DELAWARE'S DISCLOSURE: MOVING THE LINE OF FEDERAL-STATE CORPORATE REGULATION

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Delaware's dominance of the market for incorporations provokes recurring academic examination of how such a small state could be so successful. The symposium in this issue offers differing views as to whether indeterminacy poses a risk to Delaware in its competition with other states. This Article develops in Part I how the indeterminacy gap between Delaware and competing states disappears as to the core fiduciary duty questions that provoke most corporate law litigation. Part II moves beyond the indeterminacy theme to posit that Delaware's competition with the other forty-nine states is of secondary importance to the main event of corporate governance: the shrinking role of all states vis-à-vis the federal government. Within this frame, the Article develops a surprising growth area for Delaware law in its use of disclosure, along the primary domain of the federal regulators. Recent Delaware cases have effectively linked disclosure obligations (borrowed extensively from federal law) with substantive protection of the space for shareholder decisions free of director domination. Although federal regulators have sometimes attempted a similar linkage, absent new federal statutes, only Delaware can effectively combine both methods of protection. This linkage means that Delaware courts will remain at the front line of contested corporate governance contests.

Delaware's century-long success in attracting corporations to use its law has provoked a recurring series of inquiries seeking to explain how one of America's smallest and least populous states dominates such an important part of this country's national economy.[1] Adjacent articles in this issue debate the "mystery" of Delaware's success based on varying

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1. Delaware is forty-ninth in size among the fifty American states and forty-fifth in population, but it is first in terms of place of incorporation for public corporations. *See, e.g.*, Lucian Ayre Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 391 tbl.2 (2003).

views of the indeterminacy of its law as compared to other American states. Within that context, this Article seeks to make two contributions. Part I suggests several reasons why indeterminacy may not pose a mystery as to Delaware's success in the competition for corporate law. Part II argues that the indeterminacy debate misses the larger potential challenge to Delaware's hegemony, which is not a challenge from other American states, but rather the continued shrinking of the space for any state corporate law as the federal government elects to encompass more and more of all fields of American law. Against this background, Part II develops a part of corporate law—judicial requirements as to disclosure—that, perhaps somewhat surprisingly, has become a way for Delaware to push into the part of corporate governance that has been widely recognized as the federal government's domain. Recent case law illustrates this expansion of Delaware law even in an age of ever-expanding federal regulation. This development shows that the traditionally federal disclosure obligations to protect the exercise of shareholder governance rights cannot be effectively separated from the traditionally state legal protection of the shareholder's ability to act within the space provided by those governance rights. Absent a broader federalization of corporate law, only Delaware can provide protection of both disclosure and the shareholder's substantive rights, giving Delaware a continuing advantage as a lawgiver in resolving corporate governance disputes.

I. HOW BIG A PROBLEM IS INDETERMINACY?

Bill Carney and George Shepherd have argued that Delaware's indeterminacy is, or ought to be, a barrier for its success as the paramount supplier of corporate law.[2] Chancellor William Chandler rebuts their claims by reframing the comparison as not between Delaware case law and alternative statutes, but between the combined statute and case law of competing jurisdictions.[3] Larry Ribstein asserts that because the risk of indeterminacy is a function of corporation law and is not found in unincorporated associations, the indeterminacy problem, to the extent that it exists, can be met by moving to the unincorporated form.[4] The discussion that follows sets out several reasons to question the breadth of the indeterminacy risk to the primacy of Delaware corporate law.

2. William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, 2009 U. ILL. L. REV. 1.

3. William B. Chandler III & Anthony A. Rickey, *Manufacturing Mystery: A Response to Professors Carney and Shepherd's "The Mystery of Delaware Law's Continuing Success*,*"* 2009 U. ILL. L. REV. 95.

4. Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy*, 2009 U. ILL. L. REV. 131.

A. Indeterminacy and Standards Versus Rules

The indeterminacy criticism is aimed primarily at case law, which in Delaware means that it almost entirely arises within the rubric of fiduciary duty.[5] Fiduciary duty law is by nature standards based, rather than rules based. Intentional space left for uncertainty can be the breeding ground of indeterminacy, but it also makes possible the flexibility that permits law to adapt to new iterations of behavior that law has long sought to prohibit. In the current legal environment, where there have been recurring concerns about the noncompetiveness of U.S. law in financial regulation generally, there have been arguments seeking to move the "rules-based" federal securities laws more in the direction of "principles."[6] Delaware already has this characteristic, with the advantage of flexibility and the disadvantage of possible indeterminacy.

B. Multiplicity of Legal Tests as Creating Indeterminacy

Perhaps the biggest challenge to Delaware's seeming indeterminacy is the asserted randomness of judicial review visible in Carney & Shepherd's Figure 1, in which seven separate approaches are presented with no apparent link.[7] As shown in the figure that accompanies this Article, all of these apparently disparate standards fit within the same space for judicial review that can be defined between deference on one end (characterized by the business judgment rule) and more intensive judicial review on the other end (identified as "entire fairness" or intrinsic fairness).[8]

This figure illustrates what the Delaware Supreme Court has called the defining tension in corporate law between the directors' freedom to act and judicial review.[9] Two core principles explain how particular judicial rules fit within that space. First, judges always start from a position

5. Three-fourths of all corporate claims brought in Delaware are based on fiduciary duty with the remainder raising questions of statute, such as the right to inspection or to vote. *See* Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 165–66 (2004) (reporting that 75% of the cases filed in the Delaware Chancery Court over a two-year period were corporate cases).

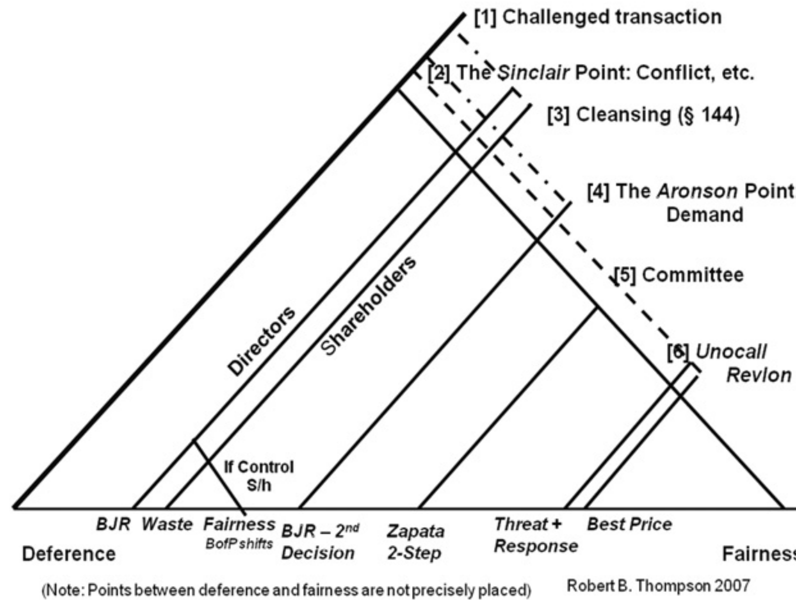
6. COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 8–9 (2006) [hereinafter INTERIM REPORT ON CAPITAL MARKETS REGULATION], *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (advocating a shift from prescriptive rules to broader principles); John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 342–43 (2004) ("Sarbanes-Oxley ushers in and accelerates a major and probably inevitable transition, which will move us from a rules-based system of financial disclosure to a principles-based system.").

7. *See* Carney & Shepherd, *supra* note 2, at 30.

8. An earlier version of this figure and a fuller discussion of this idea appear in Robert B. Thompson, *Mapping Judicial Review:* Sinclair v. Levien, *in* THE ICONIC CASES IN CORPORATE LAW 79, 90 (Jonathan R. Macey ed., 2008).

9. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 927 (Del. 2003).

FIGURE 1
THE SPACE FOR JUDICIAL REVIEW OF BOARD ACTIONS



of deference (represented by the downward sloping boundary line on the left) and will depart from that position only when the directors' position has been shown to be in breach of their fiduciary duty or otherwise wrongful. Second, the nature of litigation requires that plaintiffs first show facts that will divert the court from the deference line toward the more intrusive entire fairness review (represented by the downward sloping boundary on the right) and that defendants, in turn, respond with efforts to redirect the case back along a path to judicial deference. The five key decision points that occupy the space between pure deference and pure entire fairness can be explained as follows:

- Self-dealing as represented by a conflict of interest and a breach of the duty of loyalty is the most common context in which courts leave the deference line (see point 2 on the figure, identified as the *Sinclair* point after the classic Delaware case that explicitly illustrates this choice).[10] A breach of a duty of care (absent statutory exculpation) could also serve the same purpose.[11] Absent anything else happening, the challenged action will then be reviewed under a plaintiff-friendly judicial examination of entire

10. Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).
11. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). Delaware corporations can include in their charter a provision blocking director liability for damages arising from alleged breaches of the duty of care pursuant to title 8, section 102(b)(7) of the Delaware Code.

fairness of the transaction. But, of course, something else almost always happens.

- The conflict of interest that diverted the litigation from the deference line can usually be cleansed at the time of the transaction or before litigation is brought by action of the disinterested directors or shareholders. Statutes, such as title 8, section 144 of the Delaware Code, dating from the 1960s, suggest a limited cleansing, blocking only a claim of the transaction's voidability by reason of the conflict.[12] More recent case law suggests that the practical result is to return the litigation to the deference line.[13] If the cleansing was accomplished by shareholders instead of directors, some differences in the language of the statute[14] and in early cases suggested that judicial review did not go all the way back to deference.[15] More recent Delaware case law makes it more difficult to distinguish the review that would occur after disinterested shareholder action from the deference and waste standard that would occur under the default application of the business judgment rule.[16]

- If the conflicted transaction has not been cleansed before litigation is brought, Delaware common law and many states' statutes require a plaintiff shareholder bringing a derivative suit in the name of the corporation to make a demand on the directors.[17] The Delaware Supreme Court said in *Aronson v. Lewis* that demand is required unless the plaintiff presents particularized facts creating a reasonable doubt that a majority of the board is not

12. *See* DEL. CODE ANN. tit. 8, § 144 (2001).

13. *See, e.g.*, Oberly v. Kirby, 592 A.2d 445, 466 (Del. 1991) ("[S]ection 144 allows a committee of disinterested directors to approve a transaction and bring it within the scope of the business judgment rule.").

14. *Compare* tit. 8, § 144(a)(1), *with id.* § 144(a)(2).

15. *See, e.g.*, Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66, 74 (Cal. Dist. Ct. App. 1952) (finding that even though the requirements of the statutory conflicting interest provision were technically met, transactions that are unfair and unreasonable to the corporation may be avoided); Fliegler v. Lawrence, 361 A.2d 218, 221 (Del. 1976) (concluding that where the majority of shares voted in favor of a self-dealing transaction were cast by the defendants in their capacity as shareholders, a court "cannot say that 'the entire atmosphere has been freshened' and that departure from the objective fairness test is permissible"); Gottlieb v. Heyden Chem. Corp., 91 A.2d 57, 58 (Del. 1952) (stating that where formal approval is given by a majority of independent, fully informed shareholders, the burden of proof shifts to the objecting shareholder to demonstrate the terms are so unequal as to amount to a gift or waste of corporate assets).

16. Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) ("[A]pproval by fully-informed disinterested directors under 144(a)(1) or disinterested shareholders under 144(a)(2) permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof on the party attacking the transaction.").

17. Aronson v. Lewis, 473 A.2d 805, 811–12 (Del. 1984); *see* MODEL BUS. CORP. ACT § 7.42 (2005).

independent and not disinterested.[18] In effect, this showing provides a second illustration, similar to the *Sinclair* point above, of a situation in which the court would move off of the deference line and apply entire fairness. But there is an important difference. The question asked by the court in an *Aronson* situation is not whether there was self-dealing at the time of the original transaction but whether the directors' *later* decision not to bring a suit should be respected by the court.[19] It will often be easier for defendants to refute any breach of the duty of loyalty or care as to this later decision than to do so for the initial action. Thus, the board could decide that a suit, even if likely meritorious, would be too disruptive of the business of the company and distracting to its executives such that going forward would not be warranted. If this second decision is made by directors who are not conflicted and who have met their duty of care, the court will defer as it would to any board decision.[20] The practical result is to provide defendants a choice between having a court look at the conflicted transaction for which the defendants would have to prove intrinsic fairness to a judge, or taking advantage of an internal corporate governance alternative that would allow the case to be reviewed by directors, ostensibly disinterested, but nevertheless picked by the same process as the other directors and likely to be decision makers more sympathetic to business realities. Therefore, the result of *Aronson* was to open up a second alternative for directors to obtain something like the deferential review when self-dealing exists.

- Delaware law provides defendants with a third opportunity to move the litigation back onto a path to deferential judicial review even if the necessary cleansing action was not taken at the time of the initial conflicted transaction or at the time of the initial lawsuit. In *Zapata Corp. v. Maldonado*, the Delaware Supreme Court held that a special litigation committee appointed years

18. *Aronson*'s holding is broader in that it also permits demand to be excused if the plaintiff presents particularized facts creating a reasonable doubt that "the . . . transaction was otherwise a valid exercise of business judgment." *Aronson*, 473 A.2d at 814.

19. *Id.* at 807.

20. After the *Aronson* decision, the Delaware Supreme Court made the plaintiff's choice especially stark by holding that the mere act of making a demand would be the plaintiff's concession that there was no conflict of the board, thus virtually assuring the second decision would gain deferential business judgment review. Spiegel v. Buntrock, 571 A.2d 767, 775–76 (Del. 1990) ("[S]tockholders who, like Spiegel, make a demand which is refused, subject the board's decision to judicial review according to the traditional business judgment rule."). The court backed away from the breadth of that holding in a subsequent decision and said that a board could appear disinterested but still act conflicted in ways to lose the deference. *See* Scattered Corp. v. Chi. Stock Exch., Inc., 701 A.2d 70, 74 (Del. 1997) (noting that a board that appears independent ex ante may not necessarily act independently ex post in rejecting a demand; failure of an otherwise independent-appearing board to act independently could constitute wrongful refusal).

later could still divert the course of the litigation from intrinsic fairness review and channel it toward less intrusive judicial review.[21] Here, however, the judicial review is not redirected toward deference. The court said in *Zapata* that it could still impose its own independent business judgment, clearly a more intrusive standard of review than ordinary deference.[22] The possible inconsistency of the use of this standard has faded however, as the use of special litigation committees at earlier points in the transaction and litigation has redirected almost all litigation to the more deferential areas of review just discussed.[23]

- Judicial review of board actions in a takeover context in Delaware also falls in the space located in the middle of the bottom line of the triangle represented in Figure 1. In *Unocal* and earlier cases, the Delaware Supreme Court determined that directors did not have an explicit conflict of interest that would divert judicial review to entire fairness under the rules just presented. However, the court found that "the omnipresent specter that a board may be acting primarily in its own interest, rather than those of the corporation" called for an intermediate level of review sometimes termed "enhanced scrutiny."[24] The principal applications of this intermediate review were defined in two classic takeover cases from the 1980s, *Unocal v. Mesa Petroleum Co.*[25] and *Revlon v. MacAndrews & Forbes.*[26] In *Unocal*, the court held that when a board takes defensive actions, the board's acts must satisfy a two-part test prior to application of the business judgment rule. The board must first show that a threat to the corporation exists and second that the response taken is proportional to the threat. In *Revlon* the court laid out a more specific duty for directors when they decide to sell the company: the board has a fiduciary duty to get the best price for its shareholders.[27] Earlier judicial suggestions that interference with shareholder voting triggered a more intensive judicial review[28] seem to have subse-

21. 430 A.2d 779 (Del. 1981).

22. *Id.* at 789 ("The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests.").

23. *Zapata* was actually decided three years before *Aronson*, and the more recent case has come to dominate the judicial standard for reviewing director committee action seeking to terminate a derivative suit.

24. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954–55 (Del. 1985) (applying enhanced judicial review where directors must show they had reasonable grounds for believing a danger to corporate policy and effectiveness existed and that the defensive tactic was reasonable in relation to threat posed because of the omnipresent specter of board self-interest in taking defensive action).

25. *Id.*

26. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

27. *Id.* at 182 (holding that when the break-up of the company becomes inevitable, the duty of directors changes to getting the best price for stockholders).

28. Blasius Indus. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.").

quently been folded into the *Unocal* test.[29] Neither *Revlon*[30] nor *Unocal*[31] have the breadth that they appeared to have at their initial announcement.

The case-by-case development of Delaware law, not surprisingly, creates gaps and changes in direction that provide the basis for the cry of indeterminacy. An evaluation of relative indeterminacy, of course, also depends on the reality of an alternative system. No state differs on the core framework described above defining the space within which judicial review of director action occurs. The starting point is always deference, and a deficiency in the board's action will lead to more intrusive judicial review under the intrinsic fairness standard.

There are some differences in other states as to two major areas in the middle of the triangle. First, the Model Business Corporation Act and many states now require universal demand in derivative cases.[32] The result is to move the point of judicial review a bit deeper into the litigation, but not necessarily to produce a more determinate result. The crucial question is the intensity of judicial review of a challenge to the board's decision not to proceed with litigation once the demand is made. If the board or a committee decides not to proceed, as has been the usual result in this setting, the Model Act provides two alternative levels of review depending upon who appointed the decision maker.[33] If the decision-making group was appointed by a board with a disinterested majority, the burden of proof is on the plaintiff; if the committee was appointed by a board whose majority was not disinterested, the burden of proof shifts to the defendant.[34] The few cases in which this standard has been applied do not show evidence of less indeterminacy.

Second, not many states have had takeover litigation that would provide the occasion to adopt an intermediate standard of review, and a few states have affirmatively rejected the Delaware approach in favor of

29. MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003) (Delaware courts "have remained assiduous in carefully reviewing any board actions designed to interfere with or impede the effective exercise of corporate democracy by shareholders, especially in the election of directors.").

30. Many corporate planners will be able to avoid *Revlon* by structuring the acquisition as a share-for-share merger that has been held not to trigger *Revlon*'s duty. *See* Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1151 (Del. 1990).

31. *Unocal* has not often been used by the Delaware Supreme Court to invalidate defensive tactics. Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: Sacred Space and Corporate Takeovers*, 80 TEX. L. REV. 261, 284 (2000) (finding that no defensive tactic failed the *Unocal* test in a survey of Delaware cases applying *Unocal* between 1985 and 2000); *cf.* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 936 (Del. 2003) (finding that the lack of a fiduciary-out clause in a merger agreement where two shareholders controlled more than 50% of the vote and contractually obligated themselves to vote for the merger was preclusive and coercive and failed to satisfy the *Unocal* standard).

32. MODEL BUS. CORP. ACT § 7.42 (2005).

33. *Id.* § 7.44(d).

34. *Id.* The burden of proof is for the requirements specified in subsection (a): whether the decision-making group has determined "in good faith, after conducting a reasonable inquiry upon which its conclusions are based, that the maintenance of the derivative proceeding is not in the best interests of the corporation."

a rule that seems more deferential to director action to block takeovers.[35] While this pattern was most pronounced in the early years after *Unocal* and *Revlon*, states that rushed to provide more protection for the managers of their companies have not proven to be attractive to corporations in the years since.

C. Unprincipled Litigation as Contributing to Indeterminacy

Indeterminacy is viewed negatively not only because of the substantive uncertainty in the expected result, but also because of the extent to which it enables some lawyers to extract gains from corporations. Professors Carney and Shepherd write of "terrifying" data about the frequency of corporate litigation in Delaware and generous fee awards in class actions regardless of the merits.[36] In this regard, their article follows the earlier work of Professor Romano, which suggests that a significant proportion of shareholder suits are without merit and that the principal beneficiaries are attorneys, not the corporation and its shareholders.[37]

Earlier work that I undertook with my colleague Randall Thomas provides a more recent look at shareholder litigation.[38] We found that 78% of litigation brought in Delaware over a two-year period related to fiduciary duty, and 85% of those cases were class actions brought against public companies arising from acquisitions.[39] After excluding multiple cases resulting from the same acquisition, we recorded about one hundred acquisitions per year that were subject to litigation.[40]

For acquisition cases brought in Delaware, we found that most cases were either settled or dismissed quickly: 20% within the first six months, another 25% within the first year, and another 40% within the first two years.[41] In transactions associated with about 25% of the suits, shareholders received some substantive relief, substantially higher than percentages reported in earlier studies of class actions. Though the initial lawsuits were spread across all kinds of acquisitions, including third-party deals, the suits that produced substantive relief for shareholders were concentrated in cash-out transactions by controlling (greater than 50%) shareholders or management buyout (MBO) transactions.[42] These are

35. *See, e.g.*, OHIO REV. CODE ANN. § 1701.832 (LexisNexis 2004); 15 PA. CONS. STAT. ANN. § 1715(d) (West 1995).

36. *See* Carney & Shepherd, *supra* note 2, at 45–46.

37. Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 84 (1991).

38. *See* Thompson & Thomas, *supra* note 5.

39. *Id.* at 167. The years of the study were 1999 and 2000.

40. *Id.* at 168. In an examination of corporate governance litigation in other states and in the federal courts still in a preliminary stage and not yet published, we find Delaware has more corporate governance litigation than other states and the federal courts for the same period.

41. *Id.* at 189.

42. *See id.* at 200.

transactions where a conflict of interest is most likely to be visible and where judicial review has generally been the most intense.[43]

D. *Summary*

Despite worries about indeterminacy and other challenges, Delaware remains unchallenged by other states' incorporation statutes. Its corporate treasury does not appear to be under any imminent threat. Indeed, it dominates (with an 85% share) those companies that choose to incorporate outside the state in which their headquarters is located.[44] The lack of support for the indeterminacy argument likely reflects a combination of (1) the necessary ambiguity in any principles-based system, such as fiduciary duty law; (2) the core structure of Delaware law, which is focused on judicial review of director action exercised within the space between deference and intrusive entire fairness review; and (3) constraints on the ability of lawyers to use indeterminacy for their private ends when pursuing litigation, at least as compared to earlier periods.

II. THE FEDERAL CHALLENGE AND DELAWARE'S (SURPRISING) RESPONSE USING DISCLOSURE

The inability of any other American state to mount a challenge to Delaware based on indeterminacy (or any other reason) does not mean, however, that Delaware has a secure position as the primary maker of law relating to corporate governance. Indeed, Delaware today faces a bigger threat to its hegemony in corporate law than it has faced over the last hundred years because of the broadening intrusion of federal law into corporate governance.[45] This Part describes this challenge and Delaware's recent response using disclosure, normally thought of as primarily a federal tool, to take back its dominant position with respect to corporate governance.

A. *Defining the Federal-State Division of Corporate Governance*

Corporate governance has long been a shared function of the state and federal governments in which the states have the primary role and federal law plays a supporting function. State corporation statutes provide the means by which corporations are created; state laws name the principal actors in corporate governance—directors, officers, and share-

43. *But see* Elliott J. Weiss & Lawrence J. White, *File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions*, 57 VAND. L. REV. 1797, 1829–31 (2004) (discussing distortion arising from attorney fees in state class actions).

44. *See* Bebchuk & Cohen, *supra* note 1, at 392–93 tbl.3.

45. *See generally* Mark Roe, *Delaware's Competition*, 117 HARV. L. REV. 590, 600–02 (2003) (describing how Delaware makes law only in the space the federal government chooses not to preempt).

holders; and state law establishes the relative rights of these named participants. Over the last one hundred years there have been recurring calls for the federal government to perform this function: Theodore Roosevelt was the first of three consecutive presidents to call for federal incorporation,[46] many in the New Deal sought federal incorporation after the Great Depression,[47] and Bill Cary renewed the call in the 1970s.[48] Though Congress has consistently resisted those entreaties, it has chosen from time to time to improve the working of the state law system, usually by mandating disclosure to enable the shareholders to make more effective use of the functions allocated to them by state law. Thus, Section 14(a) of the Securities Exchange Act of 1934 was aimed at preventing management or others from obtaining authorization for corporate actions "by means of deceptive or inadequate disclosure in proxy solicitations."[49] The Williams Act in 1968 similarly sought to protect shareholders when they act via a tender offer.[50] Periodic disclosures in quarterly, annual, and 8-K reports, as required by Section 13 of the 1934 Act, have grown dramatically so that they protect investors not only when they buy and sell shares, but also when they perform a governance function such as voting.[51] Antifraud prohibitions in Rule 10b-5 police disclosure, whether it is mandated by the securities laws or volunteered, and that rule has also given rise to insider trading prohibitions absent disclosure.[52]

The dominant pattern is that the federal government has regularly chosen to channel its corporate governance law making through disclosure without changing the basic substantive relationship among the core parties as determined by state law. In the 1960s, when the federal courts gave a broad interpretation to Rule 10b-5 so as to regulate the fairness of management's use of corporate power toward shareholders, the Supreme Court noted that corporations "are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs

46. Theodore Roosevelt, U.S. President, National Regulation of All Corporations Doing an Interstate Business, Address Before Congress (Dec. 3, 1901), *in* 1 THE ROOSEVELT POLICY 162, 169 (William Griffith ed., 1908) ("[T]he Nation should, without interfering with the power of the States in the matter itself, also assume power of supervision and regulation over all corporations doing an interstate business.").

47. *See* Adam C. Pritchard & Robert B. Thompson, *The Securities Law and the New Deal Justices*, 95 VA. L. REV. (forthcoming 2009) (manuscript at 11, on file with authors) (describing efforts of Adolf Berle and William O. Douglas, among others, to push for federal incorporation during the New Deal).

48. *See* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 700–01 (1974).

49. J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

50. *See* 113 CONG. REC. 854 (1967) ("[T]he need for such legislation has been caused by the increased use of cash tender offers rather than the regular proxy fight to gain control of publicly owned corporations . . . . This legislation will close a significant gap in investor protection under the federal securities laws . . . ."); *see also* S. REP. NO. 90-550, at 3 (1967).

51. Securities and Exchange Act § 13(a), 15 U.S.C. § 78m(a) (2000).

52. 17 C.F.R. § 240.10b-5 (2008).

of the corporation."[53] In emphasizing the substantive/disclosure division, the court noted that once full and fair disclosure of a cash-out transaction has occurred, the fairness of the terms of the transaction is "at most a tangential concern of the statute."[54] When the SEC sought to go beyond disclosure and block dual-class voting by specifying substantive limitations on voting rights in Rule 19c-4, a federal appellate court struck down the agency's action as regulating "the distribution of powers among the various players in the process of corporate governance" and thus beyond its statutory power.[55]

Even with that framework, Delaware's role in corporate governance has been eroding over the last three decades because of the combination of Delaware's approach to corporate law and the unwillingness of federal lawmakers and regulators to wait for state responses when financial crises erupt. Delaware's model of corporate governance, beyond the creation and naming functions described earlier, is to provide a predictable governance structure whose central tenet is to "trust directors."[56] This is a choice to put directors, not shareholders, at the center of a corporate governance system. Delaware puts a premium on unfettered space for directors. It anticipates that directors will use that space to take advantage of the rich array of incentives and constraints beyond the law. The Delaware model intentionally leaves considerable room for private contracting to provide incentives and monitoring. To constrain possible self-dealing or entrenchment action by directors, Delaware provides for shareholder self-help via voting and for judicial oversight via fiduciary duty litigation.

This model is vulnerable to cries for federal intervention when periodic financial crises reveal flaws in the existing system. Indeed, Delaware has been slow to respond in the face of financial scandals, relying instead on the various incentives and monitoring inherent in its director-centric system and, some would argue, aligned with the interests of management who decide where to incorporate. After the Enron and WorldCom debacles, for example, Delaware's response was to stand pat while the federal role continued to expand into areas traditionally covered by state law, including the following:

- Federal law now sets out minimum qualifications of some directors via the Sarbanes-Oxley ("Sarbox") requirement that the au-

53. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977).

54. *Id.* at 477–78.

55. Bus. