Observations Relating To These Decisions of the Enterprise Chamber

In each of these cases actions of a listed company were challenged by minority shareholders. Except for the decision in re *EVC* when the Enterprise Chamber refused to order an inquiry in each case the decision was rendered on an application for injunctive relief. In *Begemann* and *Sarakreek* the application for an inquiry was never heard because the application for an inquiry was subsequently withdrawn. In *Versatel* it is expected to be heard in May (the application was filed in August 2005).[7] In Shell there will be a hearing but given the settlement

6 Court of Appeal Amsterdam, 23 December 2005, JOR 2006/6.
7 At the time this book is published this hearing has been further postponed.

that was reached this will be a hearing *sui generis* and the application for an inquiry will no longer be the subject of the hearing.

To the extent these cases are representative for applications for ordering an inquiry with listed companies one may conclude that where action of the Court is called for injunctive relief is granted but that the number of cases in which an inquiry is ordered is low.[8] At least in listed companies the companies and their shareholders do not generally have the time nor the possibility to go through the three stages of an inquiry proceeding.

If injunctive relief is granted in view of the demands of the market the company is likely to take the injunction as a given and will change its policies. Shareholders that are not interested in waiting for the completion of all three stages may use the opportunity to sell their shares before the proceedings are over. Where listed companies are involved one will have to accept that the inquiry can generally not be at the core of the proceedings. The question arises whether this calls for changing the procedures.

The appointment by the Enterprise Chamber of independent members of the Supervisory Bard or the Management Board to deal with certain specific issues addresses this problem. It has as a disadvantage that the board members so appointed by the Enterprise Chamber, as part of their function will have to carry out an analysis of the situation in which the company finds itself and the possible remedies. The steps they will have to take come close to a combination the activities of an investigator appointed in inquiry proceedings and the role of the Enterprise Chamber when measures are requested once the report on the inquiry is filed. Where open norms in corporate law result in law making by proxy by the Enterprise Chamber appointing independent board members to resolve specific issues may lead to decision making by proxy. As the *Versatel* case illustrates the actions of the board members appointed by the Enterprise Chamber continue to be subject to a certain measure of control by the Enterprise Chamber. The case also demonstrates the risks that result from an intervention in the management by the Enterprise Chamber in a fluid situation without a prior inquiry.

In view of the increased mobility of shareholders and the fact that the capital markets tend to react immediately, there may be a risk associated to this development. Given that there is as far as costs are concerned no downside and a listed company will generally have to change its course when an injunction is issued, the inquiry proceedings or rather requests for injunctive relief may become a tool for optimizing returns for the calculating investor. If that happens in a structural manner the Enterprise Chamber then inquiry proceedings risk to become part of the problem rather than part of the solution. The very fact that litigation is started before the Enterprise Chamber may have an affect on the share price of a company and may in that manner also become a tool for investors. There may be a relatively easy

8 Where insolvent listed companies are the object of an application for an inquiry one will – subject to the funding of the inquiry – generally see that an inquiry is ordered and held and that the Enterprise Chamber is subsequently asked to decide whether the company was mismanaged.

way to counter such development: the Enterprise Chamber could take into account the period during which shareholders asking for injunctive relief have been a shareholder in the company and the volume of the shares they have held when considering whether it will grant injunctive relief. The Enterprise Chamber will probebly do so in certain cases: In a case involving Unilever, which was not about corporate control or corporate governance as such the Enterprise Chamber indicated obiter dictum that it considered relevant the shareholder asking injunctive relief in that case only when they acquired their shares after the facts about which they had complained were widely known.[9]

Where the Enterprise Chamber appoints a board member with a casting vote (*Sarakreek*) or appoints board members to serve on a board with existing board members but who are entrusted on an exclusive basis with certain specific matters (*Begemann* and *Versatel*) the question arises how the two categories of members of one and the same board have together to decide on all other matters and what the responsibilities of the board members that have been appointed by the Enterprise Chamber entails. Do those members for instance have to account for their actions to the shareholders meeting and what is from a the perspective of accountability the position of the board members that have been appointed by the shareholders meeting for the actions taken by the members appointed by the Enterprise Chamber. This is still an open question but it may be that that question has been partially answered by the Enterprise Chamber when it gave a release (decharge) to the board members it had appointed at a company that was not listed. However it is questionable whether the Enterprise Chamber has the power to do so.

8.13 Closing Remarks

The Enterprise Chamber and the inquiry proceedings in combination with the possibility to ask the Enterprise Chamber to issue injunctions have proven their effectiveness. I see a number of risks that may turn into a threat for this success in the future:

a) The ever increasing use of open norms by the legislator in complex situations;
b) The automatic reaction of the legislator to designate the Enterprise Chamber to solve complex situations rather than putting effort in analysing the possibilities;
c) The tension between the type of pragmatic solutions offered by the Enterprise Chamber focusing on the company on the one hand and the rights or expectations of individual stakeholders on the other hand;
d) A lack of attention for the work load of the Enterprise Chamber in relation to its composition;
e) The risk that inquiry proceedings are denaturized by an increase of applications for injunctive relief and the risk that in listed companies short term investors may structurally seek injunctive relief form the Enterprise Chamber in order to realize short term benefits.
f) The best way to reduce this risk may be for the Enterprise Chamber to be vigilant as far as these developments are concerned. I realize that it will be difficult for the Enterprise

9 Court of Appeal Amsterdam 4 May 2005, JOR 2005/238.

Chamber not to accept an extension of its scope or to turn down a type of work such as requests for injunctive relief in active listed companies as part of a struggle for control or for a short term return on an investment. It may go against the grain of the Enterprise Chamber just like it is difficult for any advocate to say no to an interesting case also because a new case or a new development is always more appetizing than the case one is already doing.

9 Do Corporate Law Judges Matter: Some Evidence from Milan[1]

Luca Enriques[2]

Abstract
If corporate law matters to corporate governance and finance, then in order to assess its quality in any given country, one must look at corporate law off the books, *i.e.*, the characteristics of corporate law as applied by judges and other relevant public officials. This paper provides an assessment of Italian corporate law based on analysis of a sample of 123 decisions by the Milan Tribunal, Italy's most specialized court in corporate law. The judges' quality is evaluated by looking at: (1) how deferential they are to corporate insiders; (2) how keen they are to understand, and possibly take into account, the real rights and wrongs underlying the case before them; (3) how antiformalistic their legal reasoning is; (4) how concerned they are about the effects of their decisions on the generality of corporate actors.

The analysis casts a negative light on Milanese (and by extension, Italian) corporate law judges. It highlights egregious cases of deference to corporate insiders, especially with regard to parent-subsidiary relationships. Furthermore, only recently, and in any event still sporadically, have at least a few court's opinions been so drafted as to let the reader understand what the real dispute was and which party had really acted opportunistically. In any case, it appears to be rare for the court to take the substantive reasons for the dispute into any account. Cases are described, in which the court has adduced very formalistic arguments. And finally, there is no sign that the judges care about what signals they send to corporate actors: they appear to be quite unconcerned about whether their decisions provide the right incentives for directors and shareholders.

9.1 Introduction: Finance, Law, and the Role of the Judge

Participants in the debate on law and finance[3] unanimously agree, at least, upon two points.

1 First published in 3 *European Business Organization Law Review* (2002), pp. 752-821, and reproduced with the kind permission of the publisher. In 2003 a broad-sweeping reform of Italian Corporate Law was enacted. No account of it is taken here. I wish to thank Ferruccio Auletta, Fabrizio Barca, Marcello Bianchi, Fabrizio Cafaggi, Danilo Galletti, Amir Licht, Jon Macey, Curtis Milhaupt, Katharina Pistor, Alan Palmiter, Matteo Rescigno, Walter Santagata, Gianni Sofri, Lorenzo Stanghellini, Marcello Tarabusi, and participants to Workshops at the University of Siena and at the Columbia Law School, for helpful comments to previous versions of this paper. Marco Corradi, Federico Mucciarelli, and Alessandro Pomelli provided valuable research assistance. Usual disclaimers apply.

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3 This debate, as old as that on the public corporation (see Berle and Means 1933), was revived by works by La Porta, Lopez-de-Silanes, Shleifer and Vishny: see especially La Porta *et al.* (1997); La Porta *et al.* (1998) (arguing that good law in terms of investor protection is a necessary condition to the development of strong capital markets, on the basis of a statistical analysis showing that ownership is more dispersed and capital markets more developed in countries having a common law origin than in those having a French civil-law origin). Interestingly, Berle and Means argued that with separation between ownership and control, good laws are needed to protect investors (i.e., to maintain their confidence in the securities market), while LLSV argue that without the latter you can't get the former. Recent studies have shown that in the U.S. (as well as in the U.K.) the separation of ownership and control preceded good laws. See Coffee (2001a) and Cheffins (2001).

First, law does matter, as a necessary condition or, at the very least, a useful tool for the development of financial markets.[4] Even Professor Roe, who has recently questioned the idea that law is a precondition for the separation of ownership and control, admits that '[g]ood corporate law that stymies a grasping controller … is good for a nation to have … [as it] reduces the costs of running a large enterprise.'[5] Second, the relevant factor is not 'law on the books' as much as the combination of law and its enforcement mechanisms.[6] Also La Porta, Lopez-de-Silanes, Shleifer and Vishny (hereinafter LLSV) are well aware of the necessity to take enforcement into account in their oft-cited statistical analysis. The hypothesis they test is whether in countries with bad law on the books as gauged by their shareholder rights indexes,[7] 'active and well-functioning courts … step in and rescue investors abused by the management.'[8] They find that 'legal families with investor-friendlier laws are also the ones with stronger enforcement of the laws. Poor enforcement aggravate[s], rather than cure[s], the difficulties faced by investors in the French-civil-law countries.'[9] A more recent paper reports a few cases of abuse against minority shareholders in civil law countries as further evidence of LLSV's thesis that 'it is the laws themselves, *and the ways in which the courts apply them*, that matter for real outcomes.'[10]

If these two points of agreement, self-evident as they may seem today,[11] hold true, then for a better understanding of the relationship between law and finance it is helpful to inspect the interaction between the law on the books and its enforcement by judges.

4 Roe (2002: 236) dubs the 'law matters' thesis as '[t]oday's dominant academic and policy maker explanation for why continental Europe lacks deep and rich securities markets ' and see Roe (2002: 237), for references to authors accepting this idea.

5 Roe (2001: 5). See also Coffee (2001b: 2155). This author, while advancing the theory that social norms have a much more important role than legal rules in determining whether separation of ownership and control can arise in an economy, concedes that 'the[] "law matters" thesis …. would be highly plausible even in the absence of strong statistical correlations between minority protections and ownership dispersion' (*ibid.*).

6 See, e.g., Pistor *et al.* (2000: 328) ('For the law on the books to affect financial market development, law enforcement must be at least credible'); Berglöf and von Thadden (2000: 158) (suggesting that '[i]n all countries the problem is likely to be one of enforcement rather than of changes in the law'); Roe (2001: 10) (clarifying that what might count as a precondition for strong securities markets would be not just the 'law-on-the-books,' but the '"law on-the-books," including basic securities law on-the-books, as well as the quality of regulators, the efficiency, accuracy, and honesty of the court system, and so on'). See also Coffee (1999a: 6) (supporting 'the hypothesis that what really counts is not the content of the substantive law, but the adequacy of the enforcement mechanisms that underlie it').

7 See La Porta *et al.* (1998: 1126-34).

8 La Porta *et al.* (1998: 1140).

9 La Porta *et al.* (1998: 1145).

10 Johnson *et al.*, (2000: 26) (emphasis added).

11 The first statement used to be far less obvious at the time when the law and finance debate centered upon the U.S.: see especially Easterbrook and Fischel (1991: ch. 1) (arguing that law has a very marginal role compared to the markets in preventing outsiders' exploitation by insiders); Black (1990) (showing that U.S. corporate law is made of market-mimicking rules, avoidable rules, changeable rules and unimportant rules). But see also Coffee (1989: 1620-21) (noting that U.S. corporate law flexibility has gone together with 'greater judicial activism in reading implied terms into the corporate contract and in monitoring for opportunism'); Macey (1989: 1693) (stressing the central role played by Delaware judges in U.S. corporate governance); Barca (1998: 10-12) (same); Kamar (1999: 891) (describing U.S. corporate law as 'a set of loosely defined guidelines made concrete by courts after the fact'). The second statement has become even more obvious in the light of the experience of transition economies, where corporate law on the books has been shown to be as good as or even better than that of common law systems. See Pistor *et al.* (2000). See also Black *et al.* (2000: 1756-57) (recognizing that even Russian law, designed under the advice of Professors Black and Kraakman as a 'self-enforcing' model of corporate law, was absolutely irrelevant, due to the extreme weakness of the Russian enforcement system and especially of the courts).

Part II, after showing how poor enforcement may render 'good' (*i.e.*, effectively protecting minority shareholders) corporate law[12] on the books irrelevant (Section II.A), explains how, as LLSV also sensed, good corporate law 'off the books' may in theory develop in any jurisdiction, no matter how bad its formal statutory law (Section II.B). It then shows what kind of corporate law rules may most contribute to the absence of such a positive development (Section II.C).

Next, the analysis focuses on corporate law judges, to identify the requisites they must have in order for corporate law on the books (bad or good) to be good 'off the books' (Section II.E). I argue that, in order to provide a good corporate law landscape, a country must have honest and sophisticated judges who: (1) show no deferential attitude towards insiders when conflict-of-interest situations are involved; (2) are endowed with the 'nose' to sense what really is at stake among the litigants and the real causes of the dispute; (3) do not partake of a formalistic legal culture; (4) are concerned with the impact of their decisions on the future behavior of corporate actors in general.

To illustrate the relevance of these characteristics, I briefly describe recent developments in Italian corporate governance and its legal landscape (Part III), with some background information on shareholder litigation and Italian judges' 'style'[13] (Part IV). This introduces an empirical analysis of how the most specialized court in Italy for corporate law cases decides them (Part V). The analysis casts a negative light on Italian corporate law judges, and, by implication, confirms the negative picture of Italian corporate law, which can be so frequently found in the literature. Part VI concludes.

One last preliminary remark: this paper mainly focuses on the conflict of interest between outside investors and insiders (managers and controlling shareholders), typical of the listed corporation, but attention will also be given to disputes among shareholders in closely held corporations. Although the corporate governance debate usually centers on listed companies, it would be wrong to think that law matters only for them, or, as Professor Hertig has put it, 'to allege that smaller firms necessarily face a fundamentally different set of corporate governance issues. For example, the fact that a firm is closely held does not prevent complex decision-making issues from arising, in particular when the firm is family owned or attempts to overcome size disadvantages by cooperating (formally or informally) with other firms' (Hertig in press: 5).

12 Two clarifications are at point here: first, I am well aware that good corporate law is not simply one which effectively protects minority shareholder, as instead one which efficiently solves the trade-off between investor protection and the provision of firm-specific human capital by insiders, see Barca (1998: 3-4); see also Berglöf (1997: 114). Since this refinement is, albeit mostly implicitly, uncontested, the simplified definition of good corporate law in the text is fully acceptable. Second, following Roe (2001), I will use the expression 'corporate law' as including 'basic securities law.' Although my focus will be on corporate law stricto sensu, the analysis could be easily extended to securities regulation, by adding the quality of the securities agency into the picture.

13 I borrow this word from John Merryman's 1965-66 works on the 'Italian style,' which very well depicted the Italian legal system and are still relevant today: see Merryman, (1965), (1966a), and (1966b).

9.2 Corporate Law 'off the Books' and How Judges (May) Shape It

This part highlights the central role of judges in shaping the legal environment for corporate actors (investors, blockholders, managers) and how corporate law on the books may influence the way in which judges perform their role. This may produce a better understanding of which legal features really matter for corporate governance, and of what policymakers interested in improving a country's securities markets by legislative reform can do.

9.2.1 How bad judges can spoil good law.

At the most basic level, everyone agrees that a certain degree of honesty among judges and judicial effectiveness (in terms of speed and practical enforceability of courts' decisions) are necessary elements of a sound corporate law system.[14] Their absence is a real problem today mainly in developing countries (Buscaglia and Dakolias 1999). In the richer countries, including continental Europe, judges are sufficiently honest and the judicial system is broadly efficient, at least in corporate cases. This fact, which is reflected to some extent in the LLSV data,[15] also holds for Italy, which scores last in corruption and second to last (just above Spain) in judicial efficiency among countries with above average GDP (La Porta *et al.* 1998: 1142-43). In fact, according to a recent inquiry, corruption of judges in Italy is a rare phenomenon (Savona and Mezzanotte 1998: 46). And even the undeniable length of Italian trials[16] is less important in corporate law cases, where parties often ask for preliminary decisions (after which they usually abandon the case)[17] or injunctive remedies. Such rulings can usually be obtained in a matter of weeks, or at worst months (Stanghellini 1999: 36; Galletti 2001b).

Of course, honesty and speed alone are not enough. Even a quick and honest judiciary can spoil 'good' corporate law on the books. Most legal systems provide for fiduciary duties, under one name or another,[18] but judges' inclination to enforce them strictly differs greatly.[19] The most interesting case in point is Japan, where the American corporate law draftsmen, in introducing the requirement of board approval for conflict-of-interest transactions (Article 265 of the Japanese Commercial Code), clearly 'intended to import … princi-

14 See La Porta *et al.* (1998: 1140) (identifying corruption and efficiency of the judicial system as proxies for quality of law enforcement); Black (2001a: 790-91 and 807) ('An honest judiciary is a must for investor remedies to be meaningful. …. Speed is important too. …. [W]hile courts nowhere move quickly, differences in how fast they move affect the salience of investor remedies').

15 La Porta *et al.* (1998: 1141-1143).

16 See, e.g., Istituto di Studi e Analisi Economica 2001: 4 (showing that civil processes in Italy last on average 116 months, longer than anywhere else in the European Union).

17 Galletti (2001a) (Galletti is a highly regarded judge, who has specialized in corporate law and now serves in the court of Monza, a small but important business center near Milan).

18 See Enriques (2000a: 302-03) (Germany, Italy and France also impose a duty of loyalty on corporate directors); Black (2001b: 4) ('In civil law countries, directors' duties are not called 'fiduciary' duties, because a fiduciary is a common-law concept, but the practical scope of the duties is similar.' Arguably, it is more precise to say that the practical scope of the duties might be similar, if only judges so wished).

19 See Shleifer and Vishny (1997: 752) ('Although the duty of loyalty is accepted in principle in most OECD countries, the strictness with which the courts enforce it varies greatly'). But see contra Hertig in press: 15 ('It is exaggerated to believe, as common law scholars often do, that the duty of loyalty as conceived in continental European jurisdictions is significantly less protective of minority shareholders'); Hertig (1998: 48) (same).

ples that would be recognized by any common lawyer as involving essentially fiduciary standards' (Nakajima 1999: 51). Yet, 'in considering whether there has been a conflict of interest, Japanese judges have shied away from attempting any detailed analysis of the facts let alone attempting to lay down any principles of general application' (*ibid.*). Similarly, while Article 2391 of the Italian Civil Code seemingly requires company directors to remove themselves from decisions involving self-interested transactions,[20] according to the construction that has prevailed in the courts (and among legal scholars)[21] it only imposes a duty of fairness upon the director when deciding upon the transaction (either in the boardroom, when a vote by the board is required, or when directly acting on the behalf of the corporation).[22]

9.2.2 How good judges may fix things up (even in civil-law systems)

While it is plain common sense that 'bad' judges may spoil good laws, the reverse is somewhat counterintuitive but no less true. After all, at the time when English and American corporate law on the books provided no protection against unfair self-dealing, it was the courts that extended the fiduciary obligations applying to agents and trustees to corporate directors (Black 2001b). Some scholars argue, however, that judges could fix corporate law up only in a common law system. In this view, civil law systems, marshalling their codes of bright line rules to eliminate all gaps in the law, minimize the opportunity for judicial discretion and innovation, hence for the development of 'better' corporate law (Coffee 2001a: 62; Johnson *et al.* 2000).

This vision of civil law systems as limiting judges' ability to forge new rules reflects more the ideology of the civil-law tradition than the way such systems actually work. Civil law codes certainly contain bright line rules, but they also provide for 'general clauses' (*Generalklauseln*, in German, *clausole generali*, in Italian), *i.e.* standards that must be specified by judges case-by-case.[23] More, in some instances civil law judges create new standards themselves or extend the application of existing ones to areas other than those that the codes explicitly posit: a codified law is no relevant obstacle to this process.[24]

20 See Enriques (2000b: 113-19). According to Article 2391, '[a] director who, in a given transaction, has an interest in conflict with that of the company, either for his own account or for the account of third persons, shall give notice thereof to the other directors and to the board of auditors and shall abstain from participating in the decisions concerning the said transaction' (translation by Colussi 1993: 161).

21 Reference to how legal scholars construe statutes will be frequent in the following, for the simple reason that in Italy legal scholars have a great influence on judicial interpretation; see Merryman (1966b: 585-86); Sacco (1992: 269-71).

22 For references, see Enriques (2000b: 189-91) (citing the very few court decisions sticking to strict construction and the large number, including some from the Supreme Court, providing the loosen construction cited in the text). This construction (which I have elsewhere criticized: see *ibid.*) is based upon a restrictive interpretation of the terms 'interest in conflict with that of the corporation,' as including only situations in which the transaction would (instead of could) damage the corporation if approved and executed (*ibid.*). See also Enriques (2000a: 318-19), for a clarification on the equivalence between the substantial fairness judgment (as conducted for instance by U.S. courts) and the judgment upon whether the transaction or resolution would harm the corporation (as required by the Italian law).

23 See di Majo (1988: 305-08) (analyzing the structure and function of standards with reference to the Italian and German legal tradition).

24 See Hertig in press: 15 ('[in civil law countries] core rules and standards put [no] specific constraints on the development of US-type doctrines').

9.2.3 What substantive and procedural rules on the books may prevent the rise of good corporate law off the books?

It may be objected that a bad corporate law system is also one that does not give minority shareholders access to justice, *e.g.*, standing in derivative or class actions, and so on. In a system with such a procedural barrier to the protection of minority shareholders, it would be impossible for judges to develop a friendlier legal regime, because they will see no corporate law cases involving a dispute between minority shareholders and insiders at all. One can reply, first, that convergence between common law and civil law systems with this regard is already under way (Hertig in press: 16); second, and more importantly, that no corporate law in the world is so hostile to minority shareholders as to give them no legal remedy at all, however indirect it may be. In Part IV, I will show how even Italian corporate law, so often dubbed as unfriendly to minority shareholders, gives them at least two relevant ways to call the court's attention to misconduct by majority shareholders and/or managers. However, as I shall also point out, these avenues are often 'ostensible,' meaning that minority shareholders, lacking the standing to ask a court to judge the specific behavior that purportedly harmed them, must challenge other courses of action or decisions, alleging some irrelevant or collateral violations of the law and hoping that the judge will see through the case and take real rights and wrongs into account in her ruling.[25]

Consider two examples drawn from the corporate law area to support this proposition, one from Germany and one from Italy.[26] The German corporation statute (*Aktiengesetz*) says nothing on whether shareholders have a reciprocal duty of loyalty (*Treuepflicht*), but the Supreme Court, following a protracted scholarly debate (see, *e.g.*, Wiedemann 1991), has ruled that this duty does exist and requires that majority shareholders take the interests of minority shareholders into account in exercising their corporate powers.[27] A similar evolution can be observed in Italy, where no explicit statutory provision restricts the discretion of majority shareholders in exercising their voting rights with regard to resolutions on dividends, new issues of shares and liquidation.[28] Italian courts, though, have invalidated resolutions

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25 What minority shareholders expect to gain from the judge's decision in such cases is normally a stronger bargaining position against insiders to reach some kind of settlement. This is especially the case for closely held corporations. At least in theory, actions of this kind may be brought also in the context of listed corporations, as a useful bargaining tool for minority shareholders, such as institutional investors, acting as monitors of the management. Yet, even in the U.S. active institutional investors appear to use litigation as a bargaining tool against insiders only rarely. See Johnson (1997: 392) ('To date, only a small number of institutional investors have chosen to file class complaints or to intervene in existing securities class action'); see also Davies (1997: 67) ('[in the U.K. institutions] are usually unwilling to litigate').

26 Delebecque (1998: 68-69) provides examples drawn from French case law in order to illustrate his statement that '[French] corporate law, originally very rigid, thanks to intervention by the judges has become a flexible law' (*ibid.*; translation from Italian by the author). See also Hertig in press: 15 ('civil law jurisdictions are showing "common law creativeness" in protecting minority shareholders'); Cafaggi (2001: 61-62) (reporting that Italian courts have ever more frequently applied standards in the corporate law area).

27 The Supreme Court first stated this principle in the 1988 case Linotype (103 BGHZ 185), then confirmed it in the 1995 case Girmes (129 BGHZ 137) and in the 1999 case Hilgers (44 Aktiengesellschaft 517 (1999)).

28 See Campobasso (1998: 327-28): this corporate law textbook, which is the leading one in Italy, reports as 'dominant and correct' the view that Article 2373 of the Italian Civil Code, declaring voidable a shareholder resolution passed by the vote of a shareholder who has an interest in conflict with that of the company, if the resolution would bring damage to the company, does not apply to resolutions on the issues mentioned in the text). According to Italian corporate law the power to decide whether to distribute dividends, to issue new shares and to liquidate the company is assigned to the shareholder meeting.

on these matters, when they were convinced that the resolutions harmed minority shareholders and had no legitimate business purpose. The courts have based their decisions either on the grounds that majority shareholders had abused their voting powers or, under another construction, that they had violated their duty of good faith to other shareholders.[29]

The foregoing analysis carries three implications: first, when corporate law on the books is bad in terms of access to justice for minority shareholders, judges will have to be comparatively more interventionist and better at understanding (and possibly more willing to take into account) the true rights and wrongs behind the dispute; second, there will often be no way for the judges to tackle the real issue, *i.e.*, fairness to minority shareholders, and hence to develop coherent and comprehensive case law lending substance to the duty of loyalty; third, as it is more difficult to bring suit, judges will gain less experience in the core corporate law area of fiduciary duties and thus find it harder to develop a 'nose' for corporate misconduct.[30] Consequently, corporate law will be less expressive[31] and its enforcement will be less frequent.

This problem is even more acute for 'bad' corporate law jurisdictions lacking contingency fees or the standard 'American rule' that each side bears its own legal fees:[32] in other words, in these jurisdictions the law does not provide the incentives necessary for derivative suits and class actions to be brought frequently enough to deter insiders' misconduct. The consequence may be an even lower level of corporate law enforcement (Hertig in press: 16) and, as already hinted above, greater difficulty for courts to become sufficiently skilled in corporate law matters, and more precisely in understanding whether a specific transaction or resolution is fair. In itself, however, the lack of instruments providing these incentives does not absolutely prevent courts from developing a more friendly corporate law environment.

One last comment on the development of corporate law expertise is appropriate. If the substantive and procedural rules in place make it harder for courts to develop such expertise, then the judges themselves will feel they have little legitimacy to take an active role in corporate law issues or to second-guess insiders' behavior and business decisions, however tainted by conflict of interest they may be. This will be so because judges may fear that they would make wrong decisions or even because they may be aware that they cannot grasp the technicalities of the business transactions they must review. Hence, they will be keen to apply substantive or procedural rules barring the review of business decisions for fairness.

29 Campobasso (1998: 327-28) (citing a number of opinions by the Italian Supreme Court – Corte di Cassazione).
30 See *infra* note 35.
31 On the expressive function of judge made law see Cooter (1998).
32 Emphasis on the absence of contingency fees and of the 'American Rule' outside the U.S. is given respectively by Hertig (in press: 16), and by Coffee (1999: 6-7). In confirmation of the thesis that in civil law systems too judges may introduce investor-friendly innovations, it is to note that in Italy the procedural rules would allow judges themselves to develop the American rule, since the law states, as a general rule, that the losing party has to pay the winner's legal costs (Article 91, Civil Prodedure Code (Italy)), then specifies that, in the presence of 'just reasons' (self-evidently: a standard whose content has to be defined by courts), the judge may make each side bear its own legal costs (Article 92, Civil Prodedure Code (Italy)): hence, nothing in the law would prevent Italian judges from developing the principle that, save in frivolous actions, just reasons for the application of the American rule occur when minority shareholders bring suit against insiders.

9.2.4 *Some preliminary conclusions*

From the discussion to this point, three preliminary conclusions can be drawn. First, bright line rules, and substantive corporate law on the books in general, cannot foreclose the creation by judges of a more investor-friendly legal environment: judicial application of standards and general principles may do the trick. Second, substantive and procedural rules limiting investors' power to challenge insiders' conduct before courts have a three-fold indirect negative impact on corporate law off the books: in order for judges to ameliorate corporate law, they must be comparatively more interventionist, *i.e.*, better at understanding and more willing to take into account the true rights and wrongs of the dispute; moreover, since judges will rarely have the chance to tackle the core issue, *i.e.*, the fairness of majority shareholders' or managers' behavior, it will be harder to develop a coherent and comprehensive case law giving substance to the duty of loyalty; more generally, as lawsuits involving disputes between investors and insiders will be less frequent, judges will gain less experience in the core area of fiduciary duties and thus will have greater difficulty in developing, in Professor Allen's words, 'a textured situation sense respecting the problems of fiduciary duty in corporation law' (Allen 2000: 73). Third, this in turn will lead to a certain stickiness of 'bad' corporate law, as judges see themselves as lacking the legitimacy to second-guess insiders' business decisions.

9.2.5 *Assessing the quality of corporate law judges: some relevant features*

As a corollary to these conclusions, this Section identifies the most relevant features to be taken into account in order to assess one legal system's quality of corporate law judges.

Honesty, rapidity, and expertise

As already suggested, the honesty of judges and the rapidity of the courts are basic preconditions for a good corporate law system. A third relevant feature, as suggested, is a sufficient degree of sophistication and business expertise on the part of judges.[33]

No deference in conflict-of-interest cases

Business expertise, however, is not enough. Suppose that in a country with equity markets dominated by a few families or networks of managers and families thanks to pyramids, cross-holdings and other deviations from the one-share-one-vote principle,[34] the government succeeded in hiring as judges the most prominent transactional lawyers. No matter how long their mandate, such people can be expected to be quite lenient in judging their former clients' behavior, practices, and transactions. These transactions will presumably resemble those that the judges, in their former capacity as transactional lawyers, used to shape and to give advice on; and needless to say, these judges will probably have personal or at least social ties with many corporate insiders.

33 Black (2001a: 791). Of course, it is always true that 'judges are not business experts' (*Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (1919)). However, some judges undeniably have less business expertise than others.

34 This is the picture of an average country's equity markets: the U.S. and U.K., with their large number of independent public companies, are the exception. See, e.g., La Porta *et al.* (1999).

This scenario shows how business expertise is a necessary, but not sufficient condition for courts to protect minority shareholders' interests. Also needed, then, are unawed judges, who feel legitimacy to review the merits of insiders' self-interested transactions and decisions. In short, judges must not hesitate to strike such transactions and resolutions down, whenever they 'stink badly enough.'[35]

Capacity to identify real rights and wrongs

Judges should develop a good nose also for the real rights and wrongs underlying the specific facts alleged by the parties.[36] In other words, judges should be endowed with the curiosity to learn the whole story of the corporation involved in the dispute, to find out the role played by each party, and their relations with one another, in order to understand who acted opportunistically and, more generally, what went actually wrong. In short, they should be willing and able to learn all 'the particulars of the case,' and 'to be directly open to arguments based upon moral precepts of fairness and justice.'[37] This feature is especially important for closely held companies, in which disputes among shareholders often involve relationships of personal trust and opportunistic behavior by one shareholder-manager to the detriment of another who normally has made firm-specific human capital investments (Easterbrook and Fischel 1991: 229-30). This same feature is generally central, as already suggested, in legal systems that restrict access to justice for minority shareholders.

