

## The Pendulum Swings: Federalization of Corporate Law and Its Effects on the American Capital Markets

### I. INTRODUCTION

Publicly traded firms, in the wake of the Enron and WorldCom collapses, face increased scrutiny from the Department of Justice, the SEC, state attorneys general, an active plaintiff's bar, stock exchanges, and the 2002 Sarbanes-Oxley Act (Sarbanes).<sup>1</sup> Firms increasingly face shareholder challenges demanding increased power over executive compensation, merger and acquisition decisions, and directorial elections.<sup>2</sup> While substantive state law traditionally governed the internal workings of corporations, since 2002 Congress, federal courts, and the SEC have deliberately—and sometimes with good reason—intruded into these state law areas.<sup>3</sup> The resulting increase in compliance costs, coupled with expanding areas of liability for directors, and uncertainty over the federal government's often ad hoc rulemaking is forcing an increasing number of executives and public firms to explore the benefits of going private, and simultaneously pricing some private firms out of the United States' public markets altogether.<sup>4</sup> Unprecedentedly diffuse ownership in today's public capital markets makes those markets' retention of firms and top executives critical to America's long-term economic health.<sup>5</sup>

Federal courts have aided Sarbanes' intrusions into state corporate law by creating, enforcing, and broadly interpreting new rules that effectively supplant well-established state corporate law.<sup>6</sup> Though SEC officials recognize that

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1. See *Shareholder Democracy: Battling for Corporate America*, ECONOMIST, Mar. 11, 2006, at 63 (noting section on internal controls as especially onerous).

2. See Scott Hensley & Joan S. Lublin, *Pfizer Meeting Gives Dissidents Voice, Not Votes*, WALL ST. J., Apr. 28, 2006, at B1 (reporting increased debate over shareholder resolutions at major companies). In the first six months of 2006, public firms faced 400 shareholder resolutions on corporate governance and 180 on social or environmental issues compared with 383 and 169 respectively over the same period in 2005. *Id.* The upward trend is expected to continue. *Id.*

3. See *Am. Fed'n of State, County & Mun. Employees v. AIG, Inc.*, 462 F.3d 121, 129-31 (2d Cir. 2006) (ruling on election exclusion). *But see Frank v. Hadesman and Frank, Inc.*, 83 F.3d 158, 160-62 (7th Cir. 1996) (dismissing direct action where harm ran to all investors). The court stated that a federal court is an inappropriate forum in which to rewrite state corporate law. *Id.* at 162.

4. See Christopher J. Hewitt & A. Guthrie Paterson, *Going Private Transactions: Delaware Revisits Negotiated Mergers and Tender Offers Involving Controlling Stockholders*, Hewitt & Paterson Commentaries, Jan. 2006, (detailing excessive regulation driving firms going private); William B. Chandler & Leo E. Strine, Jr., *Views From the Bench: The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 981 (2003) (predicting directors will follow firms into private roles due to overregulation).

5. See *infra* note 27 (reporting shift in activity from U.S. markets); *infra* note 192 (correlating overregulation with decrease in American capital market health).

6. See *Am. Fed'n*, 462 F.3d at 129-31 (encroaching on state-law jurisprudence by overruling SEC's

state law theoretically controls corporate governance, its leadership recently suggested that the SEC “empower investors” by creating new federally-mandated directorial duties beyond substantive fiduciary duties developed over centuries of state common-law evolution.<sup>7</sup> Despite recognizing the excruciatingly high costs of compliance for small firms, SEC officials seem intent on creating duties based on social benefits and a “culture of compliance” among public companies.<sup>8</sup> Federal courts, however, at times check the SEC when it overreaches and fails to consider the economic consequences of its actions while acting in the name of corporate governance.<sup>9</sup> Indeed, *Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc.*<sup>10</sup> suggests that the Supreme Court will not give in to political and institutional advocates of far-reaching reforms where Congress has not expressly authorized such regulation.<sup>11</sup>

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interpretation of its own rule). The SEC’s interpretation of the so-called exclusion supported its traditional state law meaning. *See id.* at 123-24, 127 (describing Delaware provision governing elections and relating SEC’s position on exclusion). The exclusion applies to shareholder proposals that relate to a particular election and not the procedural rules governing elections generally. *Id.* at 123.

7. *See* Brian G. Cartwright, Gen. Counsel, U.S. Securities and Exchange Comm’n, Remarks at Dinner in Celebration of the Establishment of the Arthur and Toni Rembe Rock Center for Corporate Governance at Stanford University (May 13, 2006), <http://sec.gov/news/speech/2006/spch051306bgc.htm> (recognizing need to monitor institutional investors); Christopher Cox, Chairman, U.S. Securities and Exchange Comm’n, Address to the Stanford Law School’s Directors’ College (June 26, 2006), <http://sec.gov/news/speech/2006/spch062606cc.htm> [hereinafter Cox, Stanford Law] (advocating federal revision of corporate fiduciary duties).

8. *See* Roel C. Campos, Comm’r, U.S. Securities and Exchange Comm’n, How to be an Effective Board Member (Oct. 15, 2006), <http://sec.gov/news/speech/2006/spch081506rcc.htm> (placing “strong culture of compliance” among primary goals of SEC); Christopher Cox, Chairman, U.S. Securities and Exchange Comm’n, Introductory Remarks Before the Executive Compensation Disclosure Conference (Apr. 3, 2006), <http://sec.gov/news/speech/2006/spch040306cc.htm> [hereinafter Cox, Introductory Remarks] (advocating aggressive SEC role in corporate law).

9. *See* Chamber of Commerce v. SEC, 412 F.3d 133, 144 (D.C. Cir. 2005) (invalidating SEC rule requiring greater independence on mutual fund boards).

10. 128 S. Ct. 761, 766 (2008).

11. *See id.* (holding no SEC Rule 10b-5 violation where investor failed to prove reliance); *see also* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2510 (2007) (requiring plaintiffs to plead with particularity facts raising powerful or cogent inference of scienter). SEC Rule 10(b)-5 provides a right of action for material misstatements or omissions in connection with the purchase or sale of securities. *See* Securities and Exchange Act of 1934, § 10(b), 15 U.S.C. § 78(j) (2006); 17 C.F.R. § 240.10b-5 (1996). The Supreme Court determined that Rule 10b-5 implies a private right of action. *See* Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971) (construing Rule 10b-5 flexibly). Rule 10b-5 governs only conduct already prohibited under Rule 10(b). *See* United States v. O’Hagan, 521 U.S. 642, 651 (1997) (explaining textual limit of 10(b)). The Supreme Court has “refused to allow [private] 10b-5 challenges to conduct not prohibited by the text of the statute.” *See id.* (quoting Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 173 (1994)). Despite overwhelming pressure from some regulators and the plaintiffs bar, the Supreme Court continues to reject attempts to read into Rule 10b-5 private rights of action not clearly demanded by the text of section 10(b). *See Stoneridge*, 128 S. Ct. at 637-38 (affirming 10b-5 does not extend to aiders and abettors); *see also* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 177-78 (1994) (noting 10(b) makes no mention of aiding and abetting liability). As part of the Private Securities Litigation Reform Act, however, Congress amended the Securities Act to provide the SEC with authority to prosecute under 10b-5 “any person that knowingly provides substantial assistance to another

Perhaps no issue in the corporate governance debate is more headline-grabbing than executive compensation.<sup>12</sup> The discourse in this area is fiercely political and engenders emotional complaints to investor advocacy groups and the SEC.<sup>13</sup> While reducing executive compensation is a popular item on political agendas, even the SEC is uncertain of the effectiveness or necessity of proposed disclosure rules.<sup>14</sup> Increased disclosure requirements coupled with heightened personal liability can drive high-quality executives away from public company management and boards of directors and into private firms.<sup>15</sup> Firms may be likely to follow.<sup>16</sup>

Traditionally, state corporate law controls elections for boards of directors, with Delaware being the most influential state.<sup>17</sup> Generally, state law provides minimum default rules for director elections, which firms can voluntarily adopt in their articles so long as they do not conflict with state-promulgated minimums.<sup>18</sup> Some firms and a minority of state legislatures favor majority voting schemes, to the approval of shareholder advocates.<sup>19</sup> Through enhanced SEC rulemaking, including Rule 14-a(8)'s private right of action and narrow interpretation of the "election exclusion," federal authorities circumvent state

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person in violation of a provision of this title, or of any rule or regulation issued under this title." Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in 15 U.S.C. § 78t).

12. See Joann S. Lublin & Scott Thurm, *Money Rules: Behind Soaring Executive Pay, Decades of Failed Restraints – Instead of Dampening Rewards, Disclosure, Taxes, Options Helped Push Them Higher – Return of Golden Parachutes*, WALL ST. J., Oct. 12, 2006, at A1 (illustrating history of executive compensation as activist target).

13. See Cox, Introductory Remarks, *supra* note 8 (implying investor-related goals linked to decreased compensation). A comment to the SEC regarding its proposed Compensation Discussion and Analysis section to already existing disclosure requirements states: "It is about time someone did something to let us know how the companies in which we have invested our hard earned money are compensating the executives." *Id.*

14. See Paul S. Atkins, Comm'r, U.S. Securities and Exchange Comm'n, Remarks Before the Society of Corporate Secretaries and Governance Professionals (June 30, 2006), <http://sec.gov/news/speech/2006/spch063006psa.htm> [hereinafter Atkins, Remarks] (noting proposed disclosure rules actually produce "race to the top").

15. See Chandler & Strine, *supra* note 4, at 993-94 (noting regulation's potential to drive executives away from public companies); see also Emily Thornton, *Going Private: Hotshot Managers Are Fleeing Public Companies for the Money, Freedom, and Glamour of Private Equity*, 3973 BUS. WK., Feb. 27, 2006, at 52 (discussing executive transition into private firms). Reasons for the trend include avoiding the proposed SEC Compensation Discussion and Analysis disclosure, activist shareholders and hedge funds, and the inability to take risks in public markets without fear of litigation. See Thornton, *supra* (highlighting reasons behind trend).

16. See *supra* note 4 (providing reasons for firms going private that are similar to those for executives).

17. See Leo E. Strine, Jr., *Response to Increasing Shareholder Power: Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1762 (2006) (describing Delaware's system of corporate law).

18. See *Licht v. Storage Tech Corp.*, No. 524-N, 2005 Del. Ch. LEXIS 64, at \*12-13 (Del. Ch. May 6, 2005) (examining whether corporation's voting procedure consistent with Delaware law). *But see* *Harding v. Heritage Health Prods. Co.*, 98 P.3d 945, 948 (Colo. App. 2004) (invalidating bylaw vesting exclusive power in board to fix number of directors).

19. See Andrew R. Brownstein & Igor Kirman, *Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions*, 60 BUS. LAW. 23, 26, 33 (2004) (reporting rise in majority voting resolutions).

law and provide shareholders with greater control over the companies in which they invest.<sup>20</sup>

While firms have long embraced “going private” as a defensive measure, an increasing number of firms are currently seeking long-term growth elsewhere by opting out of U.S. public markets.<sup>21</sup> Going private refers to a publicly traded firm exiting public markets through its acquisition by a private investment group, individual, or company.<sup>22</sup> Reasons for going private include expense mitigation, avoidance of shareholder disputes, increased executive liability, compliance with Sarbanes, hostile-takeover defense, and long-term growth opportunities.<sup>23</sup> While the number of firms abstaining from entering the public securities markets for these reasons is unknown, the trend in public firms going private is unquestionably increasing.<sup>24</sup> Although some commentators suggest that this trend is limited to small firms, in recent years an increasing amount of mid—and even large sized—firms left American public markets.<sup>25</sup> While large firms are better positioned to absorb compliance costs, all firms suffer significant losses in opportunity costs.<sup>26</sup> These disincentives—in

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20. See *Am. Fed’n of State, County & Mun. Employees v. AIG, Inc.*, 462 F.3d 121, 129-31 (2006) (narrowing scope of election exclusion to require proxy disclosure for procedural proposals governing elections generally). Firms may exclude proposals relating to a particular election under the election exclusion, but not proposals relating to elections in general. *Id.* at 131. See generally *Roosevelt v. E.I. Du Pont de Nemours & Co.*, 958 F.2d 416, 417 (D.C. Cir. 1992) (crafting through judicial implication private right of action from SEC rule 14a-8).

21. See Dennis K. Berman, Gautam Naik & Ron Winslow, *Behind \$21 Billion Buyout of HCA Lies a High-Stakes Bet on Growth*, WALL. ST. J., July 25, 2006, at A1 (providing example of firm going private due to market conditions and not as defensive measure).

22. FACTSET MERGERSTAT, LLC, MERGERSTAT REVIEW 2006 42, tbls. 1-39 (2006) (defining going private and detailing increases in going private trend). “A company ‘goes private’ when it reduces the number of its shareholders to fewer than 300 and is no longer required to file reports with the SEC.” See SEC’s Defining Corporate Terms, <http://www.sec.gov/answers/gopriv.htm> (providing general overview of going-private transaction).

23. See FACTSET MERGERSTAT, LLC, *supra* note 22, at 42 (detailing reasons for going private); Thornton, *supra* note 15, at 52 (noting reasons executives leave public markets).

24. See FACTSET MERGERSTAT, LLC, *supra* note 22, at 42, tbls. 1-39 (tracking increase in going-private transactions). One hundred and forty-two firms going private in 2005 comprised 31.7% of public takeovers, up from 17% in 2002. *Id.* One hundred and forty-two publicly traded firms went private in 2005, up from seventy-seven in 2001 and seventy in 2002. *Id.*

25. See Andrew Shouvakis, Comment, *Exiting the Public Markets: A Difficult Choice for Small Public Companies Struggling with Sarbanes-Oxley*, 109 PENN ST. L. REV. 1279, 1295 (2005) (suggesting compliance costs affect only small firms but recommending firms weather storm). But see FACTSET MERGERSTAT, LLC, *supra* note 22, at 43, tbls. 1-40 (evidencing trend in larger firms going private); Henry Sender, *Ahead of the Tape*, WALL. ST. J., Aug. 11, 2006, at C1 (listing large targets on private equity lists); Steven M. Bainbridge, *Murray on SOX and Going Private*, ProfessorBainbridge.com, BusinessAssociationsblog.com, . . . On Law and Business,

[http://www.businessassociationsblog.com/lawandbusiness/comments/murray\\_on\\_sox\\_and\\_going\\_private](http://www.businessassociationsblog.com/lawandbusiness/comments/murray_on_sox_and_going_private) (Nov. 16, 2005) [hereinafter Bainbridge, Business Associations Blog] (noting larger firms going private). Sender lists targets including Kinder Morgan, Aramark, HCA, Michaels Stores, Lord & Taylor, and Neiman Marcus. Sender, *supra*.

26. See Lee Berton, *U.S. Companies Consider Going Private to Skirt Law*, Bloomberg.com, July 20, 2004, [http://www.bloomberg.com/apps/news?pid=10000039&sid=adD5HRu\\_FIGg&refer=columnist\\_berton](http://www.bloomberg.com/apps/news?pid=10000039&sid=adD5HRu_FIGg&refer=columnist_berton)

addition to promoting a going-private trend—push some firms overseas.<sup>27</sup>

Industry may be ready to battle back and begin pushing the pendulum the other way.<sup>28</sup> Courts might hesitate before opening the floodgates to any and all shareholders who may disagree with directors or management.<sup>29</sup> Perhaps most significantly, the Supreme Court recently expressed skepticism regarding trends in the federal securities regulatory regime and noted its concern that federal expansion into corporate law has potentially severe consequences on American public markets.<sup>30</sup>

This Note explores the ways in which courts, the SEC, and Congress have made being public—or working for a public company—less attractive to firms of all sizes.<sup>31</sup> Part II discusses the motivations for federal corporate reform with a particular focus on the role of institutional investors.<sup>32</sup> Part III examines the roles of the federal and state systems in regulating corporate reform as well as the deficiencies in private enforcement mechanisms.<sup>33</sup> Part IV describes the recent trend of firms and executives abandoning, or never entering, public markets.<sup>34</sup> Part V begins by analyzing the reasons firms and executives are leaving public markets, considers the effect of federal mandates on state corporate law, and observes a growing recognition on the part of courts that the

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(estimating average of 12,000 internal compliance hours for publicly traded firms in 2004). “Small public companies facing the higher costs of complying with the Sarbanes-Oxley law of 2002 are considering going private faster at a time when education is needed, not more regulation, to fight corporate fraud.” *Id.*

27. See Maurice R. Greenberg, *Regulation, Yes; Strangulation, No*, WALL ST. J., Aug. 21, 2006, at A10 (detailing decrease in United States’ initial public offerings). The United States held a 24% share of worldwide initial public offerings in 2005, down from 36% in 2001. Jeremy Grant, *SEC Chief Rejects Easing of Sarbanes-Oxley Rules*, FIN. TIMES (London), Mar. 15, 2007, [http://www.ft.com/cms/s/0/ccdd143e-d299-11db-a7c0-000b5df10621.html?ncklick\\_check=1](http://www.ft.com/cms/s/0/ccdd143e-d299-11db-a7c0-000b5df10621.html?ncklick_check=1) (reporting debate over attractiveness of American markets); Tony Tassell, *Europe Tops US in Stock Market Value*, FIN. TIMES (London), Apr. 2, 2007, <http://www.ft.com/cms/0/bf6a00e4-e14b-11db-bd73-000b5df10621.htm> (noting European markets larger than United States for first time since WWII).

28. See Stephen Labaton, *Businesses Seek New Protection on Legal Front*, N.Y. TIMES, Oct. 29, 2006, at 1 (detailing businesses’ reactions to lawsuits). Businesses are seeking relief from burdensome suits, overzealous state attorneys general, and crippling class-action lawsuits. *Id.*

29. See *In re J.P. Morgan Chase & Co. Shareholder Litigation*, 906 A.2d 766, 773-74 (Del. 2006) (dismissing direct action against board where claim was derivative); *In re The Mony Group, Inc. Shareholder Litigation*, 853 A.2d 661, 677 (Del. Ch. 2004) (upholding board’s decision to postpone vote concerning increased number of director votes). See generally *Tooley v. Donaldson*, 845 A.2d 1031, 1033 (Del. 2004) (dismissing plaintiffs’ claims as neither direct nor derivative and applying deferential standard).

30. See *Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 772 (2008) (noting costs of federalization of state corporate law). “Overseas firms with no other exposure to our securities laws could be deterred from doing business here . . . . This, in turn, may raise the cost of being a publicly traded company under our law and shift securities offerings away from domestic capital markets.” *Id.* (internal citations omitted).

31. See *infra* notes 183-189 and accompanying text (detailing causes and statistics of going-private transactions).

32. See *infra* Part II.A (describing evolution and motivations of regulatory regime since 2002).

33. See *infra* Part III (describing federal law encroaching state corporate law domain).

34. See *infra* Part IV (examining flight of executives and firms from American public markets).

federalization of substantive corporate law comes at a tremendous cost to society.<sup>35</sup> Part VI recommends that Congress, courts, and agencies reexamine their increasingly ad hoc process of legislating drastic changes to a largely successful corporate model and consider the long-term consequences on American public capital markets.<sup>36</sup>

## II. SARBANES, POST-2002 CORPORATE REFORMS, AND THEIR MOTIVATIONS

Greed, self-interest, and loose lending practices have plagued America's businesses and markets throughout history.<sup>37</sup> Congress constructed a securities regulation regime to deal with such abuses.<sup>38</sup> Despite instances of scandal, the state-law driven American corporate model has proven remarkably successful over time.<sup>39</sup> The more than 88 million Americans representing 51% of U.S. households that invest in public markets—numbers significantly greater than at any other time in American history—cause some to argue that recent scandals demonstrate that society can no longer rely on the market to fix its own problems.<sup>40</sup> If American markets have experienced overall gains over the last twenty years, however, it is unclear why diffuse ownership makes regulatory solutions more favorable than market-based reforms that helped to solve previous market failures.<sup>41</sup>

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35. See *infra* Part V (correlating federalization of corporate law with going private).

36. See *Stoneridge*, 126 S. Ct. at 772 (noting danger to American capital markets of federalized corporate law); see also Stephen M. Bainbridge, *Response to Increasing Shareholder Power: Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1739-41 (2006) [hereinafter Bainbridge, *Director Primacy*] (providing evidence of a successful, not failed, corporate system); *infra* Part VI (concluding more consideration needed to costs of federalization).

37. See Cynthia A. Glassman, Comm'r, U.S. Securities and Exchange Comm'n, *Sarbanes-Oxley and the Idea of "Good" Governance*, (Sept. 27, 2002), <http://sec.gov/news/speech/spch586.htm> [hereinafter Glassman, "Good" Governance] (cataloguing history of major corporate and market scandals). See generally John Paul Lucci, *Enron—The Bankruptcy Heard Around the World and the International Ricochet of Sarbanes-Oxley*, 67 ALB. L. REV. 211, 212-16 (2003) (detailing effects of corporate scandals); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1523 (2005) (describing regulatory environment in wake of Enron scandal).

38. See *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975) (stressing purposes of securities regulations in determining what constitutes security).

The primary purpose of the Acts of 1933 and 1934 was to eliminate serious abuses in a largely unregulated securities market. The focus of the Acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect the interest of investors.

*Id.*

39. See Bainbridge, *Director Primacy*, *supra* note 36, at 1734-40 (noting American markets outperforming world averages even during scandals); Chandler & Strine, *supra* note 4, at 976 (describing Delaware model of corporate governance as "carefully thought out").

40. See Glassman, "Good" Governance, *supra* note 37 (noting increased middle-class ownership in public markets).

41. See Bainbridge, *Director Primacy*, *supra* note 36, at 1739-40 (noting overall increases in market

A major factor in recent corporate scandals was “irrational exuberance” on the part of market institutions, which are the very institutions the market relies upon to provide at least some protection against large-scale fraud.<sup>42</sup> Misplaced exuberance rendered these actors complicit in the greed overtaking some of the nation’s largest public companies.<sup>43</sup> Managers saved themselves while many workers and pension holders absorbed staggering losses.<sup>44</sup> Scandals at other companies assumed similar characteristics.<sup>45</sup> Some observers have questioned whether state corporate law was to blame for failing to constrain the type of self-dealing underlying these scandals.<sup>46</sup>

#### A. A “Culture of Compliance”<sup>47</sup>

In response to Enron and other corporate scandals, in 2002 Congress passed the Sarbanes-Oxley Act to protect investors.<sup>48</sup> Sarbanes amended the Securities Exchange Act to enhance federal regulation of corporate

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performance); Bengt Holstrom & Steven N. Kaplan, *The State of U.S. Corporate Government: What’s Right and What’s Wrong?*, (European Corporate Government Inst., Finance, Working Paper No. 23/2003, 2003), available at <http://ssrn.com/abstract=441100> (providing evidence of economic growth despite supposed governance deficiencies). Holstrom and Kaplan conclude that “the greatest risk now facing the U.S. corporate governance system is the possibility of overregulation.” Holstrom and Kaplan, *supra*, at 2.

42. See Robert B. Thompson, *Commentary: Corporate Governance After Enron*, 40 HOUS. L. REV. 99, 101 (2003) (quoting Alan Greenspan and describing over-enthusiasm leading to market downturn); Glassman, “Good” Governance, *supra* note 37 (placing blame on institutional actors for failure to check ensure effective corporate governance); see also *Excerpts from Report by Greenspan at Senate*, N.Y. TIMES, July 17, 2002, at C8 (addressing state of economy). Some of the institutions which failed to ensure effective corporate governance include investment banks, analysts, lawyers, rating agencies, auditors, and officers and directors. Glassman, “Good” Governance, *supra* note 37. It is unclear how such “irrational exuberance” fits into the efficient capital market hypothesis that the share price of a stock reflects all publicly available information. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 253 (1988) (noting wide acceptance of efficient capital market hypothesis). See generally Paul A. Ferrillo, Frederick C. Dunbar, Ph.D., & David Tabak, Ph.D., *The “Less Than” Efficient Capital Markets Hypothesis: Requiring More Proof From Plaintiffs in Fraud-on-the-Market Cases*, 78 ST. JOHN’S L. REV. 81, 114-15 (2004) (questioning applicability of hypothesis in current market); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 552 (1984) (defining hypothesis).

43. See Thompson, *supra* note 42, at 100-02 (noting link between institutional exuberance and scandals). At the time of its collapse, Enron was the nation’s seventh largest corporation. See *id.* at 100 n.5 (noting unprecedented size of collapse). Enron’s downfall also took on a personal nature as its employees and the middle class as a whole took a substantial hit due to heavy pension and retirement fund investing. *Id.* at 100 n.2.

44. See Thompson, *supra* note 42, at 104 n.27. While Enron was spiraling downward, a change in 401k plan administrators allowed management to sell its stock and exercise options while employees’ accounts remained frozen. See *id.* Sarbanes reforms directly address the problem of blackout periods. *Id.*

45. See Glassman, “Good” Governance, *supra* note 37 (noting commonalities among scandals).

46. See Thompson, *supra* note 42, at 107-18 (questioning whether state corporate law is sufficient to prevent abuses).

47. Campos, *supra* note 8 (advocating strong culture of compliance).

48. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C., 18 U.S.C., and 28 U.S.C.) (stating law’s purpose as “improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws”).

governance.<sup>49</sup> These modifications include, for example, mandating changes to internal corporate governance structures, specifying requirements for the composition and conduct of audit boards, and requiring officer certification of financial statements.<sup>50</sup> The corresponding costs of Sarbanes compliance effectively force even honest businesses to consider leaving, or never entering, American public markets.<sup>51</sup> Furthermore, Sarbanes' strict imposition of personal liability on officers and directors drives some executives away from public companies.<sup>52</sup>

Sarbanes and other reforms passed in the wake of financial scandals at several large companies—including Enron, Worldcom, Tyco, and Adelphia—together comprise a major federal remedial system, which is somewhat random as a result of their rapid enactment.<sup>53</sup> As a result, Sarbanes deals only tangentially with the root causes of corporate scandal, while directly addressing larger political views of corporate governance.<sup>54</sup> In addition, within a year of Sarbanes' enactment, the SEC contributed to a rapid increase in federal oversight of corporate law by promulgating several sets of regulations under the auspice of restoring investor confidence.<sup>55</sup>

In many ways, these recent federal reforms supersede areas of corporate law traditionally left to state courts and legislatures.<sup>56</sup> For example, Sarbanes bans

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49. See Thompson, *supra* note 42, at 102 (specifying Sarbanes provisions supplanting state corporate law); Jeffrey Y. Wu, *Revisiting Business Roundtable and Section 19(c) in the Wake of the Sarbanes-Oxley Act*, 23 YALE J. ON REG. 249, 250 (2006) (discussing resulting discord between federal and state corporate governance in wake of Sarbanes).

50. See Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 IOWA J. CORP. L. 625, 641-42 (2004) (highlighting Sarbanes' most significant changes to corporate governance); Romano, *supra* note 37, at 1529-44 (outlining Sarbanes' substantive corporate governance mandates); Thompson, *supra* note 42, at 103-05 (detailing effects of Sarbanes on corporate governance).

51. See William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private"*, 55 EMORY L.J. 141, 141 (2006) (asking whether severity of Sarbanes compliance drives firms away from United States capital markets).

52. See Thornton, *supra* note 15, at 52 (positing executives leaving public companies in part because of regulatory pressure).

53. See Chandler & Strine, *supra* note 4, at 957-59 (describing ad hoc nature of Sarbanes). The success of Sarbanes depends on policymakers' abilities to remain flexible when implementing and tailoring the reforms. *Id.* at 958. *But see* Jones, *supra* note 50, at 625 (arguing federalization of corporate law is necessary to drive state law development). If Jones's contention is that state law is to blame for recent corporate failures, it follows that previous federalization of state corporate law must have failed adequately to drive state law development. *Id.*

54. See Chandler & Strine, *supra* note 4, at 957 (noting lack of clear connection between reforms and scandals); Romano, *supra* note 37, at 1568-71 (believing legislative enactments aimed at policy objectives not effective reform). Congress took no immediate action regarding "perverse accounting incentives" related to executive compensation, instead choosing to promote a broad corporate governance agenda. See Chandler & Strine, *supra* note 4, at 954-55 (analyzing legislative reaction to scandals).

55. See Larry Cata Backer, *Surveillance and Control: Privatizing and Nationalizing Corporate Monitoring After Sarbanes-Oxley*, 2004 MICH. ST. L. REV. 327, 333-36 (2004) (noting SEC passed at least eleven sets of Sarbanes-related regulations within one year of enactment).

56. See Romano, *supra* note 37, at 1527 (noting federal intrusion into substantive corporate law); Thompson, *supra* note 42, at 102 (noting federal changes to state corporate law). Exchange requirements for

all corporate loans to officers and directors, specifies new requirements for audit committees, more stringently defines directorial independence than does Delaware common law, strengthens company counsel's reporting requirements for breaches of fiduciary duty, and requires the chief executive and chief financial officers to reimburse the issuer for compensation if the company is required to restate its earnings.<sup>57</sup>

Aside from the substantial hard-dollar costs of complying with the federal reforms, less tangible losses include opportunity costs and an inability to attract talent.<sup>58</sup> These costs continue to rise, particularly for small companies.<sup>59</sup> Small companies frequently pay enormous sums to outside auditors, soaking up capital from other areas of their businesses.<sup>60</sup> In addition, firms absorb costs associated with changing their business models to fit federal requirements regardless of their transparency.<sup>61</sup>

The SEC recognized the problem and conceded that compliance costs have exploded.<sup>62</sup> As the "culture of compliance" evolves from an internal matter for

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companies listed on the NYSE and NASDAQ augment Sarbanes' effect on state corporate law. *Id.* Both exchanges substantially increase requirements for director independence such that directors considered independent before 2002 would not pass muster under the new rules. *See* Chandler & Strine, *supra* note 4, at 967-69 (detailing new independence requirements).

57. *See* Chandler & Strine, *supra* note 4, at 967-71 (arguing new standards decrease supply of independent directors and increase demand due to heightened requirements); Thompson, *supra* note 42, at 103-04 (listing federal government's new roles in corporate governance resulting from Sarbanes). *But see* Jones, *supra* note 50, at 642 (favoring federal bright-line rules over flexible state standards for duty of loyalty).

58. *See* Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 35 (2002) (outlining costs associated with increased liability and regulation). Agency costs increase due to increased liability and regulation because executives are encouraged "to move to less monitored firms and activities," thus increasing the costs to learn of executives' fraudulent activities "and increasing friction in the organization by reducing trust." *Id.*

59. *See* Burton, *supra* note 26 (analyzing cost statistics for small-firm compliance). As early as 2004, section 404 compliance cost small companies with revenues of \$25 to \$99 million an average of \$740,000 annually, plus auditor fees and the opportunity costs equaling 12,000 hours of internal compliance work. *Id.* Between 2003 and 2004 costs rose more than 150 percent. *Id.* Section 404 demands a management report attested to by the external auditor assessing the corporations' internal controls. *See* Carney, *supra* note 51, at 142 (linking increased costs to section 404 without corresponding benefit to investors); Romano, *supra* note 37, at 1540 (listing certification requirements).

60. *See* Peter Lauria, *SEC Rule Forcing \$ Moves*, N.Y. POST, Oct. 15, 2006, at 29 (noting \$83 million in Sarbanes auditor fees for troubled media company Interpublic).

61. *See* Carney, *supra* note 51, at 141 (questioning whether federal regulations force even honest businesses to go private); Tamar Frankel, Editorial, *Rewarding Corporate Honesty*, BOSTON GLOBE, Jan. 2, 2007, at A11 (describing compliance costs as "exorbitant and unnecessary").

62. *See* Atkins, *Remarks*, *supra* note 14 (taking notice of Sarbanes pressure on small and large companies).

For large companies, the expenses far outpace everyone's estimates. For small companies, the money and time diverted to Section 404 implementation are having a tangible effect . . . . The more that companies spend on things like internal controls, the less they can invest in developing marketing products, hiring and retaining talent, and embracing new technologies . . . . There must be a balance.

*Id.*

the corporation governed by state corporate law to federalized mandates, it is unclear whether SEC leadership truly appreciates the ballooning compliance costs.<sup>63</sup> Clearer is the SEC leadership's belief that despite evidence to the contrary, strict federal regulation of corporate governance causes higher corporate returns on shareholder investments.<sup>64</sup>

### B. *Conflicting Motivations of Corporate Reformists*

Corporate reform advocates seek to empower investors through increased regulation of public-company boards.<sup>65</sup> Not surprisingly, the egregious scandals at massive corporations like Enron and Adelphia, which caused enormous losses to individual investors and pension holders, sparked widespread political demand for corporate reform.<sup>66</sup> While the reformers' stated goals are to empower and protect investors, their motivations are often largely political, reflecting not only a desire to increase shareholder security, but also to advance broad social agendas.<sup>67</sup>

Reformers focused on increasing boardroom accountability claim that firms with voluntarily adopted shareholder-friendly mechanisms, such as majority voting, produce higher earnings as a result.<sup>68</sup> While a correlation may exist, a

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63. Compare Campos, *supra* note 8 (advocating federalized "tone at the top" approach to "culture of compliance"), with Lori A. Richards, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Comm'n, Spring Compliance Conference: National Regulatory Services (Apr. 23, 2003), <http://www.sec.gov/news/speech/spch042303lar.htm> (considering historical internal affairs approach "culture of compliance").

64. See Cox, Stanford Law, *supra* note 7 (correlating good governance and profitability); see also Lucian A. Bebchuk, *The Case For Increasing Shareholder Power*, 118 HARV. L. REV. 833, 888 (2005) [hereinafter Bebchuk, *Shareholder Power*] (rejecting "Panglossian" market-based evidence that investors do not value enhanced shareholder rights); Lucian A. Bebchuk, *Response to Increasing Shareholder Power: Reply: Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1784-85 (2006) [hereinafter Bebchuk, *Response*] (advocating reduced legal limits on shareholder power). But see Bainbridge, *Director Primacy*, *supra* note 36, at 1736 (opining markets do not view shareholder empowerment as value-adding); Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1629-32 (2005) [hereinafter Bainbridge, *Executive Compensation*] (arguing evidence fails to show pattern of acquiescence for independent directors); Romano, *supra* note 37, at 1529-34 (indicating empirical literature suggests Sarbanes not value-adding).

65. See Bebchuk, *Response*, *supra* note 64, at 1784-85 (2006) (advocating reduction in legal limits on shareholder power). Professor Bebchuk recently sought to apply his theories as a plaintiff in a declaratory judgment action to determine the validity under Delaware law of a stockholder proposed bylaw seeking to limit the authority of the defendant board of directors. *Bebchuk v. CA, Inc.*, 902 A.2d 737, 738 (Del. Ch. 2006). The bylaw was a stockholder-rights plan of unlimited duration that the board sought to keep off the ballot. *Id.* The court dismissed the action for lack of standing as the bylaw had not been enacted and no party had suffered an injury. *Id.* at 745. Though the court did not directly address the issue, its ruling signaled that Delaware courts are not forums in which shareholders can seek advisory opinions of governance rules. *Id.*

66. See Thompson, *supra* note 42, at 99-102 (cataloguing federal reactions to Enron).

67. See Bainbridge, *Director Primacy*, *supra* note 36, at 1755 (noting pension fund political goals unrelated to shareholder interests). Bainbridge asserts that majority voting requirements are an inadequate constraint on politically motivated institutional investors. See *id.* at 1757 (asserting majority voting susceptible to politically motivated actors).

68. See Bebchuk, *Shareholder Power*, *supra* note 64, at 880 (referring to increases in shareholder control as "value increasing"); Cox, Introductory Remarks, *supra* note 8 (claiming shareholder activism raising

direct causal relationship is far from clear.<sup>69</sup> If shareholder empowering initiatives caused higher earnings, more firms would adopt such measures.<sup>70</sup> Rather, the adoption of shareholder empowering mechanisms may arise as part of litigation settlement and not as a component to a business strategy intended to increase earnings.<sup>71</sup> To the extent that regulators use value-adding theories of corporate reform to justify broadening firms' "social responsibilities to the general public and even to the country" by "empowering investors," such arguments obscure the more likely case that, to many, corporate reform is essentially political, and not economic.<sup>72</sup>

Institutional investors in activist roles may have interests that do not correspond with those of other investors in a particular firm.<sup>73</sup> Institutional investors tend to focus primarily on the short-term performance of the companies in which they invest.<sup>74</sup> A large institutional investor can, through the threat of proxy battles, affect changes in share price, and, through "governance at gunpoint," constrain managers' abilities to act in the long-term interests of the corporation and its other shareholders.<sup>75</sup> When, to avoid a dip in share price and its ensuing litigation, a firm capitulates to institutional investor demands through an inefficient settlement, long-term growth suffers as a result and ultimately harms the firm's other shareholders and even the

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corporate profits).

69. See Bainbridge, *Director Primacy*, *supra* note 36, at 1736 (asserting market-based argument against shareholder empowerment).

70. See Bainbridge, *Director Primacy*, *supra* note 36, at 1736 (noting lack of investor preference for firms with shareholder empowering mechanisms); Romano, *supra* note 37, at 1528-43 (claiming Sarbanes deficiencies cause it not to be value enhancing).

71. See *infra* note 151 and accompanying text (describing trend toward use of shareholder incentives as part of litigation settlement). If securities class-action settlements are not consistently efficient due to calibration inefficiencies, negotiated governance reforms cannot be considered value-adding. See *Risk-Preference Asymmetries*, *infra* note 148, at 740-41 (suggesting calibration problem causes inefficiencies in suits and settlements); Hensler & Rowe, *infra* note 149, at 139-40 (discussing calibration problems in class actions).

72. See Campos, *supra* note 8 (advocating proactive social responsibilities for directors). While Campos suggests that the SEC hold directors legally accountable for "fail[ing] to take [a] proactive approach," he contrarily argues that the SEC brings "cases only in egregious situations where there has been a clear violation of a director's fiduciary duty to shareholders." *Id.* One possible conclusion from these seemingly contradictory statements is that Campos advocates adding social responsibilities to a director's fiduciary duties, an area state law still largely governs. Whether the SEC or some other lawmaking body delineates the social responsibilities for directors is unclear.

73. See Bainbridge, *Director Primacy*, *supra* note 36, at 1754-55 (observing tendency of private benefits to accrue to some investors over others).

74. Chandler & Strine, *supra* note 4, at 993-94 (noting short-term strategies of institutional investors).

75. See *In re JP Morgan Chase & Co. Shareholder Litigation*, 906 A.2d 766, 768 (Del. 2006) (affirming dismissal of direct action for breach of fiduciary duty); see also Phyllis Plitch, *Governance at Gunpoint: To Get Companies to Change Their Rules, Shareholders Are Dangling a Powerful Carrot: Litigation Settlement*, WALL. ST. J., Oct. 17, 2005 at R6 (describing corporate governance changes through litigation settlement). The action in *In re JP Morgan* was initiated because a *New York Times* article reported JP Morgan's CEO turned down a deal whereby Bank One offered to sell the company for no premium if its CEO could immediately become CEO of the new entity. See *id.* at 769 (affirming dismissal because claim was derivative not direct).

shareholders of the institutional investors.<sup>76</sup>

Despite their reputations for being beholden to management, fund managers should be more concerned about “the fiduciary duties they owe to their own investors, not the corporate governance policies of the firms in which they may invest.”<sup>77</sup> Institutional investors, such as some public pension funds, that place political agendas ahead of maximizing their pension holders’ returns, can, under the guise of shareholder rights, turn corporations into lobbyists for political agendas.<sup>78</sup>

Pension fund trustees have rights as shareholders to lobby for improved corporate governance, but only to the extent that such lobbying protects against fraud or otherwise improves corporate performance.<sup>79</sup> Thus, when pension fund trustees advocate a position that furthers a political agenda, but does not add value to their investments, they breach their fiduciary duty to maximize returns to their beneficiaries.<sup>80</sup> As pension fund trustees hold significant positions in public companies, their political agendas can affect not only their beneficiaries, but also other shareholders of the firms in which they invest.<sup>81</sup> Therefore, because both pension fund beneficiaries and other investors stand to lose, pension fund trustee malfeasance over the long run actually disempowers individual investors under the guise of shareholder activism.<sup>82</sup>

Some SEC officials have advocated for increased scrutiny over the lobbying positions of pension fund trustees.<sup>83</sup> SEC Commissioner Cynthia Glassman

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76. See Romano, *supra* note 37, at 1531 (arguing no clear correlation between independent board and performance).

77. See Cynthia A. Glassman, Commissioner, U.S. Securities and Exchange Comm’n, “Corporate Governance in the United States,” Remarks before the ECGI/ALI 2006 Transatlantic Governance Conference (June 27, 2006), <http://www.sec.gov/news/speech/2006/spch062706cag.htm> [hereinafter Glassman, Transatlantic Governance Conference] (discussing conflicting duties of institutional investors). Four years earlier, Commissioner Glassman appeared less concerned with the roles of institutional investors in the corporate governance area. See Glassman, “Good” Governance, *supra* note 37 (arguing for tone at the top governance structure).

78. See Bainbridge, *Director Primacy*, *supra* note 36, at 1755 (noting CalPERS as leading example of politically motivated public employee pension fund); Editorial, *Pension Fund Blackmail*, WALL. ST. J., Mar. 31, 2005 at A10 [hereinafter *Pension Fund Blackmail*] (advocating increased SEC oversight of institutional investors’ duties to their beneficiaries); Glassman, Transatlantic Governance Conference, *supra* note 77 (recognizing existence of institutional political agendas without proposing solution). “Public employee pension funds are especially vulnerable to being used as a vehicle for advancing political or social goals unrelated to shareholder interests.” See Bainbridge, *Director Primacy*, *supra* note 36, at 1755

79. See Bainbridge, *Director Primacy*, *supra* note 36, at 1754-56 (detailing conflict of interest between pension fund political goals and shareholder benefit).

80. See *Pension Fund Blackmail*, *supra* note 78 (advocating increased SEC oversight over pension fund activism); see also Glassman, Transatlantic Governance Conference, *supra* note 77 (evidencing conflicting pension fund interests).

81. See *supra* notes 77-79 and accompanying text (noting decrease in benefits to other noninstitutional shareholders).

82. See Glassman, Transatlantic Governance Conference, *supra* note 77 (discussing effect of pension fund trustees’ advocacy of political agenda).

83. See Cartwright, *supra* note 7 (noting ordinary Americans invest through intermediary institutions).

recognized the potential conflict between the political interests of large institutional investors and the interests of other shareholders.<sup>84</sup> She also noted that institutional investors should be more concerned with the duties to their clients than the governance systems of the firms in which they invest.<sup>85</sup> Considering the weak correlation between governance systems and long-term earnings, Commissioner Glassman's advice likely stands to benefit shareholder interests across the board.<sup>86</sup>

The larger "culture of compliance" at the SEC and attitude that shareholders should get whatever they want, however, will likely predominate, meaning that a serious look at the role of pension funds as activist investors is not likely to come from the SEC.<sup>87</sup> To the contrary, SEC Commissioner Roel Campos recently remarked that "directors [should] have an open mind when confronted by large shareholders."<sup>88</sup> Campos implies that large investor positions and agendas embody the broad social responsibilities, which, according to him, directors ought to be legally obligated to consider proactively in the management of their firms.<sup>89</sup> In light of the political agendas harbored by many large investors, Campos's position ostensibly confuses fiduciary duties with partisan politics.<sup>90</sup> Unless the political agendas of institutional investors

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If our public corporations, the engines of our economy, are to be governed by increasingly powerful intermediary institutions, isn't it time to begin examining in turn the governance of those intermediaries and questioning whether they are sufficiently faithful to the interests of those they represent, the ordinary Americans who are the pension plan beneficiaries and the owners of interests in mutual funds?

*Id.*; see also Cynthia A. Glassman, Comm'r, U.S. Securities and Exchange Comm'n, American Enterprise Institute—Issues Surrounding the SEC's Shareholder Access Proposal, (Mar. 8, 2004), <http://www.sec.gov/news/speech/spch030804cag.htm> [hereinafter Glassman, American Enterprise Institute] (suggesting redirected focus from corporate boards to institutional investors).

84. See Glassman, American Enterprise Institute, *supra* note 83 (questioning whether institutional interests diverge from interests of other shareholders). "[S]ome institutions are not perfect surrogates because they may have goals that include something other than maximizing shareholder return." *Id.* This problem is prevalent in institutions where money managers are chosen through a political selection or election process rather than based on their fund's performance. *Id.*

85. See Glassman, Transatlantic Governance Conference, *supra* note 77 (noting institutional activism not definitive solution to preventing corporate misconduct).

86. See Glassman, Transatlantic Governance Conference, *supra* note 77 (linking this model with managers' fiduciary duties to their own investors). "Fund managers . . . identify [] the variety of investment choices available for the fund given its strategy, analyz[e] those possible investments from a financial and business point of view, and invest[] the fund's capital to achieve the best return for fund investors." *Id.*

87. See Pension Fund Blackmail, *supra* note 78 (recommending increased SEC oversight of pension funds); see also Campos, *supra* note 8 (asserting broad federal governance agenda); Cox, Introductory Remarks, *supra* note 8 (suggesting SEC aids investors to get whatever they want from public corporations).

88. See Campos, *supra* note 8 (advocating unconditional board openness to negotiation with large shareholders). Commissioner Campos made the remark in the context of advocating heightened executive liability through increased fiduciary duties, including proactive "broad social responsibilities . . . to the general public and even to the country" within a strong "culture of compliance." *Id.*

89. See Campos, *supra* note 8 (implying federal augmentation of directorial fiduciary duties would better serve shareholders.)

90. See, e.g., Bainbridge, *Director Primacy*, *supra* note 36, at 1755 (noting pension fund political goals

add value to the corporation, which they generally do not, Commissioner Campos's political vision of corporate governance would actually harm shareholders by stifling long-term growth in favor of immediate political satisfaction.<sup>91</sup>

### C. Executive Compensation and the Hazards of Federal Mandates

Executive compensation serves as a motivating issue for shareholder activists.<sup>92</sup> In the early 1990s, amid rising executive-compensation levels, activists began urging greater use of stock options in executive-compensation plans.<sup>93</sup> Shortly thereafter, Congress responded to this political pressure by strengthening the use of options when it eliminated corporate tax deductions on executive compensation of more than \$1 million unless the overage related to performance.<sup>94</sup> Federal intervention led to an unintended increase in less transparent forms of compensation, such as stock options, and eventually option "backdating" for which more than 100 companies are now under scrutiny.<sup>95</sup> Despite its reservations that increased disclosure of compensation packages will produce a "race to the top," the SEC now requires companies to add sections to their proxy statements analyzing compensation.<sup>96</sup> The SEC's stated motivation for its requirement is the arguably circular view that shareholders ought to know why the company makes the choices it does

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unrelated to shareholder interests); Glassman, American Enterprise Institute, *supra* note 83 (questioning whether institutional interests diverging from interests of other shareholders); Glassman, Transatlantic Governance Conference, *supra* note 77 (noting drawbacks to institutional investors as shareholder advocates).

91. See Bainbridge, *Director Primacy*, *supra* note 36, at 1754-56 (arguing activist institutions likely to hurt shareholder value).

92. Joann S. Lublin & Scott Thurm, *Money Rules: Behind Soaring Executive Pay, Decades of Failed Restraints – Instead of Dampening Rewards, Disclosure, Taxes, Options Helped Push Them Higher – Return of Golden Parachutes*, WALL ST. J., Oct. 12, 2006, at A1 (noting activists' twenty year battle against executive compensation). Shareholder-initiated compensation proposals contained in proxy ballots have been relatively successful, however, the limited success is the exception rather than the rule. See Shabina S. Khatri, *CEO Compensation Survey (A Special Report) – Who's Winning? How the Battle Between Shareholder Activists and Corporate Boards over Pay Policy Is Shaping Up*, WALL ST. J., Apr. 11, 2005, at R3 (noting twenty-five percent of compensation-related votes passed in last three years).

93. Lublin & Thurm, *supra* note 92 (detailing drive to tie compensation to performance).

94. Lublin & Thurm, *supra* note 92 (recounting result-oriented compensation schemes).

95. Lublin & Thurm, *supra* note 92 (noting consequence unintended). SEC Chairman Christopher Cox agrees that federal laws passed in 1993 "belong in the 'Museum of Unintended Consequences' because it encouraged the growth of 'less transparent forms of pay,' such as pensions and deferred compensation." Lublin & Thurm, *supra* note 92; see also *Stock Options Backdating: Hearing Before the Subcomm. on Banking, Housing and Urban Affairs*, 109th Congress (2006) (statement of Christopher Cox, Chairman, SEC) (stating failed purpose of law to curb executive pay increases).

96. See Terence O'Hara, *Executive Compensation Comes into the Clear*, WASH. POST, Dec. 15, 2006, at D01 (reporting SEC mandated Compensation and Discussion Analysis section now included on proxies); Atkins, Remarks, *supra* note 1462 (predicting increased disclosure of compensation will result in race to top). The Compensation Discussion and Analysis section includes total compensation figures for named executives with an emphasis on using plain English. See Cox, Introductory Remarks, *supra* note 8 (emphasizing disclosure in plain English).

without substituting its own judgment or imposing requirements that will skew business decisions.<sup>97</sup>

The federal government's response to the issue includes the SEC's new requirement of a Compensation Discussion and Analysis section that firms will have to file disclosing total compensation figures for certain executives.<sup>98</sup> While the SEC seeks to avoid instituting measures that will skew a board's ability to make business decisions or substitute the SEC's own business judgment, it offers few concrete goals for the section other than to allow shareholders to know why a firm makes the choices it does.<sup>99</sup> The political pressure under which the SEC promulgated the rule suggests that the section is an attempt to reduce substantively executive-compensation levels thinly veiled in the name of disclosure.<sup>100</sup>

The issue came up in *In re Walt Disney Co.*<sup>101</sup> At issue in the case was the negotiation of a complex contract in which Disney compensated Michael Ovitz for leaving a lucrative position with an entertainment agency to join Disney as president where Ovitz, if terminated without cause, would receive immediate vesting of stock options and other incentives.<sup>102</sup> When Disney terminated Ovitz, shareholders brought a derivative action alleging that the directors breached their fiduciary duties of due care and good faith by approving the contract and approving the massive severance payment to Ovitz upon his termination, which the plaintiffs claimed constituted corporate waste.<sup>103</sup> The plaintiffs' core argument was that the directors' breaches deprived the board of business judgment rule protections and therefore ought to be evaluated in terms of whether the actions were entirely fair to the corporation.<sup>104</sup> In finding for the defendant directors, the Court held that in the context of corporate fiduciary law, a determination of whether a director acted in good faith is distinct from a due care analysis and whether a director acted with gross negligence.<sup>105</sup> Without delineating what constitutes a breach of the duty of good faith, the

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97. See Cox, Introductory Remarks, *supra* note 8 (stating not Commission's job to dictate "best" compensation). Nevertheless, Cox provided no reason why this disclosure mechanism will be more successful than past measures. See *id.*; Lublin & Thurm, *supra* note 92 (doubting effectiveness of new SEC measure). A University of Southern California study shows that 64% of directors expect CEO compensation to continue to rise. *Id.*

98. See Thornton, *supra* note 15 (reporting market reactions to new section); Cox, Introductory Remarks, *supra* note 8 (advocating new requirement during period of notice and comment).

99. See Cox, Introductory Remarks, *supra* note 8 (proposing facilitation of information as end in and of itself).

100. See Cox, Introductory Remarks, *supra* note 8 (suggesting examples of corporate "ostentation and extravagance" are norm).

101. 906 A.2d 27, 35 (Del. 2006) (framing issues and detailing procedural history).

102. See *id.* at 37-41 (outlining Ovitz's contract).

103. *Id.* at 46 (detailing plaintiffs' claims).

104. *Id.*; see also Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (explaining function of business judgment rule).

105. *Walt Disney*, 902 A.2d at 63-64 (distinguishing good faith from due care).

Court set a high bar by focusing on procedural defects in the decision-making process: fiduciary conduct motivated by an actual intent to do harm, intentional dereliction of duty, a conscious disregard for one's responsibilities, and the conscious doing of a wrong because of a dishonest purpose or moral obliquity.<sup>106</sup> Evidence of gross negligence does not, on its own, constitute bad faith.<sup>107</sup> By maintaining business judgment rule protection over a board's decision on executive compensation in the face of seemingly staggering sums of money, the court resisted popular political pressure and set a high bar to shareholder actions over executive compensation.<sup>108</sup>

Federal regulation of executive compensation produced at least two unintended consequences: first, increased disclosure requirements for executive compensation started a race-to-the-top that effectively increases executive salaries; second, the heightened scrutiny and litigation over compensation helps to drive some quality executives into private roles.<sup>109</sup> Disclosure requirements make the compensation levels of top executives at public companies publicly available.<sup>110</sup> While investors gain a better idea of how companies in which they invest pay their executives, lower-paid executives at other firms can use the data to demand increases from their boards.<sup>111</sup> Directors, fearful of reactions on Wall Street, may raise compensation in part to avoid Wall Street's negative inference that lower compensation levels reflect financial instability at the firm.<sup>112</sup>

Thus, the practical effect of increased disclosure is to raise, rather than lower, overall levels of executive compensation.<sup>113</sup>

Increased regulation and litigation over compensation makes private markets more attractive to executives.<sup>114</sup> Due to increases in the size and scope of the private equity market, executives lose few opportunities by moving away from public markets.<sup>115</sup> Private equity executives operate in a more entrepreneurial environment away from the short-term focus of Wall Street analysts and

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106. *Id.* at 63-65 (providing examples bad faith to define good faith).

107. *In re Walt Disney Co.*, 906 A.2d 27, 65 (Del. 2006).

108. *See id.* at 94-96 (separating due care from good faith).

109. *See* Chandler & Strine, *supra* note 4, at 993-94 (asserting overburdening regulations drive executives into private roles); Lublin & Thurm, *supra* note 12 (reporting executive pay soared despite attempts to rein it in).

110. *See* Lublin & Thurm, *supra* note 12 (noting disclosure requirements push pay higher by revealing to CEOs what peers receive).

111. *See* Lublin & Thurm, *supra* note 12 (suggesting top talent may demand more based on greater availability of information).

112. *See* Lublin & Thurm, *supra* note 12 (reporting executives demanding higher salaries because positions now entail more risk).

113. *See generally supra* notes 109-112 (cataloging unintended consequences of federal regulation driving compensation up).

114. *See* Chandler & Strine, *supra* note 4, at 993-94 (discussing reasons why public markets less attractive to executives).

115. *See supra* note 15 (describing executives leaving public companies because of regulatory pressure); *supra* notes 24, 26 (evidencing deal size and strength in private equity).

institutional investors.<sup>116</sup> Private equity thus offers executives an opportunity to operate without regulatory and litigious “guns to their heads.”<sup>117</sup>

### III. THE ROLE OF THE STATE AND FEDERAL SYSTEMS AND THE DEFICIENCIES OF FEDERAL IMPLIED RIGHTS OF ACTION AS EFFICIENT POLICING MECHANISMS

#### A. Federal Intervention into Traditionally State Corporate Law Domain

Some federal regulators are intent on establishing a one-size-fits-all agenda to rewrite substantive state corporate law.<sup>118</sup> As a result, institutional investors and an active corporate plaintiff’s bar are now able to push their political agendas through the courts by exploiting the federal reforms and using them as litigation tools under state law.<sup>119</sup> Some regulators even concede that large institutional investors may have political interests that do not coincide with those of the shareholders.<sup>120</sup>

Federal legislation has allowed the SEC, and Exchanges through listing standards, to have significantly greater influence over corporate governance, upsetting the “easy balance between federal securities law and state corporate law.”<sup>121</sup> Shareholders have, in some instances, private rights of action via SEC rules.<sup>122</sup>

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116. See Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 282-84 (2007) (describing better alignment of management and investor interests).

117. See Romano, *supra* note 37, at 1527-28 (describing new regulatory regime’s drastic departure from prior securities regulation); Thornton, *supra* note 15 (noting a “gun to [the] head” as reason for leaving public companies).

118. See Cox, Stanford Law, *supra* note 7 (advocating market where investors get whatever they want). Chairman Cox remarked that “if customers want their coffee with frothy cream, and their eggs piping hot—or, in this case, their nest egg safe and growing—then by God, that’s what they should get.” *Id.* “The SEC [] proposed a significant incursion into corporate governance that mandates shareholder nomination of directors under specified circumstances, an initiative that utterly disregards state law and has no connection to Congress’s specific derogation of state law in the corporate governance provisions in SOX.” Romano, *supra* note 37, at 1590 (predicting SEC will continue to push further into state substantive law).

119. See Chandler & Strine, *supra* note 4, at 984 (predicting claimants will take advantage of new federal avenues against corporations); Pension Fund Blackmail, *supra* note 78 (noting political aspects of shareholder litigation).

120. See Glassman, American Enterprise Institute, *supra* note 83 (noting greater shareholder access to ballot confused with political motives).

121. See Wu, *supra* note 49, at 250 (noting federal intrusions into board structure and executive compensation).

122. See *supra* note 11 (describing development of 10b-5’s private right of action); see also *Roosevelt v. E.I. Du Pont de Nemours & Co.*, 958 F.2d 416, 420 (D.C. Cir. 1992) (implying private right of action from rule 14(a)(8)). The court emphasized that a higher level of judicial intervention is necessary when “significant policy issues are at stake” and that only courts can decide whether a company is obligated to include shareholder proposals in its proxy materials. *Roosevelt*, 958 F.2d at 424, 429.

### B. Role of State and Federal Systems

The SEC's rulemaking ability is not without limits and courts have struck down some of one-size-fits-all rules for the SEC's failure to consider the consequences of its actions.<sup>123</sup> While it appears that most federal courts are reigning in SEC rulemaking in some areas, at least one court significantly expanded federal power over the corporate boardroom, even over the SEC's objections. *American Federation of State, County & Municipal Employees v. AIG*<sup>124</sup> widened shareholder access to the ballot by broadly interpreting SEC Rule 14a-(8)(i)(8), which previously allowed companies to exclude from ballots any proposals relating to elections.<sup>125</sup> The Second Circuit's interpretation allows companies only to exclude from ballots those proposals relating to a particular election, as opposed to elections generally.<sup>126</sup>

To effectuate desired increases in power, shareholders must first change the corporation's voting mechanisms.<sup>127</sup> Regarding directorial elections, Delaware law allows firms to adopt any voting standard in their certificates of incorporation or bylaws with plurality voting serving as the default mechanism.<sup>128</sup> Courts can only review bylaws actually enacted, rather than merely proposed.<sup>129</sup> Although Delaware provides the dominant body of

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123. See *Chamber of Commerce of the U.S. v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005) (invalidating SEC attempt at requiring 75% independence on mutual fund boards). According to the court,

Uncertainty may limit what the Commission can do, but it does not excuse the Commission from its statutory obligation to do what it can to apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation before it decides whether to adopt the measure.

*Id.* The same court overturned the SEC's attempt to require hedge that funds register with the Commission. See *Goldstein v. SEC*, 451 F.3d 873, 884 (D.C. Cir. 2006). The court expressed its displeasure with the Commission's procedure, finding "a disconnect between the factors the Commission cited and the rule it promulgated. That the Commission wanted a hook on which to hang more comprehensive regulation of hedge funds may be understandable. But the Commission may not accomplish its objective by a manipulation of meaning." *Id.* at 488; see also Atkins, Remarks, *supra* note 14 (describing *Chamber of Commerce* as a "stinging" rebuke). Commissioner Atkins offered his own criticism of the SEC's foray into fund governance, agreeing with SEC critics who note the Commission's tendency toward adopting one-size-fits-all approaches. *Id.*

124. 462 F.3d 121 (2d Cir. 2006).

125. *Id.* at 129 (refusing to afford deference to SEC due to SEC's prior inconsistent interpretations).

126. See *id.*

127. See generally *Bebchuk, Shareholder Power*, *supra* note 64, at 836 (claiming market favors corporate reforms as value-adding). Shareholders can sometimes threaten litigation to effect change, which may be neither efficient nor value-adding. See *Plitch*, *supra* note 75 (reporting governance changes as part of litigation settlement); *infra* note 149 (suggesting risk calibration problem causes inefficient suits and settlements).

128. DEL. CODE ANN. tit. 8, § 216(3) (2006). The default standard for the election of directors is "a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors." See *id.*; see also *Licht v. Storage Tech.*, No. 524-N, 2005 Del. Ch. LEXIS 64, at \*12-13 (Del. Ch. 2005) (holding against plaintiff's challenge to plurality voting).

129. See *Bebchuk v. CA, Inc.*, 902 A.2d 737, 742 (Del. Ch. 2006) (dismissing declaratory judgment for lack of standing).

corporate law, some states' rules diverge with regard to voting.<sup>130</sup> Shareholder-plaintiffs must also overcome the business judgment rule, which presumes that a board acted in the best interest of the company.<sup>131</sup>

When bringing an action against a board or its members, plaintiffs prefer the action to be direct—as opposed to derivative—because it is procedurally less complex, faces less imposing defenses, and most importantly, recovery flows directly to the plaintiff, possibly allowing the lawyer a larger fee.<sup>132</sup> The substantive state law of the jurisdiction in which the entity in question is organized governs the direct/derivative distinction.<sup>133</sup> Thus, states compete with each other to produce regulatory frameworks designed to attract as many incorporations as possible.<sup>134</sup> Despite recent academic efforts to rewrite the direct/derivative distinction and other significant areas of state corporate law, an overwhelming number of courts and state legislatures continue to embrace the Delaware model.<sup>135</sup> At least one federal appellate court recognizes that

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130. See *Harding v. Heritage Health Products Co.*, 98 P.3d 945, 948-49 (Colo. Ct. App. 2004) (invalidating bylaw vesting exclusive power in board to fix number of directors).

131. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (explaining business judgment rule), *overruled by* *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). Courts will presume that “in making a business decision the directors or a corporation acted on an informed basis, in good faith and in an honest belief that the action taken was in the best interests of the company.” *Id.*; see also *In re The Mony Group, Inc. Shareholder Litigation*, 853 A.2d 661, 675, 686 (Del. Ch. 2004) (applying business judgment rule to board decision intended to increase total votes).

132. See Daniel S. Kleinberger, *Direct Versus Derivative and the Law of Limited Liability Companies*, 58 BAYLOR L. REV. 63, 86 (2006) (analyzing procedural and substantive differences between direct and derivative actions).

133. *Id.* at 70 (distinguishing types of actions). There exists, however, substantial confusion as to what exactly constitutes a substantive rule of law regarding class action lawsuits. See generally Jack B. Jacobs, *The Vanishing Substance-Procedure Distinction in Contemporary Corporate Litigation: An Essay*, 41 SUFFOLK U. L. REV. 1, 4-12 (describing challenges in distinguishing between substantive and procedural rules when making demand on board of directors).

134. See Bainbridge, *Director Primacy*, *supra* note 36, at 1742-44 (noting increased shareholder value for firms reincorporating in Delaware). Strong evidence supports the proposition that “competitive federalism” produces a race to the top where states reflect market demands in their corporate laws. *Id.* at 142. But see Lucian A. Bebchuk & Allen Ferrell, *Federal Intervention to Enhance Shareholder Choice*, 87 VA. L. REV. 993, 994 (2001) (supporting federal intervention into state corporate law); Jones, *supra* note 50, at 625 (characterizing federal government as corporate law rival to Delaware).

135. See AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 2-7 (1994) (treating close corporation derivative action as direct). States tend to adopt a version of the direct/derivative distinction similar to that of Delaware, where the plaintiff must show a duty and harm running to the individual shareholder entirely separate from those running to the corporation. See, e.g., *Frank v. Hadesman and Frank, Inc.*, 83 F.3d 158, 162 (7th Cir. 1996) (noting ALI as minority position); *Malmros v. Ruth Jones*, No. 03-3489, 2004 U.S. Dist. LEXIS 4371, at \*10-11 (E.D. Pa. Feb. 27, 2004) (dismissing direct claim as derivative claim); *Cabaniss v. Deutsche Bank Sec., Inc.*, 611 S.E.2d 878, 880 (N.C. Ct. App. 2005) (applying *Tooley v. Donaldson*, 845 A.2d 1031, 1039 (Del. 2004) to Delaware limited partnership); *Schuster v. Gardner*, 127 Cal. App. 4th 305, 318 (Cal. Ct. App. 2005) (finding no standing for direct action under either Delaware or California law); *Tooley*, 845 A.2d at 1039 (dismissing claim as neither direct nor derivative). In one recent case, shareholders immediately initiated a direct action for breach of fiduciary duty after a New York Times article reported that during merger talks with Bank One, J.P. Morgan's chief executive turned down a deal where Bank One demanded no premium if its chief executive could become chief executive of the new entity. See *In re J.P. Morgan Chase & Co.*, 906 A.2d 766, 769 (Del. 2006) (affirming dismissal of direct claim because

substantive corporate law is the province of state legislatures and not the federal government.<sup>136</sup> The Supreme Court recognized that federalization of state corporate law will likely produce an uncertain regulatory environment that will make American capital markets less attractive.<sup>137</sup>

Symbolizing corporate extravagance, recent scandals leading to dramatic collapses of companies fueled public demand for widespread reforms.<sup>138</sup> Many believe that state and federal laws before 2002 allowed unscrupulous corporate executives and improperly motivated institutions ample room to reap enormous personal profits at the expense of ordinary investors.<sup>139</sup> Yet, few address the necessary next questions: will the new reforms fair any better and will the benefits of the current regulatory regime outweigh the costs of its implementation?<sup>140</sup> Federal regulation of corporations' internal affairs destabilizes forms of corporate decision-making, without any clearly correlated benefit, which for the most part have worked well for more than 200 years.<sup>141</sup> Within the scholarly debate, more emphasis is needed on the fact that some firms might opt never to enter—or exit from—public markets altogether, in which case the debate over contractarian, competitive federalist, and shareholder-empowering mechanisms becomes largely moot.<sup>142</sup> “Surprisingly, however, most corporate governance scholars have thus far ignored the important role played by private equity funds.”<sup>143</sup>

The ad hoc nature of federal corporate reform produces unintended consequences that help to make American capital markets less attractive to firms of all sizes and push quality executives away from public roles.<sup>144</sup>

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inherently derivative).

136. See *Frank*, 83 F.3d at 162 (dismissing direct action). The Seventh Circuit remarked that “[s]omeone who wants a state to change its law must ask the state . . . . Federal courts acting under the diversity jurisdiction are not the right forums for departures from established rules . . . . Only state legislatures and state courts have the authority to change state law.” *Id.*

137. See *Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 772 (2008) (linking federalization of ordinary business disputes to ineffective capital markets).

138. See *Jones*, *supra* note 50, at 629 (advocating federal reforms necessary to spur stagnant state corporate law).

139. See *Jones*, *supra* note 50, at 641 (describing motivations for Sarbanes and its progeny); Hensley & Lublin, *supra* note 2 (noting increases in shareholder resolutions to gain control of board decision making).

140. See *Romano*, *supra* note 37, at 1542-43 (suggesting optional federal guidelines will determine whether increased transparency adds value). If Sarbanes indeed doubled firms' compliance costs, more needs to be done to ensure that the costs of mandatory federal regulation do not outweigh its benefits. *Id.* at 1543 n.61 (estimating post-Sarbanes increases in compliance costs).

141. See *Bainbridge, Director Primacy*, *supra* note 36, at 1742-43 (arguing “competitive federalism” between states produces better governance choices); *Romano*, *supra* note 37, at 1528 (suggesting mandates will have little benefit to investors).

142. See *Romano*, *supra* note 37, at 1587-90 (observing firms' preference for private or foreign markets primarily due to regulatory costs).

143. *Illig*, *supra* note 116, at 230.

144. See *supra* note 22 and accompanying text (evidencing going-private trend); *infra* note 184 and accompanying text (observing correlation between increases in regulation, executive departures, and going private).

Ultimately, the gradual movement away from U.S. public markets renders our once world-leading exchanges merely second-rate destinations, which in turn decreases shareholder choice, hinders an efficient distribution of wealth, and threatens community ownership of the “community bank.”<sup>145</sup>

### C. Deficiencies in Private Enforcement of Securities Laws

Publicly traded firms face, in addition to ever increasing Sarbanes-related costs, increased scrutiny from the Department of Justice, the SEC, state attorneys general, and the plaintiff’s securities bar.<sup>146</sup> The era of corporate reform is especially lucrative for law firms specializing in plaintiffs’ securities class actions, such as Milberg Weiss, which alone recovered more than \$45 billion from defendant corporations.<sup>147</sup> Skepticism is growing over the roll of class action lawsuits in effectively policing corporate conduct.<sup>148</sup> Even the Supreme Court recognized the substantial evidence suggesting the overall inefficiency in securities class action settlements.<sup>149</sup> Still, it is commonplace for investors to turn to courts “for financial redress when businesses falter.”<sup>150</sup>

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145. See Carney, *supra* note 51, at 159 (linking regulation inflexibility with flight from public markets); Editorial, *Hot Topic: Going Private*, WALL ST. J., June 2, 2006, at A7 [hereinafter *Hot Topic*] (opining Congress pushed regulatory pendulum too far). Regulatory excess, as much as market opportunity, drives the current trend towards going private. *Hot Topic, supra*. Exchanges produce their own rules with attendant costs that push into areas of state corporate law such as directorial independence. See Chandler & Strine, *supra* note 4, at 968-70 (reporting Exchanges adopted rules for independence substantially over and above long-accepted state law requirements).

146. See *Shareholder Democracy: Battling for Corporate America*, ECONOMIST, Mar. 11, 2006, at 63 (noting substantial external controls outside of statutory framework). Firms face increasing challenges from shareholders demanding increased power over executive compensation, merger and acquisition decisions, and director elections. See Hensley & Lublin, *supra* note 2 (describing recent proxy battle at Pfizer).

147. See Peter Elkind, *The Law Firm of Hubris Hypocrisy & Greed*, FORTUNE, Nov. 13, 2006, at 154 (comparing Milberg Weiss partners to corrupt corporate executives they sue). Milberg Weiss was indicted for allegedly paying three plaintiffs \$11.4 million in illegal kickbacks spanning 180 cases. *Id.*

148. See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2510 (2008) (requiring “cogent and compelling” inference of scienter at pleading stage). *Tellabs* may reflect a growing concern that securities class-action lawsuits do not produce efficient outcomes. See Deborah R. Hensler & Thomas D. Rowe, Jr., *Beyond “It Just Ain’t Worth It”: Alternative Strategies for Damage Class Action Reform*, 64 LAW & CONTEMP. PROBS. 137, 139-40 (2001) (exploring remedies for better calibration of cost and benefits of class actions); Notes, *Risk-Preference Asymmetries in Class Action Litigation*, 119 HARV. L. REV. 587, 589 (2005) [hereinafter *Risk-Preference Asymmetries*] (noting calibration problem causes both inefficient suits and settlements).

149. See *Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 772 (2008) (observing inadequacy of class-action settlements). “[E]xtensive discovery and the potential for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies.” See *id.* (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740-41 (1975)).

150. See Sundeep Tucker, *The Risk-Reward Ratio Changes For the Worse Directors and Officers*, FIN. TIMES (London), Apr. 18, 2005, at 4 (anticipating director and officer insurance crisis resulting from increased class actions). Conversely, recent studies reflect a 38% decrease in securities fraud class actions since 2005 with the number of filings dropping from 178 to 110. *Id.* But see News Release, Cornerstone Research and Stanford Law School, Securities Fraud Class Actions Tumbled to an All-Time Low in 2006, Finds New Study by Stanford Law School and Cornerstone Research; Strong Federal Enforcement Activity and Stable Stock Market Contribute to Decline, (Jan. 2, 2007) (on file with author) (noting decrease in class actions if

As activist investors seek corporate reform, public pension funds, particularly CalPERS, typically lead the charge.<sup>151</sup> These activists generally garner limited success through direct shareholder-voting initiatives.<sup>152</sup> Companies may simply bend to shareholder demands to save enormous litigation expenses and prevent short-term dips in share prices resulting from prolonged disagreements with shareholders.<sup>153</sup>

Some observe that in “the new politics of capital,” pension funds disguise their political and social agendas as “shareholder activism.”<sup>154</sup> These institutional investors may compromise their fiduciary duties to shareholders when advancing partisan politics on campaigns that have little or no connection with shareholder equity.<sup>155</sup>

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“backdating cases” not considered). Reasons for the decline include a strong-stock market and corporations engaging in less activity that gives plaintiffs an excuse to file a complaint alleging fraud. *Id.* Continued judicial resistance to lessening Congress’s heightened pleading standards may affect the number and quality of securities class action lawsuits. *See Tellabs*, 127 S. Ct. at 2510 (upholding PSLRA’s heightened pleading standard).

151. *See* Dennis K. Berman, *Boardroom Defenestration—As Proxy Season Heats Up, Companies Consider Rules to Boot Unwanted Directors*, WALL ST. J., Mar. 16, 2006, at B1 (describing “unusual” alliance of pensions with former corporate raiders); Plitch, *supra* note 75 (exemplifying trend by citing Cendant’s governance changes pursuant to settlement with institutional shareholders). The California Public Employees Retirement System (CalPERS) is the largest U.S. pension fund and has taken the lead through lobbying and litigation on corporate governance reforms. *See* Elizabeth Wine, *Pension Funds in a Fit of Reforming Zeal: Retirement Plans Are Using Shareholder Activism to Take the Crisis of Confidence on Wall Street*, FIN. TIMES (London), May 6, 2002, at 22 (noting CalPERS leading entity in shareholder activism). Leading pension funds found a willing partner in Milberg Weiss, now under federal indictment, for attacking corporate boardrooms. *See* Elkind, *supra* note 147 (detailing investigation of Milberg Weiss); Simon Targett, *US Activists Turn Up the Heat: Radical Shareholder Champions Team Up for ‘Governance at Gunpoint’*, FIN. TIMES (London), Nov. 4, 2002, at 1 (describing close relationship between Milberg Weiss, CalPERS, and other public pension funds).

152. *See* Berman, *supra* note 151 (reporting Institutional Shareholder Services found only 14 of 14,000 board candidates rejected by majority of votes cast).

153. *See* Berman, *supra* note 151. Some executives are reluctant to aggressively challenge shareholder proposals for fear of being labeled unresponsive to investors and risk a subsequent drop in share price. *See id.*; *see also Risk-Preference Asymmetries*, *supra* note 148, at 589 (describing calibration problem); Elkind, *supra* note 147 (listing executives’ dilemmas dealing with activist shareholders). The calibration problem in class-action lawsuits involves the dilemma that “imposing too much liability can destroy jobs and deprive consumers of desirable products” while “imposing too little liability may leave corporations free to inflict tremendous harm on the public.” *Risk-Preference Asymmetries*, *supra* note 148, at 587.

154. *See Pension Fund Blackmail*, *supra* note 78 (warning against giant AFL-CIO dictating political agenda to American companies).

155. *See Pension Fund Blackmail*, *supra* note 78 (highlighting overlap between union agendas and pension fund campaigns). In one example:

New York State’s Democratic Comptroller Alan Hevesi was using his clout to aid John Kerry. When Sinclair Broadcast Group decided to air ‘Stolen Honor,’ a documentary on Mr. Kerry’s post-Vietnam antiwar activities, Mr. Hevesi fired off a letter to the company in his capacity as trustee of the state pension fund (which owned shares of Sinclair) suggesting the broadcast could hurt ‘shareholder value.’ Recognizing a not-so-subtle-threat when it saw one, Sinclair pulled the show.

*Id.* The SEC’s leadership recognizes potential problems with pension funds compromising their fiduciary duties in the name of “corporate governance.” *See* Glassman, *Transatlantic Governance Conference*, *supra* note 77 (prioritizing institutional investors’ fiduciary duties over governance policies of investment

## IV. FIRMS AND EXECUTIVES GOING PRIVATE

A. *Flight from Public Markets: Going Private*<sup>156</sup>

Publicly traded firms go private for a variety of reasons.<sup>157</sup> Increased personal liability for directors, escalating compliance costs, and a focus on short-term results that encourages litigation for any drop in stock price, collectively create heavy incentives for middle-market firms to consider going private as strategy for long-term growth.<sup>158</sup> The relative number of going-private transactions, in proportion to the total amount of public takeovers, exploded in recent years.<sup>159</sup> Where going private was once primarily a defense to hostile takeovers, firms increasingly go private as an offensive strategy for growth.<sup>160</sup> Sarbanes' requirements, in addition to threats of shareholder litigation after any drop in share price, contribute to driving public companies, especially small to medium-sized, companies, private.<sup>161</sup> While costs of being public are especially burdensome for smaller companies, costs have risen for firms of all sizes, with little relief in sight.<sup>162</sup> Accordingly, larger companies increasingly embrace the option of exiting American public

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companies).

156. See *supra* note 22 (defining "going private"). The term refers to an acquisition of a publicly traded company by a private investment group, individual, or private company. *Id.*

157. FACTSET MERGERSTAT, LLC, *supra* note 22, at 42. Aside from defensive measures, the desire to eliminate expenses unique to public companies—including shareholder meetings, proxy activities, SEC compliance and dividends—represents the primary reason for going private. *Id.* Some small firms go private because they simply fail to be profitable as public companies. See Carney, *supra* note 51, at 150 (noting even without regulatory burdens some firms not suitable for public markets).

158. See Hewitt & Paterson, *supra* note 4 (detailing reasons for going private).

159. FACTSET MERGERSTAT REVIEW, *supra* note 22, at 42. In 2002 only 7 of 411 (17%) takeovers involved going-private transactions while in 2005 there were 142 going private transactions out of a total of 448 (31.7%). *Id.* Going back to 1996, the percentage increased nearly tenfold. *Id.*

160. See Hewitt & Paterson, *supra* note 4 (noting increase in going-private transactions not linked to hostile takeovers). The removal of quarterly earnings reporting allows management to pursue long-term goals. See *id.*; see also Dennis K. Berman, Gautam Naik, & Ron Winslow, *Behind \$21 Billion Buyout of HCA Lies a High-Stakes Bet on Growth*, WALL ST. J., July 25, 2006, at A1 (noting HCA transaction intended to stimulate long-term growth not cutting costs). A strong private equity industry can provide an ample source of capital for both small and large firms. See Henry Sender, *Ahead of the Tape*, WALL ST. J., Aug. 11, 2006, at C1 (emphasizing private equity's impact on share prices).

161. See Carney, *supra* note 51, at 141, 155 (asserting Sarbanes costs too high for small companies to remain public); Chandler & Strine *supra* note 4, at 980-81 (noting time and cost demands for compliance affect bottom line); Christine Haughney, *REITs Are Increasingly Going Private*, WALL ST. J., Oct. 26, 2006, at B8 (noting rising costs and uncertainty of being public company); Lauria, *supra* note 60 (noting media industry's movement towards private markets). Four times the number of REITs went private in 2005 than in 2004. Haughney, *supra*.

162. See Berton, *supra* note 26 (estimating 150 percent increase in cost of being public over past year); Carrie Johnson, *SEC Votes to Ease Audit Requirements*, WASH. POST, Dec. 14, 2006, at D01 (reporting unanimous SEC adoption of 2002 rule revision). The SEC, however, refused to create special exemptions for small companies. *Id.*

markets.<sup>163</sup> Closer alignment of shareholder and management interests in private equity firms creates lower transaction costs in a company's decision-making process.<sup>164</sup>

The increase in size and scope of the going-private trend follows the slowdown in initial public offerings in American markets.<sup>165</sup> Going abroad is an attractive alternative for companies looking for public capital markets with infrastructures more hospitable to long-term growth.<sup>166</sup> Firms operating in European capital markets avoid some of the staggering litigation costs associated with suits from activist shareholders.<sup>167</sup> In fact, European activists view American courts as fertile ground to launch activist campaigns that would otherwise be too risky to attempt in Europe.<sup>168</sup>

### B. Executives Abandoning Public Companies

The pull of the private equity industry's emphasis on building value and the push of public markets' "governance at gunpoint" forces some of the brightest American executives into private roles.<sup>169</sup> Executives cite myriad reasons for

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163. See FACTSET MERGERSTAT, LLC, *supra* note 22, tbls. 1-40 (2006) (evidencing trend of large companies exiting public markets). In 2003 only 3 out of 124 going-private transactions were valued at more than \$1 billion, while in 2005 19 out of 142 transactions were valued at \$1 billion or more. *Id.*

164. See Illig, *supra* note 116, at 282-84 (describing benefits of private equity model compared to corporate model).

165. See Greenberg, *supra* note 27 (noting slowdown); *Hot Topic*, *supra* note 145 (describing Sarbanes and over-regulation as causes of IPO decrease in American markets); see also Letter from Barbara Blackford, Chair, Task Force on Smaller Pub. Co's., Soc'y of Corp. Sec'ys and Governance Prof'ls, to Nancy M. Morris, Federal Advisory Comm. Mgmt. Officer, SEC. (Apr. 2, 2006), <http://www.governanceprofessionals.org/commentletters/flash20j.shtml> (advocating rules accounting for differences between large and small companies).

As currently structured, the regulatory burden falls disproportionately on the smaller companies and makes them less able to compete with either their US-based competitors or their ex-US competitors of any size. The impact is clearly demonstrated by the rush of new offerings to London to avoid this burden. Thus, there is a real need for the Advisory Committee's recommendations to be adopted [by the SEC] to avoid placing smaller US companies and US markets at a competitive disadvantage.

*Id.*

166. See Carney, *supra* note 51, at 152-53 (noting outflow of IPO activity to Europe). U.S. regulators have largely ignored these strong signals that markets with better-managed regulatory systems make domestic markets less competitive. See Greenberg, *supra* note 27 (highlighting loss to free enterprise from overregulation).

167. See Aaron O. Patrick, *Bollore Focuses on Advertising As His New Game—French Corporate Raider Rattles Media-Buying World; 'I Am Not Paid To Be Charming'*, WALL ST. J., July 1, 2006, at B1 (noting less shareholder activism in Europe generally). Fee-shifting rules in Europe may alter the costs and benefits of bringing a shareholder action. See *Risk-Preference Asymmetries*, *supra* note 148, at 605 (discussing fee shifting as option for more efficient system).

168. See Joann S. Lublin, *European Shareholder Activists Reach Across Borders to U.S.*, WALL ST. J., June 12, 2006, at B1 (reporting activists see United States as litigation battle ground). The calibration of the costs and benefits of litigation may be far different abroad, effecting more efficient outcomes. See *supra* note 149 (detailing calibration problems in class-action suits).

169. See Thornton, *supra* note 15 (citing proverbial "gun to [the] head" as reason for executives leaving

the shift, including the public markets' focus on placating short-term oriented shareholders, compliance costs under Sarbanes, SEC disclosure mandates, activist institutional investors, and an abundance of private investment capital that allows boards to run companies the way they see fit.<sup>170</sup> On a more fundamental level, one-size-fits-all federal rules supplanting state corporate law principles add additional disincentives for well-qualified individuals considering whether to serve on boards.<sup>171</sup> Additionally, the rules hindering institutional investors from serving as corporate fiduciaries eliminate a large pool of talent.<sup>172</sup> Some have described the move to private equity as a “[s]ign that the ascent of widely held companies over the past century might be cresting.”<sup>173</sup>

## V. THE PENDULUM SWINGS

### A. Explaining the Trend

Many of the same reasons that drive executives into private roles cause an increasing number of firms to abandon, or never enter, American public markets.<sup>174</sup> While Sarbanes-related costs make American public capital markets prohibitively expensive for many small companies, an increasing number of larger firms cite compliance costs as a primary reason for going private.<sup>175</sup> Where going private was once a primarily defensive maneuver, threats of shareholder litigation and subsequent drops in share price are part of an overall public market focus on short-term results that drives both executives and firms to consider going private as part of long-term strategies for growth.<sup>176</sup>

Since 2002, compliance costs have been a major factor in pricing small firms out of public markets.<sup>177</sup> Costs include, but are not limited to, litigation

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public companies).

170. See Thornton, *supra* note 15 (providing reasons for “luminaries” leaving public companies).

171. Chandler & Strine, *supra* note 4, at 997-99 (criticizing federal definitions for directorial “independence”).

172. See Chandler & Strine, *supra* note 4, at 993-94 (noting activist investors shirk fiduciary responsibility to maintain fund’s ability to dump shares). Chandler & Strine argue that the rules ought to encourage institutional investors to serve in fiduciary roles because the actual shareholders would realize greater long-term benefits. *Id.*

173. See Thornton, *supra* note 15 (linking loss of executive talent to harm in public markets); see also Romano, *supra* note 37, at 1589-90 (discussing long-term risks to U.S. market related to overregulation).

174. See Romano, *supra* note 37, at 1589-90 (discussing long term risks for American public markets); see also Illig, *supra* note 116, at 230 (discussing importance of considering private markets in corporate governance discussion).

175. See FACTSET MERGERSTAT, LLC, *supra* note 22, at 43, tbls. 1-40 (evidencing trend in larger firms going private); Bainbridge, Business Associations Blog, *supra* note 25 (noting larger firms going private).

176. See Romano, *supra* note 37, at 1531 (arguing no clear correlation between independent board and performance); *Hot Topic*, *supra* note 145 (noting sizeable movement in foreign markets specifically away from U.S. regulators); *supra* note 21 (providing example of large firm going private as offensive strategy).

177. See Carney, *supra* note 51, at 141, 155 (discussing size of compliance costs).

expenses, director and officer liability insurance, and heightened legal and accounting fees.<sup>178</sup> For smaller firms, opportunity costs associated with executive time spent on compliance amplifies the expense because a large portion of fixed costs do not vary proportionately with firm size.<sup>179</sup>

Despite clear evidence that one size of regulation does not fit all firms, the federal government refuses to create significant regulatory exceptions to help small companies deal with a regulatory scheme principally designed in reaction to the unparalleled abuses at huge firms like Enron and Worldcom.<sup>180</sup> Regulators' reluctance to ease burdens on small companies and refusal to tailor compliance requirements directly conflicts with the notion that small firms should weather the storm of regulatory costs rather than go private.<sup>181</sup> Due in part to the federal regime's inflexibility and the allure of private equity, in reality, small firms have little incentive either to adopt shareholder empowering mechanisms that fail to correlate strongly with increased earnings or remain in a market not conducive to their long-term growth.<sup>182</sup>

The frequency and size of firms abandoning public markets is increasing.<sup>183</sup> Going-private transactions as a percentage of public company takeovers increased to 31.7% in 2005, up from 26.3% in 2004 and 17.0% in 2002.<sup>184</sup> The largest going-private transactions have gotten larger: in 2001, only nine of seventy-seven going private transactions topped \$100 million with only one

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178. See Carney, *supra* note 51, at 154 (detailing costs of implementing federal reforms). This analysis does not include costs arising from the SEC's Compensation Discussion and Analysis Section. *Id.*

179. See Carney, *supra* note 51, at 151 (stressing that one-sized reform does not fit all). SEC Commissioner Campos sees no room in a "culture of compliance" for distinguishing regulatory burdens according to firm size. See Campos, *supra* note 8 (stating strong culture of compliance outweighs section 404's high costs to small firms). Campos offers no evidence as to why this is the case. *Id.*

180. See Johnson, *supra* note 162 (reporting SEC's recent refusal to create regulatory exemptions for small companies). One estimate of investor losses at Enron and Worldcom totals \$100 billion. Carney, *supra* note 51, at 151. Despite the fact that Sarbanes regulation set out to prevent abuses of this magnitude, firms incapable of producing comparable losses must nonetheless comply with disproportionate requirements and their attendant costs. *Id.* SEC Chairman Cox rebuffed suggestions that Congress act to offset the negative effects on U.S. capital markets associated with Sarbanes' high costs. See Grant, *supra* note 27 (noting Cox's staunch defense of Sarbanes' in its current state).

181. See Shouvakis, *supra* note 25, at 1296 (recommending small firms adopt a wait-and-see attitude instead of going private). The irony of the wait-and-see attitude is that by accepting modern corporate regulation and its costs as the "manifestation of an American system of business values," small firms may actually do a disservice to their shareholders by not securing favorable share prices by going private, opting instead to pursue more precarious long-term commitments to public markets. See *id.* at 1291-93 (implying adoption of shareholder friendly mechanisms add value).

182. See Carney, *supra* note 51, at 159-60 (suggesting recent entrants to public markets rethink their decisions). More difficult to measure is the effect of compliance costs on firms considering entrance into U.S. public capital markets but opting instead to stay private or list exclusively on foreign exchanges. See *id.* at 153 (noting advantages of less expensive London Stock Exchange's Alternative Investment Market (AIM)).

183. FACTSET MERGERSTAT, LLC, *supra* note 22, at 42, tbls. 1-39 (evidencing upward trend).

184. FACTSET MERGERSTAT, LLC, *supra* note 22, at 42, tbls. 1-39. Since 2001, the total number of public takeovers has decreased substantially, but going private transactions have actually increased in number, almost doubling from 2002 to 2003. *Id.*

topping \$1 billion from a total of 591 public takeovers.<sup>185</sup> In 2005, of only 448 public takeovers, 68 of 142 going-private transactions exceeded \$100 million and 19 exceeded \$1 billion.<sup>186</sup> The average price of going-private transactions increased from \$331.8 million in 2004 to over \$700 million in 2005, with a four-fold increase in median price over the same period.<sup>187</sup>

Recent evidence thus supports an inference that many firms are going private as part of long-term growth strategies and not as defensive maneuvers.<sup>188</sup> The fact that firms are willing to deal with the potentially costly, lengthy, and unpleasant process of going private further evidences an eagerness to escape the burdens of public company regulation.<sup>189</sup> A key attribute of the private equity market is that managers are less concerned that a negative comment from a regulatory agency could bring about a drop in share price and immediately trigger a shareholder action.<sup>190</sup> This factor is particularly significant because it applies to firms of all sizes.<sup>191</sup> Firm and executive exodus from American public markets is bad for everyone because it decreases shareholder choice and broad ownership that produces a more efficient distribution of wealth, threatening community ownership of the “community bank.”<sup>192</sup>

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185. See FACTSET MERGERSTAT, LLC, *supra* note 22, at 43, tbls. 1-40 (illustrating increase in frequency and value of going-private transactions).

186. FACTSET MERGERSTAT, LLC, *supra* note 22, at 43, tbls. 1-40.

187. FACTSET MERGERSTAT, LLC, *supra* note 22, at 43, tbls. 1-40; see Bainbridge, Business Associations Blog, *supra* note 25 (noting median price increase from \$40 million to \$160 million from 2004 to 2005). Not all increases in going private-transactions result from costs of compliance. See Carney, *supra* note 51, at 154 (noting liquidity for large investors fearful of selling large block of shares in thin market); *supra* notes 157, 160 and accompanying text (outlining additional reasons for going private).

188. See *supra* note 21 (using HCA as example of going private to avoid Sarbanes' cost and create new value).

189. See *Hot Topic*, *supra* note 145 (reporting largest IPOs taking place in foreign markets away from reach of U.S. regulators). Since June 30, 2002, 191 public companies, worth \$146 billion in deal value, have gone private. *Id.* A combination of increased costs, regulatory uncertainty, and threats of shareholder suits for even a temporary stock price dip, correlates with the increase in going-private transactions among firms, as well as the 15.3% of CEOs at the world's 2,500 largest public companies who left office in 2005, many of whom shifted to private companies with focuses on long-term goals. *Id.*

190. See Greenberg, *supra* note 27 (crediting culture of over-regulation with pushing public firms private); *supra* note 149 (suggesting current paradigm promotes inefficient settlements).

191. See Greenberg, *supra* note 27 (noting recent trend of major companies going private); *supra* note 21 (using HCA as example of large firm going private); see also Lauria, *supra* note 60 (noting management of mid-sized firms favoring going private).

192. See Carney, *supra* note 51, at 159 (linking regulation inflexibility with flight from public markets); *Hot Topic*, *supra* note 145 (asserting Congress pushed regulatory pendulum too far). Regulatory excess, as much as market opportunity, drives the current trend toward going private. *Hot Topic*, *supra* note 145. Exchanges, by pushing into areas of state corporate law such as directorial independence, make themselves less attractive. See Chandler & Strine, *supra* note 4, at 968-70 (reporting Exchanges adopted rules for independence substantially over and above long-accepted state law requirements).

### B. Federal Mandates and Their Substantive Effect on State Corporate Law

Despite state predominance, corporate reforms since 2002 reflect “a marked increase in federal government . . . regulation of the corporate boardroom . . . where, traditionally, states have been predominant.”<sup>193</sup> It is unclear whether regulators considered the role of states in the corporate regulatory regime before significantly displacing large amounts of their corporate laws.<sup>194</sup>

Changes to director-independence requirements and corporate loans are the two most direct intrusions into areas of substantive state corporate law.<sup>195</sup> Congress banned, with certain limited exceptions, corporations from making loans to officers and directors.<sup>196</sup> Sarbanes also redefines director independence.<sup>197</sup>

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193. See Chandler & Strine, *supra* note 4, at 958-59 (discussing aggressive federal moves into board decision-making and composition). *But see* Jones, *supra* note 50, at 637-39 (arguing state corporate law rules evolved in stagnant environment). Jones then subsequently states that Delaware authorities developed their corporate law with “considerable expertise and experience.” *Id.* at 638. Jones’s system is one in which the federal government reacts to public pressure to preempt state corporate law whenever politically expedient. *Id.* at 639 (stating federal regulators must intervene when public becomes dissatisfied with state regulatory regimes). Her argument that Delaware’s leading role lacks legitimacy in part due to its small size, coupled with her affinity for federalization when “the public becomes dissatisfied,” inevitably leads to the annihilation of Delaware’s sovereignty over its own corporate law because large states, like California and New York, which tend to host the most political shareholder activists, could through Congress exert their political influence to preempt Delaware corporate law. *Id.* at 637 (advocating popular political control over state corporate law). Reforms since 2002 may have upset the “easy balance between federal securities law and state corporate law” and allowed the SEC and exchanges to have a significantly greater influence in corporate governance. See Wu, *supra* note 49, at 250 (putting into context Sarbanes’ effect on corporate law).

194. See Thompson, *supra* note 42, at 107 (noting Senate investigations focused on directors, SEC, and exchanges, but not on states). The Senate Permanent Subcommittee on Investigations published a report entitled “The Role of Directors in Enron’s Collapse,” that failed to encourage states to reform perceived loopholes through which firms had perpetrated abuses. *Id.* This omission most likely resulted from a general misunderstanding of state corporate law, the desires of politicians to leave their “imprint[s] on the resulting product,” and haste as a result of immense political pressure. See Chandler & Strine, *supra* note 4, at 957 (noting randomness of federal response to corporate fraud). In fact, during House debates over Sarbanes there was no “mention [of] audit committee independence or executive loans, the subjects of the [Sarbanes] corporate governance mandates most intrusive on state law jurisdiction, nor did those mandates appear in House Democrats’ bills.” See Romano, *supra* note 37, at 1551 (detailing legislative process).

195. See Romano, *supra* note 37, at 1551 (noting importance of two areas).

196. See Chandler & Strine, *supra* note 4, at 971-72 (highlighting section 402’s proscription of executive loans as clear example of intrusion into state corporate law). Specifically, Sarbanes’s section 402 says that “[i]t shall be unlawful for any issuer . . . to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer . . .” *Id.* at 972 n.48 (quoting Sarbanes-Oxley Act of 2002, 15 U.S.C.A. 78m(k) (West 2003)). This clearly contradicts Delaware’s corporate law, which authorizes loans to officers where “in the judgment of the directors, such loan, guaranty or assistance may reasonably be expected to benefit the corporation.” *Id.* at 972 n.49 (quoting DEL. CODE. ANN. tit. 8, § 143 (2001)). Chandler and Strine also discuss Exchange proposals that would alter executive compensation by seeking to require shareholder approval for certain equity-based compensation plans. See *id.* at 972 (noting Exchange involvement in area traditionally reserved for state law).

197. See Chandler & Strine, *supra* note 4, at 967-69 (observing Exchange’s work in concert with federal regulators to alter independence rules); Thompson, *supra* note 42, at 103 (noting new federal role requiring independence of audit committee). In addition to changing independence requirements for the audit committee, Sarbanes affects corporate governance by requiring auditors to report directly to the committee and not to

Sarbanes and exchanges together provide strict rules for director independence.<sup>198</sup> The New York Stock Exchange requires that the director have no material relationship to the company other than the role as director, and outlines extensive preclusions for familial relations to directors, officers, or other specified employees, which in some instances are curiously distant.<sup>199</sup> The National Association of Securities Dealers Automated Quotations (NASDAQ) has its own requirements, which broaden the definition of relative to include marriage, adoption, or member of the same residence.<sup>200</sup>

Each rule, however, might not be appropriate for every public corporation in the United States.<sup>201</sup> While director independence has always been a concern of state law, advocates for strong federal regulation, despite unclear evidence, contend that even independent directors tend to acquiesce to management.<sup>202</sup> Director ownership had long been regarded as beneficial because it encourages a good-faith incentive to monitor; however, the post-2002 reforms cast suspicion on owner-directors, making it difficult to distinguish an owner who does not engage in self-dealing from one who does.<sup>203</sup>

On a more practical level, the heightened independence standards potentially sideline huge numbers of talented executives who serve on other boards or at institutional investors holding large percentages of the firms' stock.<sup>204</sup> The ironic, and most likely unintended, result is that large institutional investors who are often in activist roles may now be precluded from serving on the boards of companies they seek to affect.<sup>205</sup> These investors are reluctant to

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management and mandating that the committee take responsibility for the appointment, compensation, and oversight of the auditors' work. See Thompson, *supra* note 42, at 103 (detailing changes in audit process).

198. See Chandler & Strine, *supra* note 4, at 967-71 (detailing Exchange and Sarbanes independence requirements).

199. See Chandler & Strine, *supra* note 4, at 968 (noting prohibition against family member of employee whose company's audit committee includes officer of company).

200. Chandler & Strine, *supra* note 4, at 969.

201. See Chandler & Strine, *supra* note 4, at 978 (noting diversity of American corporations).

202. See Bainbridge, *Director Primacy*, *supra* note 36, at 1739 n.13 (responding to advocates, namely Bebchuk). Bebchuk argues that even independent directors have incentives to acquiesce to management on compensation decisions. See *id.* (critiquing Bebchuk's argument); Bainbridge, *Executive Compensation*, *supra* note 64, at 1630-32 (arguing evidence fails to show pattern of acquiescence for independent directors).

203. See Chandler & Strine, *supra* note 4, at 990-91 (noting Sarbanes deems director independent only if not affiliated with company or subsidiary). Ironically, private-equity models produce more efficient decision making through better alignment of management and investor interests. See Illig, *supra* note 116, at 282 (noting better alignment of interests and lower transaction costs at private firms). One positive effect of more stringent independence rules is that parties may litigate fewer cases over demand excusal as compliance may raise a presumption of independence. *Id.* at 988.

204. See Chandler & Strine, *supra* note 4, at 992-94 (noting reforms cutting off promising new sources of independent directors); Glassman, Transatlantic Governance Conference, *supra* note 77 (noting misplaced reliance on independence).

205. See Chandler & Strine, *supra* note 4, at 994 (expressing skepticism over true motivations of activist institutional investors). Pension fund trustees may be reluctant to serve due to the director liability they helped to create. See *id.*; *supra* note 151 (noting close relationship between pension funds and leading plaintiff's firm under indictment).

serve in the first place because Exchange rules hamper the fund's ability to sell the company's stock quickly.<sup>206</sup> Therefore, federalized reforms of independence standards for directors directly contribute to a shrinking pool of executive talent at American public companies, without providing corresponding benefits.<sup>207</sup>

The "careless use" of language in federal reforms effectively ignores existing state law tests that apply a high level of scrutiny to transactions where a director is interested or where directorial independence is challenged.<sup>208</sup> Delaware's corporate law examines the propriety of director conduct based upon "nuanced and fact-driven consideration[s]," whereas the federal rules make determinations based solely on the director's status.<sup>209</sup>

In *In re The Limited, Inc.*,<sup>210</sup> shareholders brought a derivative action against several directors for breach of fiduciary duties where the board rescinded a contingent stock redemption agreement and funded a self-tender offer.<sup>211</sup> The plaintiffs contended that a demand on the board would have been futile because of the interested nature of the rescinded agreement, which included a call option to purchase 18.75 million shares of common stock from a trust set up for the benefit of the children of Leslie Wexner, The Limited's president, chief executive officer, and chairman of the Board.<sup>212</sup> The transaction inherently

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206. See Chandler & Strine, *supra* note 4, at 994 (discussing short-term focus of institutional fund managers).

207. See Chandler & Strine, *supra* note 4, at 981 (predicting executives will follow firms into private roles due to overregulation); Glassman, Transatlantic Governance Conference, *supra* note 77 (noting federal reforms mistakenly treat independence as substitute for quality).

208. See Chandler & Strine, *supra* note 4, at 996 (criticizing federal definitions of director independence). An interested director possesses a personal financial stake that is adverse to the interests of the corporation and its shareholders. DEL. CODE ANN. tit. 8, § 144 (2001); Chandler & Strine, *supra* note 4, at 997. Delaware's interested director statute places an affirmative duty of disclosure on directors with financial interests in transactions and places an affirmative duty of good faith on the disinterested directors in their authorization of the transaction. Chandler & Strine, *supra* note 4, at 997. Alternatively, shareholders may approve a transaction where a director is interested provided that the director has fulfilled substantial disclosure requirements. DEL. CODE ANN. tit. 8, § 144 (a)(2) (2001). Independence, on the other hand, refers to whether directors who lack a personal financial stake are beholden to those who do—i.e., the interested parties. Chandler & Strine, *supra* note 4, at 997-98.

209. See Chandler & Strine, *supra* note 4, at 998 (noting transaction-specific nature of state corporate law tests in contrast to one-size-fits-all federal rules). "Directorial interest exists whenever divided loyalties are present, or a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled by* *Brehm v. Eisner*, 746 A.2d 244 (Del. 1998).

210. No. CIV.A. 17148-NC, 2002 WL 537692 (Del. Ch. 2002).

211. See *id.* at \*1 (reviewing record of self-interested parties).

212. *Id.* A demand on the board in a derivative action is futile and therefore excusable if the plaintiff pleads particularized facts sufficient to create a reasonable doubt that either first, the directors are disinterested and independent or second, that the challenged transaction was otherwise the product of a valid exercise of business judgment. *Aronson*, 473 A.2d at 814. Plaintiffs prefer a victory on the first prong is because it immediately deprives the transaction of business judgment rule protection, which is highly deferential to the board of directors. See *supra* note 131 and accompanying text (describing business judgment rule's protection).

afforded Wexner a personal financial benefit in which the stockholders did not share equally, and, as a result, the plaintiffs successfully challenged Wexner's disinterestedness.<sup>213</sup> After initially determining Wexner's interest in the transaction, the court inquired as to the independence of the remaining directors on a subjective director-by-director analysis.<sup>214</sup> By showing that six of twelve directors were interested or lacked independence from the CEO, the plaintiffs met their burden of demonstrating that making a demand of the board would be futile.<sup>215</sup> In contrast to federalized standards promoting a one-size-fits-all methodology based on status rather than circumstance, *In re The Limited, Inc.* importantly illustrates that in determining director independence, courts may rigorously apply existing state standards when evaluating the circumstances of a particular case and transaction.<sup>216</sup>

### C. Judicial Resistance to Federalization of Corporate Law

Federal regulators have not enjoyed unfettered reign in imposing standards for directorial independence.<sup>217</sup> In *Chamber of Commerce v. SEC*,<sup>218</sup> the court initially invalidated an SEC rule requiring mutual funds to ensure that at least 75 percent of its directors are independent, and to maintain an independent chair, because it failed under the Investment Company Act of 1940 "to do what it can to apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation before it decides whether to adopt the measure."<sup>219</sup>

After remand and an opportunity for the SEC to fulfill its statutory obligations, the court again determined that the SEC had not fulfilled its statutory duty to place interested parties on notice of its basis for cost estimations.<sup>220</sup> While the SEC did not attempt to disguise the haste in its

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213. *In re The Limited*, 2002 WL 537692, at \*4; see *supra* note 209 (defining director interest).

214. *In re The Limited*, 2002 WL 537692, at \*4-5. Directors are not independent where they bases their decisions on extraneous considerations or influences and not the corporate merits of the subject matter before the board. *Id.* at \*4. "[A] plaintiff meets his burden by showing that the directors are either beholden to the controlling shareholder or so under its influence that their discretion is sterilized." *Id.* (applying *Aronson's* first prong).

215. See *id.* at \*7 (denying defendant directors' motion to dismiss). The court also addressed claims alleging the directors breached their duties of loyalty and due care. See generally *id.*

216. See *Chandler & Strine*, *supra* note 4, at 998 (arguing federalized standards for independence not transaction specific).

217. See *Chamber of Commerce of the U.S. v. SEC*, 443 F.3d 890, 893-94 (D.C. Cir. 2006) (considering for second time on remand SEC's mutual fund board independence requirements). The Court of Appeals for the District of Columbia originally invalidated the SEC requirement based upon its failure to determine the costs of its proposed rule which required mutual fund boards to have more than 75 percent independent directors and an independent chair. See *id.* at 893; see also *Chamber of Commerce of the U.S. v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005) (invalidating requirement for first time), *remanded to* 443 F.3d 890 (D.C. Cir. 2006).

218. 412 F. 3d 133 (D.C. Cir. 2005).

219. *Id.* at 144; ICA § 2(c), 15 U.S.C. § 80a-2(c) (2006).

220. See *Chamber of Commerce*, 443 F.3d at 904-05 (noting SEC's continued noncompliance). The court

rulemaking, the court rejected the SEC's continued argument that empowerment of shareholders justified its faulty rule promulgation procedures.<sup>221</sup> In that regard, both cases demonstrate that the SEC views-in at least one instance—its pursuit of a “culture of compliance” as a ticket to abandon thorough consideration of the costs of its actions.<sup>222</sup>

In other instances, however, federal courts have expanded federal power into the state law domain.<sup>223</sup> In *American Federation of State, County & Municipal Employees v. AIG*, the United States Court of Appeals for the Second Circuit held that Rule 14a-8(i)(8) of the Securities & Exchange Act of 1934, known as the “election exclusion,” applies to shareholder proposals that relate to a particular election and not to proposals that would establish the general procedural rules governing elections.<sup>224</sup> The SEC interpreted the rule inconsistently, causing the court to embrace the SEC's former interpretation as it provided no sufficient reasons for its change in position, stating it would “take no side in the policy debate regarding shareholder access to the corporate ballot. . . . Congress has determined that such issues are appropriately the province of the SEC, not the judiciary.”<sup>225</sup> It is curious, then, why the court did not defer to the subsequent SEC position, especially when its ruling has the potential to displace profoundly state corporate laws governing procedures for

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stated:

The Commission's bare request for information on costs and its expectation that these costs would be 'minimal' did not place interested parties on notice that . . . the Commission would base its cost estimates on an extra-record summary of extra-record survey data that . . . was not the sort, apparently, relied upon by the Commission during the normal course of its official business.

*Id.*

221. *See id.* at 895, 908 (rejecting SEC's justification its haste “ultimately serve[s] the interests of fund shareholders”). Significantly, the court also took a skeptical view of the SEC's assertions that compliance costs would be minimal for firms of all sizes. *See id.* at 894 (criticizing agency's decision not to reopen public comment period); *Chamber of Commerce*, 412 F.3d at 143-44 (refusing to ignore SEC's statutory obligations just because no reliable basis existed to determine costs).

222. *See Chamber of Commerce*, 443 F.3d at 895 (noting and rejecting SEC's investor empowering motivations).

223. *See Am. Fed'n of State, County & Mun. Employees v. AIG*, 462 F.3d 121, 129-31 (2d Cir. 2006) (interpreting narrowly SEC's 14(a)-(8)(i)(8) election exclusion); *Roosevelt v. E.I. Du Pont de Nemours & Co.*, 958 F.2d 416, 417 (D.C. Cir. 1992) (implying private right of action under Rule 14a-8). Fear of upsetting shareholder expectations and equity concerns justified a higher level of judicial intervention where “significant policy issues are at stake.” *Roosevelt*, 958 F.2d at 420, 429. Justice Ginsburg emphasized that only courts can decide whether a company is obligated to include shareholder proposals in its proxy material. *Id.* at 424. *But see Frank v. Hadesman & Frank, Inc.*, 83 F.3d 158, 160-62 (7th Cir. 1996) (noting federal court inappropriate forum for rewriting state corporate law); *In re The Mony Group, Inc. Shareholder Litigation*, 853 A.2d 661, 669 (Del. Ch. 2004) (upholding board's decision over cash-for-stock acquisition where postponed vote increased pro-board votes). It is therefore unclear whether state authorities have acceded to ad hoc federalized changes in their state corporate law. *See Jones, supra* note 50, at 636-37 (touting success of vertical competition between state and federal corporate laws).

224. *Am. Fed'n*, 462 F.3d at 123.

225. *Id.* at 131.

director elections.<sup>226</sup>

The Supreme Court took notice of the increasing costs associated with the federalization of corporate law in *Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc.*<sup>227</sup> There, investors of a cable company sued suppliers and customers under SEC Rule 10b-5, alleging that the customer and supplier (Scientific-Atlanta) purposefully arranged for the investor's company to mislead its auditor, resulting in a misleading financial statement and subsequent drop in stock price.<sup>228</sup> The Supreme Court denied the plaintiffs' request to extend 10b-5 liability to reach aiders and abettors because although Scientific-Atlanta participated in the fraudulent scheme, it did not participate in the preparation or dissemination of the fraudulent financial statement.<sup>229</sup>

Generally, state law governs normal business disputes.<sup>230</sup> Though an ordinary business transaction may in some way affect securities markets, section 10(b) liability "does not reach all commercial transactions that are fraudulent and affect the price of a security in some attenuated way."<sup>231</sup>

The Court considered the consequences of judicially expanding implied rights of action.<sup>232</sup> The Court's recognition of a calibration problem in securities class actions reflected its skepticism that expanding private rights of action will better police corporate wrongdoing.<sup>233</sup> The Court's holding in

226. See Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 674-79 (2005) (describing contract-based relationship between corporation, directors, and shareholders governed under state law). Strine provides an effective historical rebuke to Jones's claims that state corporate law developed in an environment of stagnation. See generally *id.* (outlining historical evolution of corporate law from Europe to United States and federalist system). But see Jones, *supra* note 50, at 638 (labeling historical development of state corporate law as stagnant).

227. 128 S. Ct. 761, 770-72 (2008) (recognizing costs of supplanting state corporate law with federal mandates).

228. See *id.* at 766 (describing facts of case). Charter Communications, a cable operator, crafted a deal with Scientific-Atlanta whereby Scientific-Atlanta supplied cable boxes to Charter, who would overpay by twenty dollars per box. *Id.* In return, Scientific-Atlanta purchased advertising from Charter, who booked the advertising purchases as revenue. *Id.* Charter booked approximately \$17 million in revenue as a result of this practice, and its financial statements filed with the SEC reflected this revenue. *Id.* at 767. Importantly, Scientific-Atlanta never participated in the preparation or dissemination of Charter's financial statements, limiting its involvement to participation in the fraudulent scheme. *Id.*

229. See *id.* at 769 (affirming § 10(b) private right of action does not extend to aiders and abettors). Scientific-Atlanta "had no duty to disclose; and their deceptive acts were not communicated to the public. No member of the public had knowledge, either actual or presumed, of respondents' deceptive acts . . ." *Id.* Therefore, the plaintiffs could not show reliance—a required element for section 10(b) liability—upon Scientific-Atlanta's actions. *Id.*

230. See *id.* at 770 (declining to apply federal securities law to purchase and sale contracts). As the Court made clear, section 10(b) neither incorporates common-law fraud into federal securities laws nor provides a broad remedy for all fraud. *Id.* at 771.

231. *Stoneridge*, 128 S. Ct. at 771.

232. See *id.* at 772 (describing consequences of federalizing state law).

233. *Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 772 (2008) (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975)); *supra* note 149 (describing calibration problem).

*Tellabs, Inc. v. Makor Issues & Rights, Ltd.*<sup>234</sup> is consistent with its skepticism in *Stoneridge*.<sup>235</sup> By upholding the PSLRA's heightened pleading requirements, *Tellabs* will likely produce fewer, but stronger, securities class action cases.<sup>236</sup> Extending liability to aiders and abettors in *Stoneridge* would raise the costs of doing business without clearly correlated benefits in terms of policing corporate wrongdoing.<sup>237</sup> Echoing critics of federal reforms, the Court anticipated that extended federal liability for a business transaction already prohibited under state law would not only deter foreign firms from U.S. markets, but also would raise costs of being a public company and shift offerings away from American public markets.<sup>238</sup>

## VI. CONCLUSION

The corporate scandals that rocked an overly exuberant economy at the beginning of this century unsurprisingly generated a surge in federal regulation of corporations not seen since the New Deal. As agencies and courts struggle to implement reforms, the federal government imposes enormous regulatory burdens on firms and directors, seemingly without adequate consideration of its mandates' costs. The resulting costs and uncertainty, for small firms especially, create a precarious environment in which public markets seem increasingly less appealing.

Regulators demand from corporations conformance with one-size-fits-all mandates that often have few clearly correlated benefits in terms of investor protection or increased earnings. In the name of "shareholder empowerment," regulators promote agendas that place politics above carefully thought-out regulation. Ignoring the exorbitant costs and inefficiencies of a one-size-fits-all regulatory regime causes an overall loss to American public markets when one considers the options of a firm going private, moving to a foreign exchange, or never entering public markets altogether. Is life in American public markets so risky that some firms would rather avoid their benefits altogether? Substantial evidence seems to suggest so. If this is the case, we all lose as more Americans now own larger and more diverse portfolios of investments than at any time in history. The current regulatory regime may purport to empower investors, but such empowerment may come at an unacceptable cost.

*Adam M. Fliss*

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234. 127 S. Ct. 2499 (2007)

235. *See id.* at 2510 (requiring plaintiff to provide cogent and compelling inference of scienter at pleading stage).

236. *See id.* at 2509 (noting failure to meet heightened pleading standard for strong inference of scienter results in dismissal).

237. *See Stoneridge*, 128 S. Ct. at 772 (anticipating costs of protecting against extended risks).

238. *See id.* (recognizing substantial costs of extended liability). The Court noted that secondary actors are subject to criminal liability not only under federal law, but also under some state securities laws. *See id.* at 773 (noting Delaware statute for criminal liability under state law).