Antiformalism

Judges should be immune from a formalistic legal culture, which unfortunately still predominates in many civil law countries.[38] Antiformalism is a precondition to the ability to play a creative role in evaluating the real rights and wrongs behind the dispute.

Furthermore, when the law requires corporate actors to comply with certain formalities, which may be absolutely unjustified in smaller companies and are hence often disregarded,[39] frivolous suits may well be brought simply to extract side-payments from the corporation or from majority shareholders. When such suits are brought, good judges should construe formalities as narrowly as possible. A narrow construction will also reduce the burdens such rules

35 It is well known that U.S. practitioners refer to the fairness test as applied by Delaware judges as the 'smell test.' As Yablon (1991: 502) puts it, 'if the terms of the underlying transaction stink badly enough, the [Delaware] courts will find a way to abrogate any procedural protection supplied by the business judgment rule.'

36 Cf. Hansmann and Kraakman (2004: 26) ('judges must … understand the possible motivations, both legitimate and illegitimate, of corporate actors').

37 Allen (1992: 17) (highlighting the distinctive features of Delaware judges' attitude towards the cases they are called to decide upon).

38 See, e.g., Zweigert and Kötz (1998: 122-23) (with specific reference to the French Cour de Cassation).

39 In some continental European countries, even medium-sized firms adopt the form of the public limited corporation, even though the law may be quite strict and burdensome. See Rojo (1993: 6-7) (contrasting the German model of corporation, which is thought exclusively for large firms, usually listed on a stock exchange, with the 'Latin' model of corporation adopted by France, Belgium, Italy and Spain, which is relatively more flexible and is widely spread among medium-sized businesses with few shareholders). In Italy the reasons for the adoption of the stock corporation (società per azioni) by medium businesses, although another, less burdensome, form of limited liability company exists (società a responsabilità limitata) have to do (a) with the fact that only stock corporation shares may be represented by a certificate (azioni), which in turn makes it easier to transfer them and to give them as guarantees to banks, and (b) with a sort of higher respectability of società per azioni, especially among bankers: see Weigmann (1996: 904).

impose on businesses. But in countries that restrict minority shareholders' ability to bring suit, it may happen that minority shareholders allege the violation of rules of this kind for want of more direct access to the courts. In such cases, judges should be ready to play the formalist and rule in favor of the plaintiff, if they are satisfied that, given the peculiarities of the specific case and possibly of opportunistic conduct by insiders, they may strengthen the plaintiff's bargaining position or otherwise favor him or, in the end, punish misconduct by insiders.[40] In other words, good corporate law judges working under 'bad' substantive and procedural rules should be ready to be 'functionally' formalistic.

Concern for spillover effects

Finally, good corporate law judges should be concerned with the message their decisions send to corporate actors on what is (im)permissible and (un)fair. In other words, judges should always be conscious that their decisions mold corporate actors' behavior and, more specifically, affect the incentives to act cooperatively instead of opportunistically.[41]

9.2.6 Conclusions

To conclude, corporate law off the books, even in civil-law systems, can be very good or very bad, irrespective of the quality of corporate law on the books, depending on the quality of judges. However, it will be harder for judges to fix things up when substantive or procedural rules limit minority shareholders' ability to bring suit against insiders. In any event, to evaluate the quality of judges, one should assess: (1) at the most basic level, their integrity and the speed of the judicial system in deciding cases; (2) their business expertise; (3) their independence from (as opposed to deference to) corporate insiders; (4) their ability to understand where rights and wrongs actually lie; (5) their antiformalism; (6) their concern for the behavior-molding potential of their decisions.[42] In Part V I shall evaluate the 'quality' of decisions by Italy's most important court for corporate matters on the basis of the last four of these criteria. First, however, it will be useful to briefly describe the Italian corporate governance system and the role of the courts in it.

9.3 Corporate Law on the Books and Corporate Governance in Italy: Recent Developments

The purpose of this part is to inform the reader about recent developments in Italian corporate governance and corporate law, as a background to the empirical analysis of Part V. Cor-

40 Of course, judges in these cases must be careful to write opinions that allow future judges to identify functionally formalistic reasoning that may not be appropriate in other cases.

41 See Barca (2001: 10-11) (arguing that this concern for spill-over effects is a necessary precondition for successful reform of Italian corporate law); Barca (1998: 8) (stressing how central this concern is to Delaware judges' decision-making); Fisch (2000: 1079) ('Delaware courts … have repeatedly announced legal principles solely to guide future decisionmaking'). See also Allen (1997: 895) ('the elemental purpose of corporation law is the facilitation of cooperative activity that produces wealth').

42 Predictability is noticeably absent from this list of relevant features. Arguably, this is not such an essential feature, as the unpredictability of Delaware judges' decisions suggests. See, e.g., Fisch (2000: 1078-1079); Allen (2000: 72).

porate law on the books has been improved by the reform enacted in 1998,[43] but its effectiveness in better protecting minority shareholders is still dubious. The 1998 reform has also made it more probable that courts will be asked to evaluate and possibly punish insiders' misconduct. This, in turn, makes the empirical inquiry in Part V relevant also to a forward-looking assessment of the Italian corporate governance system.

In the last decade, the literature has generally depicted Italy's corporate governance system as the black sheep among the most industrialized countries, sometimes associating it with such notorious ones as Russian and Korean systems.[44] Italy scored poorly in LLSV's indices, especially the antidirector rights index.[45] According to Professor Macey (1998: 140), in Italy '[t]here is a complete absence of protection for minority shareholders;' and recently, one Milan court's decision has been brought as an example of how civil law judges are unable to enforce fiduciary duties (Johnson *et al.* 2000: 24-25).

This bad name reflected some well-known data on Italian corporate governance. The ratio of market capitalization to GDP used to be lower than in other industrialized economies,[46] with very few listed companies and IPOs (Macey 1998: 133-34). The voting premium, which is widely recognized as a good proxy for private benefits of control (Roe 2002), is among the highest around the world.[47] The use of pyramids and other deviations from one-share-one-vote has traditionally been very common, allowing families and networks of families and managers to retain control of the largest Italian corporations.[48]

43 Legislative Decree 25 February 1998, No. 58, Consolidated law on financial intermediation pursuant to Articles 8 and 21 of Law 52 of 6 February 1996 (in Italian: 'Testo unico delle disposizioni in materia di intermediazione finanziaria, ai sensi degli articoli 8 e 21 della legge 6 febbraio 1996, n. 52'; hereinafter, in short: T.U.I.F.). An English translation of this statute is available at the Web site of the Italian securities and exchange commission, Consob (www.consob.it).

44 See Shleifer and Vishny 1997: 742 ('In many countries today, the law protects investors better than it does in Russia, Korea, or Italy'). For an account of how bad Russian corporate law off the books is, and especially was in the mid-Nineties, see Black *et al.* (2000: 1752-53). On the Korean corporate law and governance system, see Milhaupt (1998: 1158-79); Milhaupt (2001: 206-08) (describing the typical 'chabeol group' and how corporate law is highly ineffective in preventing minority shareholders' wealth expropriation by the dominating families).

45 La Porta *et al.* (1998: 1131) (finding that Italy has in place only one of the antidirector rights which build LLSV's antidirector index). To be sure, LLSV's data are not very accurate with regard to Italy. In fact, even prior to the 1998 reform, contrary to LLSV's data, proportional representation on the board was allowed (and even mandated for privatized companies since 1994: see Bianchi, Bianco, and Enriques 2001: 185) no less than in the U.S. (where the cumulative voting system is permitted, but rarely used: see Roe, 2001: 27). There is also some arbitrariness in the choice to assign Italy a 0 under the 'Oppressed minority' heading, since the Article 2409 procedure (which I will describe *infra*, text accompanying notes 78-85) has been in place since 1942.

46 Romano (1993: 137) provides 1988 data showing that the market capitalization/GDP ratio for Italy was the lowest (16.1 percent) in a sample comprising some of the most industrialized economies, i.e. U.S. (with a ratio of 51.2 percent), the U.K. (84.9), West Germany (20.4), France (23.8), Canada (43.6), Switzerland (82.9), Spain (24.5), the Netherlands (38.2), and Belgium (38.1).

47 See Zingales (1994: 126) (finding an outrageously high voting premium for companies listed on the Milan Stock Exchange, 82 percent, compared to the much lower figures found by other researchers for other countries – using, to be sure, different methodologies); Nenova 2000; this is the first study calculating the voting premiums across countries using the same methodology, and shows that the voting premium in Italy is just below 30 percent, compared to much lower values for other industrialized countries, such as Sweden (1 percent), the U.K. (9 percent), the U.S. (2 percent) and Germany (9 percent). Italy's figure is just slightly higher than France's (28 percent).

48 See Bianchi , Bianco, and Enriques (2001: 180) (providing data on pyramidal groups in Italy); Bianchi, Fabrizio, and Siciliano (1998) (providing data on cross holdings in Italy).

Considering only corporate law on the books, one could argue that things have changed completely with the 1998 reform. Among other things, the new law, which applies only to listed corporations, has: (a) reduced to 10 percent the percentage of voting share capital required to call an extraordinary shareholder meeting;[49] (b) allowed minority shareholders representing 5 percent of the voting shares to bring derivative suits against directors;[50] (c) allowed for voting by mail.[51] With these three reforms, Italy would definitely jump right to the top in the LLSV's antidirector rights standings.[52]

A closer look at current Italian corporate law on the books, though, warrants a lower degree of optimism about the effectiveness of the new rules in protecting investors. In listed corporations, the 10 percent stake required to call a shareholder meeting is seldom reached by institutional investors, either individually or jointly.[53] Considering how hard it is to form coalitions among institutional investors willing to move proactively against insiders (Black and Coffee 1994), it is not surprising that this right (which is the only Italian equivalent to shareholder proposals: Bianchi and Enriques 2001) has been exercised only once until today (Consob 2002). Much in the same vein, it is not surprising that no derivative suit has been brought by minority shareholders since the reform came into force on 1 July 1998. Further, seven Italian listed corporations' charters only allow for shareholder voting by mail (Consob 2001).

Even more importantly, the 1998 reform brought no relevant change to the law on self-dealing transactions (Enriques 2000b: 132-33), which are among the most common tools of 'tunneling' in Italy[54] as well as elsewhere.[55] As a matter of fact, recent anecdotal evidence suggests that the private benefits of control remain high.[56] And significantly, the use of pyra-

49 Article 125, T.U.I.F. (in connection with Article 145, Para. 6, T.U.I.F. which clarifies that '[t]he share capital represented by savings [i.e., non-voting] shares shall not be counted … for the purpose of calculating the ratios referred to in … Articles 125, 128 and 129 of this decree'; translation available at www.consob.it).

50 Article 129, T.U.I.F. (see also the preceding note). This provision allows corporate bylaws to fix a threshold lower than 5 percent. Not surprisingly, no listed corporation has lowered the threshold. See Consob 2001: 28.

51 Article 127, T.U.I.F. (to be precise, this provision has lifted the previous ban on clauses in corporate charters allowing shareholders to vote by mail).

52 Italy would now have a score of 5, the same as United States and United Kingdom, see La Porta *et al.* (1998: 1130). To be sure, one could doubt whether it would be correct to consider the provision on voting by mail as 'allow[ing] shareholders to mail their proxy vote to the firm', see La Porta *et al.* (1998: 1122), since this is possible only if the corporation bylaws so provide. However, consistent with LLSV choice to assign the U.S. 1 with regard to 'Cumulative voting or proportional representation', see La Porta *et al.* (1998: 1130), although Delaware law only provides for cumulative voting as a default rule (see *supra* note 395), it would be fair to assign Italy 1 on 'Proxy voting by mail allowed.'

53 See Bianchi and Enriques (2001: 29) (showing that at the end of 1998 institutional investors singularly held a 10 percent stake in only 5 listed corporations, while the three and five institutional investors with the largest holdings aggregated 10 percent or more in 17 and 24 listed corporations respectively, i.e., in 8 percent and 11 percent of all listed companies).

54 See Zingales (1994: 146-47) (describing a transaction in 1992 in which the majority shareholder had an interest, and which clearly damaged minority shareholders).

55 Johnson *et al.* (2000: 22-23); Milhaupt (2001: 206) (with specific regard to Korea).

56 In February 2000 the board of Telecom Italia, the former monopoly telecommunications company taken over less than a year earlier by a pool of investors led by Roberto Colaninno and Emilio Gnutti, decided to take over a leading Internet company (Seat), whose shareholders included a holding company in which Colaninno and Gnutti had an indirect interest. The aggregate gain from the transaction for Colaninno and Gnutti was around 13 million euros. See Pons (2001). More recently, Pirelli took working control of the holding company controlling Telecom Italia, paying an 80 percent premium above the market price. See Ratner (2001). And see also Lex Column 2001 ('Mr. Tronchetti Provera [Pirelli's C.E.O.] may find the only way to [recoup such a big premium] is to abuse Pirelli's control. TI and TIM investors should be wary: their new master has as many potential conflicts of interest as the old [i.e., Colaninno and Gnutti]').

mids as a means of separation between ownership and control has hit an all-time record with the acquisition of Telecom Italia by Pirelli in the Summer 2001.[57]

To be sure, there are also signs of change.[58] A few facts are worth mentioning here. First, market capitalization is much higher today than in the past, having come into line with the European average (Draghi 2001), and IPOs have boomed in the last few years (Coffee 1999b), especially (and understandably) before the Internet bubble burst in Spring 2000.

Further, the Italian press has recently been readier to criticize transactions that serve the interest of the controlling shareholder instead of maximizing shareholder wealth, and it has also started to find it awkward to accept that controlling shareholders may gain (whether fairly or not) from related-party transactions without at least letting the market know it (something which would have gone through unobserved only a few years ago).[59] At the beginning of 2001, a proposed parent-subsidiary merger was blocked by minority shareholders, who took advantage of a provision in the 1998 reform, according to which certain resolutions have to be approved by two thirds of the shareholders attending the meeting.[60]

57 See Minervini *et al* (2001). Beyond causing a 20 percent collapse of Pirelli's shares on the market; see Brown *et al.* (2001), the acquisition of Telecom by Pirelli received harsh critiques from the Anglo-Saxon press also for the excessive use of shareholder cascades by Pirelli's controllers. See, e.g., Leader (2001); The Economist (2001a). To such critiques Marco Tronchetti Provera, the C.E.O. of Pirelli and a member of the controlling family, replied: 'Sure, if you look at it with anglo-saxon eyes, there is no transaction in Italy which escapes criticism. …. They want to tell us what the rules are, but when we go there (i.e., when we try to make an acquisition in the U.S.), we only find poison pills discouraging foreign investment', see Polato (2001; translation by the author). And he also stated: '[minority shareholders] may come and go as they please, like any shareholder', see The Economist (2001a: 53). These statements remind one uncomfortably of Raul Gardini's reaction, more than ten years earlier, to the harsh criticism which followed the announcement of an unfair parent-subsidiary merger within the group he headed at the time (and which later collapsed): 'Mr. Gardini replied that he would not be judged by "Wall Street criteria." He also noted that "(t)his is an (I)talian operation in the Italian context and those shareholders who do not like it can leave it" See Macey (1998: 132).

58 For a rosier picture of corporate governance in Italy see Stanghellini (1999: 31-42) (concluding that 'the theory of the lack of protection of minority shareholders as a cause of the delay in the development of the Italian stock market is hardly credible').

59 See Pons (2001). The market only got to know about Colaninno and Gnutti's conflict of interest (see *supra* note 54) a year after the acquisition of Seat went through, also thanks to Consob's pressure on the Telecom's board (which was at the time chaired by Colaninno). The press covered the story extensively and very critically. One may realistically wonder, however, whether the press would have been as critical had the interested directors been Giovanni Agnelli (who controls the Fiat group) or Marco Tronchetti Provera (who controls the Pirelli group), i.e., two insiders 'more insider' than Colaninno and Gnutti. As a matter of fact, Marco Tronchetti Provera was until the end of September 2001 the chiarman of Il Sole 24 Ore Editore, the publisher of the Italian leading financial newspaper (Il Sole 24 Ore), which is owned by Confindustria (the Association of Italian Industries). The Agnelli family owns one of the leading Italian newspapers, Turin's La Stampa. Carlo De Benedetti (who is still today at the head of a listed conglomerate) controls La Repubblica, one of the two best-selling newspapers, the other one (Il Corriere della Sera) being under the control of a coalition of shareholders comprising, among others, a former Fiat CEO (Cesare Romiti), the Agnellis, Pirelli & Co. (controlled, in turn, by Tronchetti Provera), and Mediobanca.

60 Article 126, T.U.I.F. See Del Giudice (2001). This case was even more sensational, as the parent was under the working control of Mediobanca, the once all-mighty player in the Italian corporate governance landscape. On the central role played by Mediobanca in the Italian corporate governance system until the mid-Nineties see Barca (1996: 10); Amatori and Colli (2000: 20).

Finally, Consob, the Italian counterpart of the S.E.C., has started exercising the power, also conferred on it by the 1998 reform,[61] to file complaints against members of the board of auditors,[62] who have failed to monitor directors properly (Tedeschi 2000). This may have the effect of providing stronger incentives for internal auditors to act in the interest of (minority) shareholders. Internal auditors have in fact traditionally been indulgent towards controlling shareholders (Bianchi and Enriques 2001). The T.U.I.F. also mandates minority representation on the board of auditors[63] and strengthens its powers by enabling it to file an Article 2409 complaint in court.[64]

This account of recent developments in the Italian corporate law and corporate governance shows that the landscape has improved in the last few years. However, the effectiveness of investor safeguards is still dubious and the features of Italian crony capitalism are still in place. This brief analysis has also shown that the 1998 reform grants judges a less marginal role than before, opening up new avenues for judicial review of insiders' misconduct. This role is doomed to become even more central in the next future, after the Government enacts a general corporate law reform which is expected to facilitate access to justice for minority shareholders (Barca 2002: 76).

9.4 Shareholder Litigation and Judicial Style in Italy

This part constitutes a further, more direct introduction to Part V's empirical analysis of the Milan court's corporate law decisions. First, I describe the remedies available to minority shareholders, and second, I provide some needed clarifications on the 'style' of Italian case law.

9.4.1 Shareholder litigation in Italy.

Under Italian corporation law,[65] directors are elected by the shareholders' meeting for terms not longer than three years, and may be removed with or without cause (Di Sabato 1999). The shareholders' meeting has much broader powers than, for instance, its American coun-

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61 See Article 152, T.U.I.F.

62 Italian law assigns the audit function in corporations to a separate board (collegio sindacale), composed of three or more auditors, and requires that its members be independent of the board of directors (they may have no family relationship with these, or with directors of controlling or controlled corporations, nor employment or other work relationships with the same). See Articles 148-154, T.U.I.F. for listed corporations and Articles 2397-2408 Civil Code (Italy) for unlisted ones.

63 Article 148. For doubts on the effectiveness of this provision (since individual auditors have no powers of reaction against insiders' misconduct), see Bianchi and Enriques (2001: 38-39).

64 This remedy is described *infra*, text accompanying notes 80-87.

65 Unless otherwise specified, the description that follows covers all three legal forms of corporations under Italian law: the società per azioni (or joint stock company or corporation), the società a responsabilità limitata (or limited liability company), and the società in accomandita per azioni (an infrequent form in which some of the shareholders carry unlimited liability and have a right to be directors of the corporation). The legal regimes for the latter two legal forms 'borrow from that of the societ[à] per azioni, the only one of the three that is complete and self-standing:' Stanghellini (1995: 99).

terpart.[66] This fact allows one to better understand the importance of the power that any shareholder has according to Article 2377 of the Italian Civil Code to bring suit (formally against the corporation, *de facto*against its majority shareholders) to nullify shareholder resolutions that she has not voted for, if they violate the law or the corporation's bylaws. This power may be exercised only up to three months from the day of the voidable resolution. But there is no statute of limitations, if the resolution has an 'illicit or impossible object.'[67] While it is widely debated among legal scholars what an 'illicit object' is, the courts have consistently held that this heading catches all resolutions violating laws aimed at protecting a general interest, instead of simply the interest of shareholders.[68] Since rules concerning the process of approving shareholder meeting resolutions (like those on how to summon the meeting, how to conduct it, how to express votes and so on) are thought to be in the interest of shareholders, courts have also introduced a third category of invalidity unknown to the Italian Civil Code, *i.e.*, 'non-existence,' which applies when a resolution is taken in the presence of most serious procedural irregularities.[69] This development (another example of civil law judges' creativity) originates from judges' willingness to provide some protection for minority shareholders who, not necessarily for their fault, had not brought the Article 2377 suit before the lapse of the three-month time limit.

66 Beyond electing directors and auditors (Article 2364, No. 2), Civil Code (Italy)), the shareholder meeting:
determines directors' and auditors' compensation (in the case of the former, only partially) (see Article 2364, No. 3), and Article 2389, Civil Code (Italy) (Para. 2 of the latter Article provides that compensation for executive directors is determined by the board of directors, after hearing the advice of the board of auditors));
approves the annual accounts (Article 2364, No. 1), Civil Code (Italy));
authorizes liability suits against directors, auditors and general managers (Articles 2393 and 2396, Civil Code (Italy). See also *infra*, text accompanying notes 73-75). Any shareholder may propose that the shareholder meeting authorizes liability suits during the annual meeting (Article 2393, Para. 2, Civil Code (Italy));
decides on the distribution of earnings (Article 2433, Civil Code (Italy));
authorizes share buy-backs (Article 2357, Civil Code (Italy));
decides on any change in the company's bylaws and on whether to dissolve the company (see *supra* note 28);
authorizes the issuance of stock, bonds, warrants and convertible bonds (see Article 2365, stating that the shareholder meeting decides on amendments to the corporation bylaws and on the issuance of bonds; the issuance of stock, warrants and convertible bonds requires an amendment to the bylaws: see, e.g., Stanghellini (1995: 105));
approves mergers and divisions (which also imply a modification of the corporate bylaws: see, e.g., Bianchi and Enriques (2001: 33));
in the case of listed companies, authorizes defensive tactics when the corporation is the target of a takeover bid (Article 104, T.U.I.F.);
in the case of listed companies, authorizes cross-holdings higher than 2 percent: Article 121, Para. 2, T.U.I.F. (the law imposes a limit on cross-holdings between listed companies of 2 percent, i.e., if a company holds more than 2 percent of the voting shares of another, the latter may not hold more than 2 percent of the voting shares of the former, unless the shareholder meetings of the two companies give their prior authorization. In any case, the latter company may not hold more than 5 percent of the voting shares of the former. See Bianchi, Bianco, and Enriques (2001: 160-61));
decides on whether to delist from a stock exchange (Article 133, T.U.I.F. In the silence of the law, it is debated whether a shareholder resolution is needed also in order to list on a stock exchange. See, e.g., Marchetti (1999: 15));
decides on any other issue which the corporate bylaws allocate to it and on issues which directors decide to submit it for approval (Article 2364, No. 4), Civil Code (Italy)).

67 Article 2379, Civil Code (Italy).

68 See Campobasso (1998: 341) (referring to the relevant case law).

69 Campobasso (1998: 338-40) (providing examples of irregularities which were judged to lead to the non-existence of the resolution, such as when a shareholder meeting had never been convened, or when the resolution had passed by the vote of someone who was not a shareholder).

It is interesting to note that courts have held that resolutions approving false or unclear annual accounts are void.[70] Since the annual accounts of closely held corporations in Italy are seldom impeccable, it is not uncommon that minority shareholders challenge their approval in court.[71] This is a clear example of how minority shareholder litigation in Italy can be 'ostensible.' In fact, these suits commonly bear no relation at all to the grievance that the shareholders bringing them have against majority shareholders or directors (Enriques 2001). The fact is that the threat of such suits or the refusal to settle them is very effective as a bargaining tool, because they have potentially serious consequences for the corporation and for its directors (which, in closely held corporations, are normally the majority shareholders themselves).[72]

Another reason for the relative frequency of this kind of actions, however, is simply that non-ostensible remedies are often unavailable under Italian law. What happens, in fact, if a minority shareholder's grievance has to do with violations of fiduciary duties or, more broadly, with opportunistic behavior by insiders? The primary remedy, the derivative suit, is not available to shareholders of non-listed corporations, while it is available only to share-holders representing at least 5 percent of the voting shares in listed corporations, a threshold 'too high to allow this procedure to be an effective tool for minority shareholders.'[73] In closely held corporations, it is only the shareholders' meeting that has the power to authorize liability suits against directors.[74] Majority shareholders may cast their vote in such resolutions, unless they are themselves the directors against which the suits should be brought.[75] It is therefore very rare for directors to be summoned as defendants in liability suits, unless the company goes bankrupt (Stanghellini 1995: 169-70).

70 See Campobasso (1998: 435-47), also for references to the relevant case law.

71 A conspicuous body of 'accounting' case law has developed in the last forty years or so. See, e.g., Colombo (1994: 440-44 and 450-54) for references. However, it is very difficult to bring this kind of suits for shareholders of listed corporations: Article 157 T.U.I.F. (which has taken the place of the slightly less restrictive Article 6, Legislative Decree of Mar. 31, 1975, No. 136) provides that, if the certified accounting firm has approved the annual accounts, then the resolution of the shareholders' meeting approving the annual accounts may be challenged, on the grounds that the accounts fail to conform with the provisions governing the preparation thereof, only by shareholders representing at least five per cent of the share capital.

72 It is a criminal offense for directors to present false annual accounts (see Articles 2621 and 2622, Civil Code (Italy)): the judge finding that accounts are false will have a duty to report the facts to the public prosecutor (see Article 361, Criminal Code (Italy), punishing public officials who do not denounce a crime they have come to know of in the exercise of their duties). To be sure, the criminal provisions on false accounting have been made almost unenforceable by a law reform recently enacted by the Government (see Crespi (2001); this law reform basically aimed at avoiding the conviction for false accounting of a well known tycoon turned politician: see The Economist 2001b).

73 Cheffins (2000: 35). See also Bianchi and Enriques (2001: 38)(providing data showing that the five institutions holding the largest institutional shareholdings in the 30 largest Italian listed corporations reached the threshold in only one third of these corporations).

74 See *infra*, text preceding note 87 for an exception to this rule. A further exception applies to insolvent corporations: for these, the liability suit can be brought (only) by the bankruptcy trustee. See Article 146, Royal Decree of Mar. 16, 1942, No. 267.

75 Article 2373, Para. 3, Civil Code (Italy). In order to avoid the prohibition on voting in such resolutions, directors shareholders are normally well-advised enough not to own their shares personally (see Stanghellini 1995: 172); they often use trust-like devices, nominees or holding companies instead. No prohibition applies even to relatives and spouses of the directors, nor to their associates, according to the dominant view among legal scholars and courts. In other words, the directors' associates, no matter how interested on behalf of the director, are allowed to vote in such resolutions (see Enriques (1994: 130), for references). The only consequence of the associates' voting, according to the opinion prevailing among courts and legal scholars, is that dissenting or absent shareholders may challenge the resolution rejecting the authorization of the liability suit on the basis of Article 2377. However, they have to prove that the denial of authorization is potentially harmful to the corporation, i.e., that the liability suit would probably be successful.

Truth to tell, one provision in the Italian corporate law on-the-books might have been construed by judges as allowing recovery for damages suffered by shareholders as a consequence of mismanagement. Article 2395 of the Italian Civil Code reads: '[t]he provisions of the preceding articles[76] do not affect the right to compensation for damages of an individual member or third person who has been *directly* injured as a result of malice, fraud or negligence of the directors.'[77] This provision has been consistently construed as not allowing recovery of damages by shareholders if the damage is a consequence of misconduct which harms the shareholder *as* a shareholder.[78] Courts deciding on Article 2395 suits have regularly dismissed Article 2395 actions in a number of cases in which shareholders tried to be compensated for the loss of value of their shares following directors' mismanagement of the corporation.[79] As already hinted, this construction, like all matters of legal interpretation, is not without alternatives. It has been argued that an interpretation more consistent with the basic principles of Italian tort law would allow individual shareholders to recover against directors also damages suffered *qua* shareholders (Stanghellini 1995: 172).

Right or wrong as the dominant construction may be, Article 2395 is of little help to minority shareholders suffering from insiders' misconduct. What else can they do? If the board of directors adopts a resolution that prejudices an individual shareholder's right, she may challenge the resolution in court. But a comprehensive analysis of the case law in this area has shown that in only one instance have the courts invalidated a board of directors' resolution challenged by a minority shareholder (Irrera 2000: 113-30), hinting that this is not a very effective remedy.

The last (but certainly not least) remedy available to minority shareholders, and one which is frequently used (Stanghellini 1995: 173), is the complaint against serious irregularities in the management of the company. According to Article 2409 of the Italian Civil Code,

> '[i]f there is a founded suspicion of serious irregularities in the discharge of the duties of the directors and auditors, shareholders representing at least one-tenth of the company's capital can complain of these facts to the court.
>
> The court … can order an investigation of the company's management ….
>
> If the irregularities are found to exist, the court may grant any appropriate precautionary remedy and call the shareholders' meeting for the consequent resolutions. In the most serious

76 I.e., specifically, Article 2393's requirement that the shareholders' meeting authorize liability suits.
77 Translation by Colussi (1993: 163) (emphasis added).
78 See Bonelli (1985: 313), who refers to the almost unanimous legal scholarship siding with the courts on this issue.
79 See, e.g., Judgment of Sept. 7, 1993, No. 9385, Cass. Civ., 1994 Giurisprudenza commerciale II, 365 (*Negretti v. Chiaretti*). See also *infra* text accompanying note 11 for a similar case.

> cases, [the court] may remove directors and auditors and appoint a temporary administrator, determining his powers and the term of his office.
>
> The temporary administrator may bring a liability action against directors and auditors.
>
> …. The public prosecutor may petition the court for the remedies provided for in the present Article. ….[80]

For listed corporations, standing in an Article 2409 proceeding has been extended to shareholders representing 5 percent of the voting shares,[81] to the board of auditors[82] (in case of serious irregularities in the discharge of directors' duties), and to Consob (in case of serious irregularities in the discharge of auditors' duties).[83]

A few comments on this provision will be useful before proceeding in the analysis. To begin with, the threat to file an Article 2409 complaint is an effective bargaining tool in the hands of minority shareholders. Since the approval of false annual accounts is deemed to be a serious irregularity (Tedeschi 1988: 197), the same considerations made above with regard to challenges of resolutions approving annual accounts apply;[84] moreover, the temporary administrator whom the court may appoint has the legal status of a public official (Tedeschi 1988: 253), and hence has the duty to denounce any criminal offence discovered in discharging the duties assigned.[85] And generally, 'the operations of … companies usually suffer as a result of court inspection pursuant to Article 2409' (Stanghellini 1999: 37).

The law affords courts great latitude in determining the appropriate measures to stop serious irregularities and to counter ract or attenuate their harmful consequences (Tedeschi 1988: 236). Hence, in theory, courts may play a very important and creative role in the Italian corporate governance landscape, at least in closely held companies, in which minority shareholders may more easily reach the relevant threshold.[86] In practice, however, it is extremely rare for courts to order precautionary remedies of any kind (Marcinkiewitz 1990: 521): they usually just appoint a temporary administrator or call the shareholder meeting, when they do anything at all (Marcinkiewitz 1990: 522).

80 Translation by the author.
81 Or a smaller fraction at the company's discretion. No company has lowered the threshold, however: see Consob (2001: 28).
82 See *supra* note 62.
83 See Articles 128, 145, Para. 6, and 152, T.U.I.F.
84 See *supra*, text accompanying notes 70-72.
85 See *supra*, note 70.
86 While it is not so rare that public prosecutors file such actions (pursuant to Article 2409, Para. 5), sometimes also on the behalf of minority shareholders representing less than the required percentage (see, e.g., Tedeschi (1988: 212-13)), seldom if ever have they filed the complaint against directors of a listed corporation, where it might be very difficult for minority shareholder to reach the required 5 percent (10 percent before 1998) threshold.

Finally, although the temporary administrators do sometimes bring liability suits against directors and auditors, often the shareholders' meeting, by vote of the majority shareholders, authorizes the directors elected after the temporary administrator has left office to settle or abandon those suits.[87]

To conclude, four judicial remedies are available to minority shareholders in case of oppression or, more generally, of insiders' opportunistic behavior: the action against void or voidable shareholders' resolutions; the liability suit in the (rare) case that they have suffered harm directly from directors' behavior; the action against board resolutions that prejudice individual rights; and the complaint against serious irregularities in the management of the company, which may lead to a liability suit against the directors.

It is frequent, then, for legal remedies allowing minority shareholders to challenge a specific opportunistic course of action to be unavailable. Minority shareholders will then try to proceed with other, more or less ostensible, remedies, at the very least to strengthen their bargaining position against insiders. It may also be that, in certain instances, shareholders choose an ostensible remedy in the presence of other ones, more strictly related to the opportunistic act, simply because the former is a more effective bargaining tool. So, quite commonly in Italy shareholder suits have nothing to do with the real cause of dispute, and the real rights and wrongs (*i.e.*, the more or less fair and cooperative way the parties in the dispute behaved), are difficult to perceive for the judge, let alone for the reader of the judge's decision, as the following Section shows.

9.4.2 A few remarks on the 'Italian style.'

Before proceeding with the empirical analysis in Part V, it is useful to recall that there is a striking difference between judicial opinions in common law and in Italian (and more generally civil) law. As an American comparative law scholar pointed out a few decades ago, '[t]he civil law judge is not a hero-figure (or a father figure), as he tends to be in England or in the United States' (Merryman 1966b: 586). Italian judges are 'just another kind of civil servant' (Merryman 1966b: 589), who perform their duties in a cultural environment in which the traditional view that judges do not make law still prevails.[88] They are selected on the basis of a written and oral exam in which candidates deal exclusively with legal subjects (Oberto 2001) among law graduates usually lacking any prior significant professional experience. According to an oversimplified but nonetheless enlightening view, the idea is that

87 See Cottino 1999: 456. See also Stanghellini (1995: 169) (reporting how rare reported decisions on liability suits brought by temporary administrators are). To be sure, settlement agreements and decisions to abandon the case may not be authorized by the shareholders' meeting if shareholders representing at least twenty percent of the capital oppose (Article 2393, Para. 4, Civil Code (Italy)). But this may not be necessary in order to frustrate the liability suit, as the case *Mondialpunte v. Lovati* aptly shows. See Decision of 17 January 1991, Tribunal of Milan, 1991 Giurisprudenza italiana I, 2, 563, in which the court rejected a liability suit brought by the temporary administrator on the simple grounds that, after the end of the temporary administration, the corporation, again in the hands of the majority shareholders, simply failed to provide evidence substantiating the charges against directors. Hereinafter, decisions cited with the name of the parties only are from the Tribunal of Milan.

88 See Taruffo (1988: 209) (noting that the style of judicial opinions still reveals that Italian judges see themselves as bureaucrats and 'mouths of the law' rather than as 'problem solvers').

the law can only be made by the legislature, while it is for legal scholars to provide the correct interpretation of statutes: 'The work of the scholar is … exalted; that of the judge is, although important, on a lower plane. Jurisprudence [in the continental sense: judicial opinions] is not only dominated by doctrine, it attempts to imitate it' (Merryman 1966b: 586). As is still true today, '[t]he more exalted role of the doctrine, as compared with the jurisprudence, leads naturally to the emulation of the one by the other. The form and style of Italian judicial opinions is closely imitative of doctrinal writing,'[89] which, in turn, is still dominated by 'abstractness, conceptualism, and cultural agnosticism,'[90] at least in some areas (like corporate law).[91] It follows that 'in the writing … of opinions the abstractness and conceptualism of the doctrine are prominent. The factual emphasis, the concreteness, common lawyers associate with judicial writing is absent in the Italian. Opinions often contain no coherent statement of the facts of the case,'[92] instead reading 'more like excerpts from treatises or commentaries on the codes than the reasoning of a court in deciding a concrete case.'[93]

Why do opinions often contain no coherent statement of the facts? A legal explanation for this lies in the procedural rules that describe the content a judicial opinion must have in order to be valid: as a leading Italian civil procedure scholar critically points out, these rules require the exposition only of those facts and evaluations that enable counsel to appeal the decision and that facilitate the appellate judge's work (Taruffo 1988: 187-88). In other words, these rules justify the judges' habit of writing their opinions for an audience consisting solely of the parties' lawyers and the appellate judge.[94] No wonder that to an outsider the statement of facts is often impossible to understand.

Outsiders' access to the facts of cases is made even more problematic by the lack of complete collections of judicial opinions, except for Supreme Court's and Constitutional Court's ones. Law journals publish selected judicial opinions, but generally in abridged form. Very often,

89 Merryman (1966b: 586-87).

90 Merryman (1966b: 586; 1965: 546-48). See also Calabresi (2000: 481-82).

91 See Enriques (2001: 91). There are, of course, notable exceptions: in the last two decades an increasing number of corporate law scholars have approached the law and economics methodology. For references to some of the main recent works in this area, see Sanfilippo (2000: 49-63).

92 Merryman (1966b: 587). Merryman's account is still accurate to describe today's reality. See Enriques (2001: 85-86). Taruffo (1975: 300-11) provides an interesting analysis of the ideological roots of this tendency to undervalue the factual elements of the disputes judges decide.

93 Merryman (1966b: 592). See also Taruffo (1975: 437). A good example of this tendency to leave facts in the background is found in one of the Milan court decisions in the database collected for Part V (*Sedona v. Elli*, Nov. 3, 1986, 1987 Le Società 407). After stating some objectively relevant facts of the case (which by the way was decided properly, both in terms of legal interpretation and in the light of the underlying rights and wrongs of the parties), the court states: 'The chronological course of the aforesaid events, independently from the evaluation of their validity and of their merits, which is totally unconnected with the question to be solved here and which, from a judicial point of view, appears to be just an evocative, yet insignificant, undertone, shows that …' (*Id.*, at 408). The translation of this judicial opinion and those which will follow below are as literal as possible. The result often sounds awful. This is due not only to differences in structuring sentences between Italian and English (and plausibly to the author's lack of skills in the complex art of translation), but also to the fact that Italian judges' legalese is a heavy, bureaucratic, and inelegant jargon: see Taruffo (1988: 209-10).

94 See Preite (1988: 976-77) (criticizing a decision by the Milan Tribunal which concluded that there was no effective conflict of interest between the majority shareholder and the corporation in the specific circumstances of the case, without providing any factual basis for this conclusion).

> 'at the point where the facts might be found, one encounters the disheartening term "omissis," signifying that a part of the opinion is omitted. The emphasis, rather than on the facts, is on the production of the polished maxim (*massima*), and this abstract and conceptual statement, divorced from the factual context out of which it arose, may be the only part of the opinion to be published.'[95]

This well reflects the propensity of Italian legal scholars, practitioners and judges for conceptualism and abstractness. The effect of this widespread faith in legal 'maxims' on judges' legal discourse is 'to reduce legally relevant facts to the minimum in the interest of: abstract order at the expense of pragmatic concreteness, the rule at the expense of the exception, the category or class at the expense of the individual' (Merryman 1966b: 587).

It is worth noting here that such an attitude is itself especially critical within the corporate law field: as Professor Macey points out, good corporate law relies crucially upon a mix of flexible statutes and active courts engaging in 'case by case analysis because of the necessity for close attention to the specific fact patterns' (Macey 1989: 1698). Especially in the corporate governance arena policymakers 'cannot benefit shareholders by developing rules that successfully regulate whole classes of transactions,' since these will prove to be inevitably either overinclusive or underinclusive (Macey 1989: 1697).

A final clarification serves: although there is formally no *stare decisis* doctrine in Italy (Merryman 1966b: 588), there is wide consensus that precedents 'do in practice have some effect on future cases' (Merryman 1966b: 591). In fact, opinions frequently cite prior decisions (of the Supreme Court as well as of lower courts: Merryman 1966b: 605-06) and usually stick to the rules of law (or more precisely to the maxims) extrapolated by those prior decisions, quite similarly to what common law judges do.[96]

To conclude, Italian judges produce highly abstract opinions, centered much more upon the legal issues than on the factual specifics. Often the facts are described in such a way as not to allow an outsider to get a clear idea of them. Only a fraction of the opinions are available to the public, thanks to law journals, and these unfortunately quite often excise the facts. This is certainly not the ideal background for an empirical investigation of how Italian corporate law judges perform in terms of lack of deference, ability to identify real rights and wrongs, antiformalism, and concern for spill-over effects, since such an evaluation obviously requires knowledge of the facts. Nevertheless, I attempt precisely such an evaluation in the next section.

95 Merryman (1966b: 587); Galgano (1988: 506-508). Legal scholars have long criticized the habit of omitting facts and the emphasis given to maxims. See, e.g., Bin (1989: 557-58), where further references. Both phenomena, are, however, still commonly observed. See Fusaro (2001: 142-43) (noting also that 'maxims,' although under different names, play a central role in France and in Germany as well).

96 Merryman (1966b: 591). See also Sbisà (1989: 521). Taruffo (1994) provides a very acute analysis of the use of precedents by Italian judges.

9.5 Italian Corporate Law off the Books: Evidence from Milan

9.5.1 *The sample*

In order to evaluate the quality of Italian corporate law judges I have gathered all of the 123 opinions issued by the Milan Tribunal (*i.e.*, the court of first instance), published in law journals between 1986 and 2000,[97] and deciding upon: (1) suits brought by shareholders under Articles 2377-79 of the Civil Code[98] (73 decisions); (2) shareholder suits challenging board of directors' resolutions (2 decisions); liability suits brought by the corporation against directors outside bankruptcy (11 decisions); individual liability suits brought by shareholders against directors (13 decisions); and Article 2409 complaints brought by shareholders (27 decisions).[99]

The reason for choosing the Milan court is twofold. First, the Milan Tribunal has '[a] leadership role in the corporate area .... [and] is generally regarded as the most specialized in Italy' (Stanghellini 1999: 35). Hence, the analysis of its decisions should provide the most sanguine picture possible of the quality of Italian corporate law judges. This is justified by the fact that any Italian corporation may choose the Milan court as the forum for its corporate law controversies simply by inserting a clause in the corporate statute to that effect. Second, Milan is the financial and business heart of the country, and home to many of the major Italian corporations.[100] The choice of a first instance court is justified not only because litigation at this stage should be more fact-intensive, but also because corporate law cases in Italy are relatively rarely appealed.[101]

Of the 123 decisions gathered, 61 involved *società per azioni* (of which 13 were listed on the Milan Stock Exchange) and 57 dealt with *società a responsabilità limitata*,[102] while in 5 cases the legal form of the company involved was unspecified. Of these 123 decisions, 26 only proved-useful for the inquiry.[103] Of the other 97, 45 were written or reported in such a way as

97 The decisions were identified by searching the CD-ROM 'Repertorio del Foro Italiano 2000-2001,' Ed. 1.0, June 2001, which contains references to (and 'maxims' of) all of the decisions by Italian courts published in Italian law journals from 1981 to 2000.

98 The sample does not include challenges to resolutions approving annual accounts, due to the high level of technicality of the accounting issues decided by judges.

99 In one case, the same decision decided on an action challenging both a shareholder resolution and a board of directors' resolution. In two cases, the same decision decided both on an action brought under Article 2377 and on an Article 2395 individual liability suit.

100 More than one quarter of Italian listed corporations have their seat in Milan. More precisely, 81 of the 293 corporations listed on the Italian Stock Exchange (27.6 percent) have their seat in Milan or in small towns nearby, for which the competent court is the Tribunal of Milan. Source: Consob data on Italian listed corporations, 2001 (on file with the author).

101 Of the 26 cases which have proved useful for the analysis, one was itself an appeal case (*Fingem v. Montedison* (2)) of another case among the 26, while of the remaining 24 only 2 were decided by the Milan Court of Appeals according to the CD-ROM 'Repertorio del Foro Italiano 2000-2001,' Ed. 1.0, June 2001. It is possible, however, that some of the appeals were never published or had not been decided by June 2001.

102 See *supra* note 65.

103 All these 26 cases, together with the other Italian cases cited in Section B, are listed in the Appendix.

to make it impossible to understand the facts of the case.[104] The rest of them were simply irrelevant, mostly because the decision was based on, and dealt exclusively with, a very specific matter of interpretation of the relevant statutes, showing no peculiar sign of either formalism or antiformalism.[105]

9.5.2 The cases

Due to space constraints, I will describe the most revealing decisions in the text and refer to the other cases in the footnotes.[106] Needless to say, the small number of relevant decisions does not allow any meaningful quantitative analysis.

How do Milan corporate law judges decide on self-interested transactions/ resolutions?

Seventeen decisions in the sample may provide an answer to this question. I first report those that have rejected the plaintiff's claim, *i.e.*, that for one reason or another, deferred to insi-

104 This does not mean that the other 78 decisions were published in full. A few were, but more frequently the 'omissis' luckily do not prevent the reader from understanding the facts (at least on the face of it).
These 45 cases, reference to which can be found in the CD-ROM cited *supra* note 99, are: *De Luigi v. S.N.C.* (Mar. 6, 1986), *Delle Piane v. Mariani* (Sept. 22, 1986), *SIAC v. Accetti* (Oct. 2, 1986), *Inzana v. Dalmine* (Jan. 1, 1987), *Montonati v. SO.GE.MI.* (Jan. 1, 1987), *Sedona v. Cartiere di Verona* (Oct. 15, 1987), *Piccole Partecipazioni v. BAI* (Nov. 5, 1987), *Gasparini v. Cagliani & Marazza* (Dec. 13, 1987), *Lamanna v. Saccavini* (Dec. 21, 1987), *Saffi* (Mar. 24, 1988) *Maugeri v. Mondadori* (June 21, 1988), *Abruzzo v. D'Addato* (Sept. 26, 1988), *Dossena v. Zinken Italiana* (Sept. 29, 1988), *China v. Studio Elle* (Oct. 24, 1988), *Lamanna v. Orefro* (Nov. 11, 1988), *Rava v. Pomponio* (Dec. 13, 1988), *Maugeri v. Mondadori* (Sept. 11, 1989), *Porzio v. Ipotesi* (Sept. 28, 1989), *Colla v. Nelke Italiana* (Oct. 23, 1989), *Ovadia v. Bisafe* (Nov. 24, 1989), *Bontempi v. Bontempi* (Dec. 18, 1989), *Carlucci v. Tracanella* (Apr. 9, 1990), *Ronchi v. Fall. Tecson* (May 17, 1990), *Sead* (Jul. 6, 1990), *Brokersfin Leasing* (Jul. 16, 1990), *Valè* (Dec. 7, 1990), *Dario v. Crea* (Jan. 9, 1992), *C.M.F. v. P.M.P.* (Jan. 30, 1992), *Bettonio v. Li Rosi Marini* (May 18, 1992), *Zanchi v. Manini* (Jun. 17, 1992), *Zanchi v. Autocarman* (Mar. 22, 1993), *Gesundheit v. Sanyo Italiana* (May 19, 1993), *Arnold v. Cominelli* (Oct. 18, 1993), *Bossi v. Idea Azione* (Jul. 7, 1994), *Grifona v. Orfei* (Oct. 20, 1994), *Argentina Giocattoli* (Jan. 30, 1995), *Serta* (Feb. 13, 1995), *Rolla v. Rolla Angelo F.A.S.C.O.* (May 18, 1995), *Cultrera v. GE-S.PE.R.* (Oct. 3, 1996), *Fiordelli v. CO.MO.I. s.i.m.* (Mar. 27, 1997), *Saracchi v. Ondaverde* (Jan. 26, 1998), *Dragone v. AGESTI* (Jun. 11, 1998), *Busci v. Momedil* (Jul. 25, 1998), *Magnocavallo v. Tecnogea* (Jan. 30, 1999), and *Avezzano Calcio* (Feb. 19, 1999).

105 See, e.g., *Spalletti Trivelli v. Gallarati Scotti* (Decision of Nov. 11, 1993), 1994 Giurisprudenza commerciale Part 2: 866 (deciding on the validity of a resolution introducing in the bylaws a right of first refusal). The high number of decisions which turned out to be of no use for the analysis is somewhat disturbing. It is less disturbing, however, if one considers that this finding is falsifiable. These decisions, reference to which can again be found in the CD-ROM cited *supra* note 99, are: *Fabris v. Mediobanca* (May 22, 1986), *Fabris v. Mediobanca* (June 9, 1986), *SO.FI.MA v. SO.GE.MI* (Jun. 9, 1986), *Sedona v. Elli* (Nov. 3, 1986), *Colombo v. Refi* (Feb. 12, 1987), *Hugony v. Giannini* (Mar. 5, 1987), *Gelmi di Caporiacco v. Cogepa* (June 27, 1987), *Colombo v. ELCA* (Nov. 9, 1987), *S.I.G.E. v. Maffi* (Mar. 3, 1988), *Lamanna v. Orefro* (Apr. 28, 1988), *Morganti v. Immobiliare Opus* (May 2, 1988), *Lo Porto v. Milan A.C.* (Jul. 25, 1988), *Celestini v. I.T.P.* (Sept. 29, 1988), *CO.MI.TA. v. Fumagalli* (Oct. 17, 1988), *Viglio v. T.T.V.* (Nov. 23, 1988), *Mollona v. Verdiglione* (Dec. 21, 1988), *F.E.P. v. Rusconi Hachette Associati* (Mar. 2, 1989), *Placido v. Bertarelli* (May 26, 1989), *La Centrale Finanziaria Generale v. Leemans* (Jun. 26, 1989), *Cipifin v. Bruno* (Oct. 16, 1989), *Fuzio v. Barro* (Dec. 18, 1989), *Fusco v. Omar* (Dec. 20, 1989), *Silvestro v. Forgiatura Lombarda* (Jan. 10, 1990), *Kofler* (Mar. 7, 1990), *Lovati v. Mondialpunte* (Apr. 26, 1990), *Fassina v. La Fiorente* (June 4, 1990), *Montoli v. Immobiliare Tavezzano Prima* (Sept. 24, 1990), *Mondialpunte v. Lovati* (Jan. 17, 1991), *Lovati v. Mondialpunte* (Decision of 9 May 1991), *Pellizzari v. Del Campo* (Jun. 10, 1991), *Favara v. RAS* (Sept. 26, 1991), *Cartiera di Vidardo v. Hocevar* (Oct. 10, 1991), *Cambi v. Walpa* (Apr. 16, 1992), *Studio Gatto v. Balzaretti* (May 7, 1992), *Furlan v. Farmitalia* (May 14, 1992), *Lignum v. Favero* (May 25, 1992), *Pantano v. Lubner* (Sept. 14, 1992), *Magazzini di Lainate v. Antonioni* (Sept. 14, 1992), *Bastogi v. Adileasing* (Apr. 22, 1993), *Spalletti Trivelli v. Gallarati Scotti* (Nov. 11, 1993), *Comocalor* (Nov. 26, 1993), *Capriotti v. ACME International* (Jul. 11, 1994), *Comitalia v. Broggi* (Oct. 13, 1994), *Gatti v. Migliore* (Apr. 21, 1996), *Petrelli v. Dafram* (Jun. 9, 1997), *Gozzetti v. Eurosim* (Jan. 29, 1998), *Coopservice v. Tel e Tel* (Jan. 29, 1998), *Brustia v. Marbel* (Mar. 16, 1998), *Enfi v. Finwork* (Sept. 16, 1998), *Zorloni v. SEI* (Feb. 26, 1999) *Bruni v. Trenno* (Mar. 13, 1999), and *Aliverti v. Silex Mineraria* (Jun. 10, 1999).

106 In footnotes, I shall also mention or describe three decisions, not included in the 26 for the reasons specified below, which are highly suggestive of judges' deference to insiders.

ders' behavior. Next, I will describe those that may to some extent support the claim that Italian judges are prepared to use their discretion to counter insiders' abuses.

Deferential judges?

In *Cavaggioni v. Rotondo (1)*, the plaintiff shareholder had filed an Article 2409 complaint alleging that the majority shareholder and sole director of Athena s.r.l. had entered into a self-dealing transaction: he had let Athena acquire an undertaking heavily burdened with short-term debts and owned by Chartour s.r.l., a company which he also controlled.[107] Despite the fact that the director had also succeeded in postponing the entrance of new minority shareholders into the company, clearly in order to avoid any interference with the transaction he was realizing, the Court found no legitimate basis for suspicion of serious irregularities, since no evidence had been provided by the plaintiff that the transaction, 'considered as a whole,' had harmed the corporation.[108,109]

In *Serafini v. Tosi*, the plaintiff had asked the court to issue a preliminary injunction against a shareholder resolution authorizing a parent-subsidiary merger, alleging that the resolution had been approved with the vote of the majority shareholder (a corporation owning roughly 90 percent of the shares), and was hence voidable for violation of Article 2373 on shareholders' conflict of interests,[110] or because the majority shareholder had abused its voting power. After dismissing the conflict of interest issue with a (well consolidated) formalistic argument,[111] the Court denied any abuse of power by the majority shareholder, on the grounds that a finding of abuse of powers 'requires evidence of the majority's fraudulent intent to harm other shareholders to its own or to third parties' advantage; it is very difficult to prove this with regard to the share exchange ratio of a merger, since the law imposes disclosure and procedural obligations (*i.e.*, the obligation to deposit the merger project and all

107 Under Italian law, the acquirer of an undertaking ('azienda') is liable for the debts resulting from its books: Article 2560, Civil Code (Italy).

108 *Cavaggioni v. Rotondo* (1), at 405. Luckily for shareholders, the Milan Court of Appeals reversed this judgment: see *Cavaggioni v. Rotondo* (2).

109 Similarly, in *Finter v. Immobiliare Cassinazza*, the Court, while giving account of all the relevant facts, failed to perceive that, with regard to a shareholder meeting's resolution concerning the acquisition of a building, a confict of interest existed between the corporation and a shareholder, who indirectly owned the majority of the shares of another corporation, which in turn owned that building. Again similarly, in *GE.VI v. ME.AL.*, the court declined to void a resolution denying authorization to bring suit against the director, passed by the vote of a majority shareholder who was the director's husband, on the ground that the plaintiff had not proved that the director had violated her duties.

110 See *supra* note 28.

111 See *infra* text accompanying note 154.

the relevant documents in the company register and the obligation to ask an accountant for a fairness opinion) such as to discourage any fraudulent intent.'[112]

In *Ferrara v. Torpia*, the court rejected an Article 2395 liability suit brought by an individual shareholder against directors, on the ground that the damage suffered by the shareholder was indirect. In dictum, it also stated that the shareholder would have had no recovery in light of the intrinsic merits of the claim. The shareholder had alleged that the board of directors, after seeking the advice of the corporation's outside counsel, had decided not to take action to challenge an allegedly illegitimate arbitration award concerning a dispute with another corporation. One of the controlling shareholders of the latter corporation was a defendant-director of the first corporation. The court stated that the board's decision, 'corroborated by the very relevant advice of the same lawyer who had defended the corporation in the arbitration proceeding, cannot be criticized in terms of its legality …, as it was taken in observance of the criteria of professional diligence which directors have to abide by in the discharge of their duties.'[113] In other words, the court applied the business judgment rule to a resolution in which one of the two joint-controlling shareholders was interested, and attached considerable weight to the advice of a lawyer whose independence was far from self-evident, as he had been appointed by the directors – that is, by the controlling shareholders.

Milan v. Trema Gestione is perhaps the most striking example of how respectful of dubious behavior by insiders the Italian judges can be. Trema Gestione s.r.l. brought a liability suit against its former director, Alberto Milan, as a counterclaim to an action for damages brought by the latter, who had been removed from office. In the court's words:

> While it is uncontested that Milan used credit cards issued in the name of the corporation, it is completely unproven that he abused them. In order to prove it, it is not enough to state that the credit cards were used in order to pay for 'goods and services having nothing to do with the discharge of his duties,' 'in vaca-

112 *Serafini v. Tosi*, at 813. The obligations mentioned in the text are imposed by Articles 2501-bis and 2501-quinquies, Civil Code (Italy). Similarly, in *Aliverti v. Immobiliare Isaia Volontè*, the court held that the plaintiff had not proven that the share exchange ratio in a parent-subsidiary merger, as determined in a resolution passed by the vote of the majority shareholders, was unfair. On the reliability of fairness opinions and on their effectiveness as a tool for minority shareholder protection see Bebchuk and Kahan (1989).
Two other decisions, which clearly highlight judges' deference in conflict-of-interest situations involving parent-subsidiary relationships, are worth mentioning here. *Anguissola v. Bonello*, which is not included in the dataset since it was decided in 1985, is the case cited by Johnson *et al.* (2000: 24-25) as the 'Marcilli case' (a mispelling of the corporation's name, Marsilli). The majority shareholders of company A had sold their stake to a foreign corporation, B, formerly a competitor of A. After the acquisition, B became the sole distributor of A's products and was hence free to decide whether to sell its own or A's products. Minority shareholders filed an Article 2409 complaint alleging that B was abusing its control of A. The court held that no legitimate suspicion of serious irregularities was proved, after reading all of the specific circumstances of the case with a clear bias in favor of the new majority shareholder: B's choices concerning A's business were all 'easily justifiable in the light of the "group" relationship existing between the two companies.' (*Anguissola v. Bonello*, at 468). The *Tetrafin v. ICIT* decision of 17 May 1991 (absent from the dataset, since the decision was never published: information on it is provided by the Milan Court of Appeals ruling which confirmed it: see *Tetrafin v. ICIT*) decided in the same way as *Anguissola v. Bonello* on an almost identical case.

113 *Ferrara v. Torpia*, at 622.

> tion resorts or anyway in localities having nothing to do with those in which the corporation had an interest or was doing business;' nor is it enough to state that they were used to pay for 'other persons accompanying him and resulting to have no relationship with the corporation' …. It is, in fact, uncontested that Milan was the leading man not only of the corporation, but also of the whole Financière Trema group, and that – as the corporation itself has declared – in the discharge of his duties, he might act 'with wide discretion and absolute freedom.' It is, then, perfectly plausible that negotiations for this or that transaction, the contacts with prospective clients, the relationships with third parties connected somehow with his duties as a director, may have taken place also in holiday resorts, and that he may have paid for highway tolls and hotels, even luxury ones, perhaps offering a meal in this or that restaurant, giving small gifts or paying for other 'entertainment' expenses. None of these expenses can be deemed unrelated to Milan's activity as a director and the broad management powers entrusted to him; and [the corporation] has produced no specific evidence to prove that this or that expense was in fact unrelated to his activity.[114]

Apparently, the acquisition of such goods and services in holiday resorts did not 'stink badly enough' for the judge to place the burden of proof on the defendant or at least to alleviate the plaintiff's burden by evaluating the director's behavior more severely.[115]

In *FIN.GE.M. v. Montedison (1)*, the court had to decide whether sufficient information had been given to shareholders in connection with their approval, as required by law,[116] of the settlement of a liability suit between the company and its former directors. The settlement had been negotiated as part of a broader agreement by which a pool of banks had acquired the controlling stake of the Montedison corporation from the Ferruzzi family, whose holding companies at the top of their pyramidal group were insolvent (Penati and Zingales 1997). The new controlling shareholders and the directors they had appointed were potentially in a conflict of interest situation: in fact, the grant of a generous settlement agreement to former directors (most of whom were members of or had close relations with the Ferruzzi family) might be a way to reduce the acquisition price (Enriques 2000b: 255-56). The court held that directors had properly informed shareholders on the settlement agreements, by distributing at the meeting a report on those agreements. Directors had declared that the full

114 *Milan v. Trema Gestione*, at 70.

115 This is how the 'smell test' works in U.S. courts: see Yablon (1991: 498). Another decision which rejected the plaintiff's claim on the ground that he had not provided evidence of unfairness of an admittedly self-interested resolution by the shareholders' meeting is *Brichetti v. Nuova COI.*

116 Article 2392, Para. 4, Civil Code (Italy).

text of the agreements was available for shareholders requesting to read it, and 'the report [had] exhaustively illustrate[d] the *basic* and *qualifying* clauses of the agreements;'[117] further, the directors had provided sufficient clarifications to the shareholders, upon their request; and, in any case, the shareholders should have asked to read the full text of the agreement or even to postpone the meeting, if they felt that they were not sufficiently informed:[118] they had only themselves to blame if they had not done so.[119] In the next section, I shall illustrate the Milan Tribunal decision overturning this one, that clarifies just how strongly biased in favor of the defendants (*i.e.*, the directors and, indirectly, the new controlling shareholders) this ruling is.[120]

No deference?

To be sure, there are also cases in which the court reviewed transactions or resolutions for fairness and found them unfair or in which it found for the plaintiff-shareholder. In two cases, *Barbiani v. Compagnia Latina di Assicurazioni* and *Cavalli v. GAIC*, the court, petitioned for a preliminary injunction against parent-subsidiary mergers, judged the share exchange ratio for the mergers unfair, since the directors had failed, in both cases, to take some relevant data into account.

However, these holdings did not lead to the issuance of a preliminary injunction, since the court in both cases denied that shareholders had provided any evidence of irreperable damage:[121] no danger of not recovering the damages suffered by exercising an ordinary action was in fact proven. From the plaintiffs' point of view, the practical effect of the rulings was consequently nil.

117 *FIN.GE.M. v. Montedison* (1), at 833.

118 *Ibid.*According to Article 2374, Civil Code (Italy), '[i]f members in attendance, who aggregate one-third of the capital represented at the meeting declare themselves not sufficiently informed on the matters to be dealt with in a resolution, [they] may request that the meeting is postponed for not more than three days';translation by Colussi (1993: 151).

119 *FIN.GE.M. v. Montedison* (1), at 832-33.

120 It is worth describing here the decision (not in the sample, as it was published after December 2000) in *Cofisa v. Mauri*. Cofisa (A in the following) sued its former chairman of the board, Mauri, alleging that he had violated his duty of loyalty to the corporation in two self-interested transactions. Mauri was C.E.O. of another corporation, B, and a shareholder of a third corporation, C, in turn a shareholder of B. Mauri proposed to A's board the acquisition of a controlling stake in B. The board authorized him to proceed according to the plan he presented. Mauri concluded the transaction in a different way than that outlined in the plan, and more precisely in the following way: A buys the shares held in B by C for 10,000 lire per share. It also buys other B shares from C at 6,850 lire per share. These shares had been bought by C, just prior to the sale to A, from other B shareholders for 5,000 lire per share on credit. In addition, the agreement between A and C provided that A would guarantee C's debt to these other B shareholders. Later, since C had not paid its debt, these shareholders took advantage of the guarantee provided by A. The court, after noticing that the board had approved the plan and authorized Mauri to proceed with its execution, held that no damage had been suffered by A as a result of these transactions, since A had obtained an opinion by the Rothschild bank, which judged B shares as worth at least 10,000 lire. It also held that the fact that Mauri had gained from the transaction as a shareholder of C was irrelevant, since A had not overpaid for B shares (*Cofisa v. Mauri*, at 331). The second transaction had to do with the acquisition by A of an 18 percent stake in D, a corporation controlled by E, a closed-end investment fund managed by F, of which Mauri was the legal representative (so the decision says, without better explaining what his exact position and interests were in F). After the acquisition, A started to heavily finance D, pouring money into it and guaranteeing its debts, although it did not have a controlling interest. No information of this financing activity was given to the board. The court found that Mauri had no liability for the damages stemming from this transaction, since it was proven that it was A's C.E.O., not Mauri (the Chairman), who had carried through the transaction on A's behalf (*Id.*, at 333).

121 Together with some preliminary evidence that the action is well founded (fumus boni juris), the plaintiff petitioning for a preliminary injunction has to persuade the court that there is a risk of irreparable damage (periculum in mora), i.e., that waiting for a court's decision in an ordinary proceeding could jeopardize the plaintiff's interests irreparably. See Article 700, Civil Procedure Code (Italy).

In *FIN.GE.M. v. Montedison (2)*, the court dealt with the same case as in *FIN.GE.M. v. Montedison (1)*,[122] but judged very differently. It found it 'perplexing' that the directors had not made all the documents concerning the settlement agreement public prior to the day of the meeting, in the light of their importance to the corporation: this settlement ended a dispute with the former controlling family, which had mismanaged the company, bringing it almost to insolvency and severely damaging the corporate image.[123] Even more perplexing, the court found, was the fact that although shareholders at the meeting had asked immediately to see the full text of the settlement agreements, they were only made available hours later.[124] Then, the directors read a summary of the agreements, implicitly suggesting that this contained all pertinent information,[125] when in fact the summary omitted information that was highly material, which the court extensively reports.[126]

FIN.GE.M. v. Ferruzzi was decided for the plaintiff shareholder who had sued the former directors of a listed corporation for damages. FIN.GE.M. alleged that it had invested in the corporation, and failed to divest from it, on the basis of annual reports which turned out to be false: among other things, these reports did not mention or did not properly account for a number of transactions draining money from the corporation and its subsidiaries to the controlling family.[127] It was an easy case from the factual point of view[128] and from that of the identity of the defendants (all members or associates of the Ferruzzi family, by then fallen into disgrace after the collapse of their business empire), but the court decided favorably to the plaintiff a series of highly controversial legal issues such as the causal link between factual omissions in the annual reports and the damage suffered by the shareholder).[129]

In *Iniziative Finanziarie v. Baraldi*, the court found for the plaintiff corporation in an Article 2393 liability suit against directors.[130] Iniziative Finanziarie alleged that the directors had overpaid for shares representing a controlling stake in a corporation (I.C.C.U. Containers), in a transaction with another corporation, which in turn was controlled by the controlling shareholder of Iniziative Finanziarie.[131] The court held that the price paid for those shares was in fact excessive, based on an expert opinion which relied on balance-sheet data. In response to the obvious objection by one of the defendant-directors that expected profits,

122 The plaintiff in *FIN.GE.M. v. Montedison* (1) had asked for a preliminary injunction, which had been denied. The 31 October decision was the appellate decision on the denial. See Article 669-terdecies, Civil Procedure Code (Italy).

123 See *FIN.GE.M. v. Montedison* (2), at 838.

124 *Ibid.*

125 *Id.*, at 838-39.

126 *Id.*, at 839. Another decision in favor of the minority shareholder on an issue of procedural fairness is *Giuliani v. Le Forane*. The court voided a shareholders' resolution adopted with the vote of a shareholder who was patently self-interested. Further, it held that the requirement in Article 2373 that a shareholder resolution passed by the vote of a self-interested shareholder may be voided only if it may harm the corporation has to be construed as requiring the plaintiff-shareholder to prove that there is a risk of damage for the corporation if the resolution is executed. The plaintiff need not prove that the resolution would harm the corporation if executed (as Article 2373's wording might allow to conclude).

127 *FIN.GE.M. v. Ferruzzi*, at 559-62, providing an impressive catalogue of misappropriation practices in which the controlling shareholders had engaged.

128 This is also the opinion of the decision's annotator: see Weigmann (2000: 556).

129 *FIN.GE.M. v. Ferruzzi*, at 563-70.

130 In all likelihood the suit had been brought after a change in control. The opinion does not clarify this point, however.

131 *Iniziative Finanziarie v. Baraldi*, at 713.

not balance sheet data, should be used to determine the value of the shares, the court stated that the contention was 'arbitrary,' since, as the expert also had stated, it ignores the 'correct legal and technical criteria' to be applied in order to appraise shares.[132] It also noted that the expert's valuation was in line with the price of the shares in a sort of unofficial and highly illiquid exchange called Terzo mercato,[133] not taking into account any control share premium. It is hard to say whether the court simply deferred to a faulty expert opinion, never doubting its merits, or whether it also took into account the fact that a 'stinking' conflict-of-interest transaction was involved. In any event, the decision illustrates the unfamiliarity of Milan judges (and their experts) with basic notions of finance.

Finally, in *Tonani v. Viscontea*, two shareholders together holding 10 percent of a company's shares had challenged a resolution increasing the share capital. This resolution had been passed by the vote of the majority shareholders (who were also the directors), after the court, at the request of the plaintiffs, had ordered the inspection of the corporation pursuant to Article 2409. The increase in capital left the minority shareholders with a difficult choice: they either had to increase their investment, although they were clearly at odds with the controlling shareholders, or they would lose standing in the Article 2409 proceeding, since they would fall below the 10 percent threshold of Article 2409. The court voided the resolution, holding that it had been passed for the exclusive purpose of reducing the minority shareholders' stake in the corporation and thus of depriving them of standing in the Article 2409 proceeding. The majority shareholders had thus abused their voting power, as indicated by the fact that the meeting was called just after the Article 2409 judicial hearing of the directors.[134]

Do the Milan court judges care for the real underlying rights and wrongs?

Italian corporate law decisions never start with a brief history of the corporation involved, a description of its business, or the personal relationships among its shareholders, as is normally the case for Delaware opinions.[135] In the decisions gathered for the present analysis, the background of the cases, *i.e.*, the real reasons why the plaintiff brought suit, is seldom reported.[136] This is especially true of the earlier decisions in the sample. In no decision issued before 1997 are the background reasons for the dispute disclosed. In most cases, therefore, it is impossible to determine whether the court took real rights and wrongs into account. In a few opinions, however, one gets the impression that the court did so, based on a tension be-

132 *Ibid.*

133 *Ibid.*

134 *Tonani v. Viscontea*, at 276-77. A similar case is *Megamoda v. Provasoli*, in which the court voided a shareholder meeting resolution which had appointed new directors before the temporary administrator had accomplished his duties, and, specifically, before he was able to sue former directors for liability.

135 See, e.g., *Shreiber v. Pennzoil Co.*, 419 A.2d 952 (Del. Ch.) (describing extensively Pennzoil's business and its recent developments); *Citron v. Du Pont de Nemours & Co.*, 584 A.2d 490 (Del. Ch.) (same, with regard to two corporations, the merger of which had been challenged in court with a class action); *Nixon v. Blackwell*, 626 A.2d 1366 (Del.) (describing in detail the history of the corporation involved in the dispute since its foundation); *Riblet Products Corp. v. Nagy*, 683 A.2d 37 (Del.) (describing in detail how the defendant was both a shareholder and an employee of the corporation and the terms of the employment contract).

136 Possibly, in some proceedings the parties themselves make no reference to these real reasons. But this is no less a consequence of the courts' lack of interest in them than a justification for the courts' silence.

tween the facts as explicitly related by the judge and the outcome of the case. In other words, several seemingly anomalous judgments may be explained by an implicit evaluation of the merits by the judge. This finding appears less conjectural when one considers that most of these cases dealt with excessive compensation in closely held corporations.

In Italy, as elsewhere, for tax reasons, profits in closely held firms are distributed to shareholders in the form of director employee compensation (Weigmann 1991: 793; Easterbrook and Fischel 1991: 229). This is fine with the shareholders as long as they get along and serve as directors of the corporation. If circumstances change, and shareholders begin to disagree for business or personal reasons, the majority shareholder(s) normally dismiss the minority shareholders from the board but continue to distribute all profits as directors' compensation (Weigmann 1991: 793-94). In that situation, minority shareholders find themselves owning shares worth almost nothing, while the value of any firm-specific human capital investments they may have made plummets.

In *GE.VI v. ME.AL.*, two minority shareholders challenged a shareholder resolution determining directors' compensation. They alleged that the resolution was passed by the vote of self-interested majority shareholders (a director and her husband) and that the compensation was excessive. The court held the compensation packages excessive on the grounds that they exceeded the company's profits for the year and that the director's involvement in the company had been limited, with much of the management in the hands of her husband, an officer of the company.[137]

As suggested earlier, in more recent decisions the real dispute is sometimes revealed and appears to be implicitly taken into account by the court.[138] In *Innenz v. Fiduciaria Sant'Andrea*,[139] one of the two fifty percent shareholders of a corporation challenged the other's repeated refusal to approve the financial statements and appoint new directors. As the decision makes clear, the two shareholders disagreed over the strategy of their joint venture. The plaintiff argued that the refusal to approve the financial statements and the appointment of directors was an abuse of the voting right. The court rejected the claim because the defendant consistently provided specific reasons for the negative vote on the financial statements,

137 A very similar case is *Terracciano v. F.r.o.m.m.*. Similarly, in *Casterida v. Immobiliare V.O.R.*, the court voided a resolution determining a very high compensation for a director who was over 70, lived in Montecarlo and, as it was proven, had had no active role at all in the management of the company. The plaintiff had not been able to provide evidence that the the indirect beneficial owner of the corporation which held a majority stake in the company and which approved the resolution was the director herself, so that a conflict of interest was unproven. However, the court found that the compensation was so unreasonable as to constitute, per se, evidence of an abuse of the shareholder's voting right.

138 In *Bonfiglio*, the court rejected an Article 2409 complaint stating that 'in the present case it is apparent that the plaintiff has exploited the Article 2409 complaint in order to pursue a different aim, i.e., in order to … get a higher price for his shares.' In *Fiordelli v. CO.MO.I. s.i.m.* (2), an Article 2377 case decided in favor of the defendant, the court states that the defendant had 'claimed that the suit was an instrumental one, as many suits were pending between the plaintiff and the corporation, some of them even in labour court.'

139 Decision of June 2, 2000.

and the refusal to appoint new directors was justified by the substantial strategic disagreement between the shareholders. Since an abuse of the voting right exists only where a shareholder's exclusive aim is to harm other shareholders, the fact that the vote was properly justified excluded a finding of abuse.[140] Whatever the general implications of such a holding,[141] the court appears to have correctly resolved this dispute. In fact, as the court acknowledges,[142] deadlock may cause the dissolution of the corporation.[143] Yet this is the outcome the shareholders had implicitly agreed in the event of serious disagreement, as indicated by their decision to each hold fifty percent of the shares.[144]

Another case in which the background disagreement is not only well described in the opinion but also duly taken into account in the judgment is *Cornelli v. Fratelli Cornelli*. The case involved two corporations, Fratelli Cornelli (FC), a forwarding agent, and Cotras, a carriage company. The shareholders of both were members of the same family. Alberto Cornelli was the majority shareholder of FC, which had as minority shareholders other family members. These, in turn, were the majority shareholders of Cotras, in which Alberto Cornelli had a minority stake. Cotras often provided its carriage services to FC. Cotras had financial problems, and its majority shareholders, in order to help it out, proposed to modify the terms of the carriage agreements between the two companies in favor of Cotras. Alberto Cornelli refused to do so. At the annual meeting of FC, the minority shareholders took advantage of Article 2373's voting ban[145] and authorized a liability suit against Alberto Cornelli and his son, also a director of the company. They alleged that Alberto Cornelli had engaged in self-dealing transactions: he had employed his son and he had bought a luxury car, despite the allegedly critical conditions of FC. Alberto Cornelli challenged the shareholders' resolution in court, alleging, in turn, that the fact that he had employed his son, *per se*, was not harmful for the corporation, unless it was shown that his son was overpaid; he also denied any personal use of the luxury car. The court found for Alberto Cornelli, noting that the minority shareholders had a conflict of interest in the resolution, since they had presumably taken advantage of the situation to persuade him to accept the proposed changes in the agreements with Cotras.[146]

140 *Innenz v. Fiduciaria Sant'Andrea*, at 3642-43.

141 One may fear that an abuse of the voting right be almost never be found to exist, if the judge must be satisfited that the shareholder aimed exclusively (i.e. in the absence of any appreciable interest) at harming the other shareholders: see Enriques 2001: 89.

142 *Innenz v. Fiduciaria Sant'Andrea*, at 3641.

143 See Article 2448, No. 3, Civil Code (Italy) (providing that a corporation dissolves in case the shareholder meeting is unable to work, e.g., in the case of a deadlock).

144 This is even more apparent if one considers that Italian law does not provide for exit remedies except in very peculiar circumstances. See Enriques (2001: 81).

145 See *supra* note 75.

146 *Cornelli v. Fratelli Cornelli*, at 94.

Do the judges have a formalistic mentality?

As Part IV suggested, formalism is still a pervasive mental habit of Italian legal scholars, judges, and practitioners, even in the corporate law area. It would be surprising to find that Milan Tribunal's judges do not share this mind-set. After all, their decisions will be reviewed by an appellate court and, indirectly, by a Supreme Court also of this mind-set (Enriques 2001: 91). I have searched the decisions in the dataset for symptoms of either formalism or antiformalism. It is quite possible that I failed to identify signs of antiformalism, since antiformalistic judgments and constructions are consistent with common sense, and so might more easily go unnoticed. In any event, I found only one relevant example of antiformalism as against five cases showing formalistic thought on the part of the judges.

The antiformalistic decision is *Cavalli v. GAIC*. After solving a complex legal issue in favor of the plaintiff-shareholder, the court held that the exchange ratio in a merger was unfair. The court held that a certain provision protecting the right of holders of non-voting shares to a privileged treatment vis-a-vis holders of voting shares, literally not applying to merger transactions, ought to be applied to them as well. Otherwise, as the court held, the non-voting shareholders right to a privileged treatment would be nullified.[147]

Sviluppo Immobiliare v. Reale is the most striking example of formalistic reasoning by the Milan court. A corporation brought a liability suit against its internal auditors. The defendants alleged that the shareholders' resolution authorizing the suit had been taken during an irregular shareholders' meeting, because the present shareholders (representing 100 percent of the capital) had failed to properly deposit their share certificates at least five days before at a bank's premises or at the corporation's registered office, as required by a 1962 law.[148]

In fact, the share certificates had not been deposited because employees of the corporation's registered agent (apparently one of the very auditors subject to the liability suit) had refused to accept them in deposit without justification.[149] According to the court, the shareholders should have obtained a declaration from a notary that it was impossible to deposit

147 *Cavalli v. GAIC*, at 86-87.

148 See Article 4, Law No. 1745, of Dec. 29, 1962. This provision had been enacted as a defense for incumbents against creeping acquisitions: its purpose was in fact to let incumbents know before the meeting if someone had gathered a block of shares, so that they could prepare adequate defenses (like a delay of the meeting or some other legal defense). This rule applies also to closely-held corporations, for which, of course, it has never had any meaningful purpose. See Enriques (2001: 92).

149 As published with its 'omissis,' the decision does not explicitly state that the registered agent was one of the auditors. However, the circumstances of the case are peculiar enough to justify the inference, also in the light of the fact that it is not uncommon for Italian corporations to have their registered office by their certified accountants (internal auditors have to be chosen among certified accountants according to Article 2397 of the Italian Civil Code): not only had the employees of the registered agent refused without justification to accept the certificates in deposit; on the day of the meeting (called in order to authorize the liability suit against auditors), which was to be held at the registered agent's facilities, these remained closed the whole day, so that in the evening shareholders ended up holding the meeting in a bar nearby.

the share certificates, and deposited them elsewhere.[150] Failing this, the court held that the shareholders' resolution was 'non-existent'[151] and rejected the liability suit on this ground.[152]

Formalistic thinking about corporations is shown by decisions denying that Article 2373[153] applies to resolutions on parent-subsidiary mergers passed by the vote of the parent. For example, in *Serafini v. Tosi*, the plaintiff argued that the resolution was voidable because the majority shareholder corporation, who was of course interested in determining a share exchange ratio most favorable to itself, had voted, in violation of Article 2373 of the Italian Civil Code. The court denied that a conflict of interest between a shareholder and the corporation may arise with regard to a resolution concerning a merger and its exchange ratio, because 'not only majority shareholders have an interest to a certain exchange ratio, but also minority shareholders have an interest, which is of course opposite to that of majority shareholders, while the corporation is indifferent to the exchange ratio, which only involves personal relationships among its shareholders.'[154] The reasoning underlying this opinion is that the assets of the corporation cannot be affected by the exchange ratio: regardless of the exchange ratio, assets are the same, even though they have become part of a greater entity.[155]

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150 *Sviluppo Immobiliare v. Reale*, at 613.

151 See *supra* text accompanying note 69.

152 *Sviluppo Immobiliare v. Reale*, at 613-14. The court had to resort to non-existence because the auditors had failed to challenge the resolution within three months: it was hence too late to declare the resolution simply voidable. A more recent case, *Biocoral v. Borgonuovo Sim* also deals with the 1962 provision on the deposit of shares. The problem here was to determine how to count the five-day period, in connection with another (also quite meaningless) rule that distinguishes between first and second call shareholders' meetings, providing a lower quorum for the latter (Articles 2368-69, Civil Code (Italy)). Often, corporations call the shareholders' meeting for a certain day as a first call meeting and for another day as a second call meeting. Then, the meeting will usually take place as a second-call meeting, because of the lower quorum requirement. The law does not specify whether the five-day period for the deposit of certificates has to be counted backwards from the day of the first call meeting or from the day of the second call meeting. In *Biocoral v. Borgonuovo Sim*, the majority shareholder (having become such two years before) had deposited its shares on 31 January in order to take part in a shareholders' meeting called on the same day as a first call meeting and on 5 February as a second call meeting. The minority shareholders (who had somehow retained some form of control) did not allow the majority shareholder to take part to the meeting. Consequently, the majority shareholder challenged the resolutions taken at that meeting before the Milan court. The court rejected the claim, stating that the five-day period had to be counted backwards from the day of the first call meeting, so that the other shareholders were right not to let the majority shareholder take part to the second call meeting. According to the court 'this construction is not the expression of some useless procedural formalism; instead, it conforms to the rationale underlying the [1962] provision: avoid so-called "last-minute tricks"' (*Biocoral v. Borgonuovo Sim*, at 1430; remember that the majority shareholder had acquired the shares two years before). This is a very questionable construction (as the fact that most legal scholars are of the opposite view also suggests: see Cavalli, Marulli, and Silvetti 1996: 116-17, for references) and one which unduly hampers the functioning of corporations. It also has bad spill-over effects, because it encourages opportunistic behavior by controlling shareholders (who may take advantage of any sort of formalistic construction of existing corporate law rules such as those described above) or by minority shareholders (who may file frivolous suits on similar grounds).
In *Mazzoni v. Saeco*, the plaintiff challenged as void a resolution for a capital increase from 20millions lire to 200millions lire. The plaintiff had not exercised her pre-emption rights and her share had consequently dropped from 15 percent to 1.5 percent. During the proceeding, the plaintiff had sold her shares to a third party, but did not abandon the action: her agreement with the buyer was apparently that she would continue her suit, so that possibly the shares would represent 15 percent of the capital. The court rejected the claim, on the ground that by selling her shares the plaintiff had lost standing in the proceeding. According to the court the provision in Article 111, Civil Procedure Code (Italy) (according to which if, during the proceeding, one party transfers the contested right to a third party, the proceeding may continue between the original parties) did not apply to the specific case, because no controverted right had been transferred: the argument supporting this view is too technical to be worth reporting. It is enough to note that, if the plaintiff had kept one share worth no more than 1,000 lire (0.51 euros), the court, on those grounds, would have had to pronounce differently.

153 See *supra* note 28.

154 *Serafini v. Tosi*, at 812-13.

155 See also *Aliverti v. Immobiliare Isaia Volontè*.

This conclusion implicitly denies that the purpose of the corporation is to maximize shareholder wealth. It does so without considering whether rejecting the shareholder primacy norm is wise or unwise from a policy perspective. Instead, it simply partakes of the view, popular among Italian judges,[156] that a corporation is a real entity with its own purpose, distinct from the shareholders' interests. This is not suprising, since, as will be shown below, Milan judges are indifferent to the effects their decisions may have on corporate actors and on society as a whole.

Are the judges concerned with spill-over effects?

As is well known, common law judges in general are inclined to consider the effects that their rulings may have on the rest of society, or at least on the actions of people who may find themselves in a similar situation.[157] Professor Allen, reflecting upon his twelve-year experience as Chancellor of Delaware, vividly expressed how relevant this concern for the behavior-molding potential of judicial decisions in corporate law was in his decision-making process:

> 'I thought of each case as an opportunity to craft a just result with due regard for the effect that such a ruling, to the extent it could be generalized, would have on others in the future. …. [E]ach judicial ruling is …. an offering to history, both to the men and women of a future moment who will work with it anew to try to achieve their ends, and to future judges who will try once more to work out the requirements of justice in a new setting' (Allen 1997: 903).

A sharp illustration of a similar concern can be found in Justice Cardozo's oft-cited description of trustees' obligations in *Meinhard v. Salmon*:[158]

> A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. …. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. …. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. *It will not consciously be lowered by any judgment of this court.*[159]

156 See Enriques 2000b: 162-63. And see also *Terracciano v. F.r.o.m.m.*, at 798.
157 See, *e.g.*, Fisch 2000: 1079-81 (with specific regard to Delaware corporate law judges).
158 164 N.E. 545 (1928).
159 *Id.*, at 546 (emphasis added).

Trying to find any similar concern in an opinion by a Milan judge is an exercise in futility. Judges never express concern for how a decision might influence the behavior of corporate actors, nor do they ask themselves whether, for example, holding a director not liable in a specific case might send the wrong message to other corporate directors. Of course, one cannot rule out the possibility that they do engage in such reasoning, omitting to *express* it in their opinions. But the mere fact that courts do not give voice to this concern is itself a negative feature of Italian corporate law and governance, as the signals that judges send indiscriminately to corporate actors through their decisions are vaguer and more obscure.[160]

One may think that judges' lack of concern for spill-over effects is to be connected with the absence of a formal stare decisis doctrine in Italy; in this view, judges do not need to worry that they are establishing a precedent and hence will not consider that they may be guiding future business decisionmaking. Yet, as previously hinted, also in Italy precedents have considerable persuasive power on judges. This is confirmed by the Milan Tribunal's frequent citation of its own prior decisions.[161] Furthermore, Delaware law judges do share this concern, in spite of the fact that their decisions 'have little stare decisis effect' (Fisch 2000: 1079).

A civil law theorist might object that it is not the judge's duty to decide what rules would be best for corporate actors, or to send the right messages to the business world: the judge's duty is to apply the law, not to make it, the latter being the legislature's function.[162] Yet, this is certainly not what goes on in the real world, in Italy or elsewhere (Mengoni 1994; Merryman 1966b).

In the face of judges' silence concerning these grounds, one may examine the decisions in the sample to see whether judges do in fact send the 'right' messages to corporate actors. This sort of analysis can only be sketched out here. Some of the decisions described in Section V.B.3, which construe abstruse legal rules in such a way as to impose cumbersome formalities on corporate actors are not the best products of a corporate law judge.

Some interesting implications can be drawn from challenges of resolutions on parent-subsidiary mergers passed by the vote of the parent. The Milan court takes it for granted that the parent may vote at the subsidiary's meeting called to approve the merger.[163] Further, the court consistently refuses to grant a stay against the merger, holding that minority shareholders damaged by the share exchange ratio may later recover damages in an ordinary action.[164] Thus, under the Milan case law, majority shareholders can unilaterally proceed

160 The relevance of judges' 'dialogue' with corporate actors in shaping a better corporate governance environment is emphasized, with an eye to the U.S. experience, by Barca (2001: 13).

161 It is the case of most of the decisions described above. Just to mention a few, see *Terracciano v. F.r.o.m.m.*, at 802; *Innenz v. Fiduciaria Sant'Andrea*, at 3642; *Mazzoni v. Saeco*, at 252 and 257; *Biocoral v. Borgonuovo s.i.m.*, at 1430.

162 I have received this critique by some of the Italian legal scholars who have read this paper in earlier versions.

163 See especially *Serafini v. Tosi*, at 813, stating that '[t]his conclusion is consistent with a fair [corretta] view of intra-corporate relationships, especially apparent in intra-group mergers, where, beyond the majority shareholder's interest, there exists also an interest of the group of companies involved, and a slender minority would be able to dispose of this interest without any reason, if a duty to abstain were imposed upon the majority shareholder.'

164 See *supra* text accompanying note 121.

with a parent-subsidiary merger and set the terms of the transaction. If the terms are unfair to minority shareholders, they must bring an ordinary action for damages. Since the damage to the individual shareholder is normally small, while the cost of suing (in the absence of class actions, contingency fees and the American rule) is high, even substantially unfair mergers may easily proceed without compensation to minority shareholders. In other words, at least at first sight, it is highly doubtful whether the liability rule applied by the Milan Tribunal to this kind of self-dealing transactions is an efficient one, in light of all the relevant factors including the efficacy of the judicial system and the disciplinary role of markets and social norms.[165]

9.6 Concluding Remarks

If corporate law matters to corporate governance and finance, then in order to assess the quality of the law in any given country, one must look at corporate law off the books – the characteristics of corporate law as applied by judges and other relevant public officials. This chapter has provided an assessment of Italian corporate law based on an analysis of a sample of decisions by the Italian court most specialized in corporate law. I have tried to evaluate the quality of the judges by examining: (1) how deferential they are to corporate insiders; (2) how keen they are to understand, and possibly take into account, the real merits of the case before them; (3) the degree of antiformalistic reasoning revealed; (4) their concern for the effects their decisions have on corporate actors generally.

It is fair to say that this analysis casts a negative light on Milanese (and by extension, all Italian) corporate law judges. The empirical analysis in Part V has highlighted egregious cases of deference to corporate insiders, especially with regard to parent-subsidiary relationships. Furthermore, few opinions are drafted so as to allow the reader to understand the actual nature of the dispute and whether a party had acted opportunistically. In any case, it appears that courts rarely take into account the substantive reasons for the dispute. I have also described cases in which the court has relied on very formalistic arguments. Finally, there is no sign that judges care about the signals they send to corporate actors and the incentive effects of their decisions on directors and shareholders.

These conclusions, in turn, confirm the negative assessment of Italian corporate law and governance so often found in the literature. Arguably, a similar analysis of many other legal systems would provide comparable results. It may be useful, then, not only for Italian corporate governance but for many countries, to consider how policymakers could change the landscape of bad corporate governance off the books.

First, a revision of corporate law on the books would be helpful. Access to justice for minority shareholders should be made easier and more 'direct' by enabling them to challenge self-interested transactions in court. As argued in Section II.C, this would reduce the incen-

165 The theoretical framework for such analysis, which cannot be attempted here, is provided by Goshen (2000: 23-33).

tives to bring ostensible suits, making it easier for courts to address the real issues. It would also enable judges to gain experience with such cases and thereby develop a good nose for corporate misconduct. The fact that Italian judges do substantially defer to corporate insiders makes the proposal to extend minority shareholders' access to justice less troublesome in Italy than elsewhere. In fact, generally speaking, the main problem with this kind of suits is that of 'type two' errors, *i.e.* the possibility that judges will strike down transactions or hold directors liable in the absence of any wrong. Italian judges' 'natural' inclination to judge in favor of insiders makes this outcome less probable. Further, statutory provisions maintaining pointless formalities should be eliminated, so that attention is not diverted from more substantive issues.

Policy initiatives more directly targeted at corporate law judges would seem to take much more time to be effective, as their effectiveness will crucially depend upon changes in a country's (legal) culture.[166] It would obviously be useful to have judges devoted exclusively or at least predominantly to corporate law. In Italy, a recent provision by the judges' self-governing body prevents judges from dealing with corporate law cases for more than ten years (Civinini 2000: 606). Interestingly, this rule reflects the suspicion that judges may otherwise become too powerful and, implicitly, that they may abuse their power to extract rents or, worse, to get bribes (Civinini 2000: 608). A rule like this should be scrapped and, as the case may be, the appropriate forms of accountability should be introduced instead.

Needless to say, in order to have more specialized judges, they must be trained to handle complex corporate cases, and exposed to at least basic notions of corporate finance, accounting, and business administration.[167] Acquiring more knowledge in these areas should also enhance their sense of legitimacy to second-guess the self-interested decisions of corporate actors.

Yet changing a judiciary's deferential attitude towards corporate insiders and reducing formalism in the construction of the law will be very difficult. After all, corporate insiders are often wealthy and powerful. Most Italians, not simply corporate law judges, have a deferential attitude toward the wealthy and powerful. Moreover, judges in Italy and other civil law jurisdictions share a formalistic approach to law with most practicing lawyers and legal scholars. They were taught to be formalistic and possibly were selected as judges thanks to their skills in formalistic reasoning and the application of rules.[168] Policymakers may find few effective tools to deal with such cultural features, at least in the short term. It is far more realistic to expect that changes in national (legal) culture will be the product of globalization and competitive forces.

166 On the relevance of culture to corporate governance and its institutions see generally Licht (2001).

167 Truth to tell, some Italian judges, and among them most corporate law judges at the Milan Tribunal, are familiar with accounting issues.

168 Cf. Georgakopoulos (2000: 220) (with reference to civil law judges generally).

Appendix: Italian cases cited in Part 9.5

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Brichetti v. Nuova COI, Decision of Apr. 27, 1989, 1989 Giurisprudenza italiana Part 1.2: 932 (Quatraro, J.).

Casterida v. Immobiliare V.O.R., Decision of Nov. 20, 1995, 1996 Giurisprudenza commerciale Part 2: 825 (Riva Crugnola, J.).

Cavaggioni v. Rotondo (1), Decision of June 26, 1986, 1987 Foro Padano Part 1: 402 (Manfrin, J.).

Cavaggioni v. Rotondo (2), Decision of Oct. 28, 1986, 1987 Foro Padano I, 402 (Milan Court of Appeals).

Cavalli v. GAIC, Decision of Sept. 28, 1995, 1996 Giurisprudenza italiana Part 1.2: 77 (Manfrin, J.).

Cofisa v. Mauri, Decision of Feb. 10, 2000, 2001 Giurisprudenza commerciale Part 2: 326 (D'Isa, J.).

Cornelli v. Fratelli Cornelli, Decision of July 26, 1997, 1998 Giurisprudenza italiana: 93 (D'Isa, J.).

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Mazzoni v. Saeco, Decision of June 23, 1988, 1989 Giurisprudenza commerciale Part 2: 248 (Marescotti, J.).

Milan v. Trema Gestione, Decision of May 18, 1995, 1996 Le Società: 68 (Gilardi, J.).

Megamoda v. Provasoli, Decision of May 13, 1994, 1994 Le Società: 1389 (Marescotti, J.).

Serafini v. Tosi, Decision of Jan. 20, 1998, 1998 Le Società: 811 (Tarantola, J.).

Sviluppo Immobiliare v. Reale, Decision of Jan. 27, 1986, 1986 Le società: 609 (Quatraro, J.).

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Catharina Elisabeth Godefrida (Karien) van Gennip (1968) was appointed Minister for Foreign Trade in the second Balkenende government on 27 May 2003. Ms Van Gennip studied applied physics at Delft University of Technology, graduating in 1993. In 1995, she graduated as a Master of Business Administration (MBA) from the European Institute of Business Administration (INSEAD) in Fontainebleau, France. In 1994 and from 1996 to 2002, Ms Van Gennip worked for McKinsey & Co. in Amsterdam and San Francisco. From September 2002, she led the reorganisation of the Financial Markets Authority, and was appointed its director in 2003. From 2002 to 2003, Ms Van Gennip was a member of the board of the Christian Democratic Alliance (CDA) in Amsterdam.

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Amsterdam Center for Corporate Finance

The Amsterdam Center for Corporate Finance (ACCF) is a thinktank specializing in the financial management of corporations and the operations of the financial sector. The ACCF promotes high quality research on the interface between financial theory and corporate policy. With a variety of activities, it provides a forum for dialog between academics and practitioners. The ACCF is an independent foundation and is supported by major financial and industrial corporations, consultancy agencies and (semi) government bodies. It is affiliated with the University of Amsterdam.

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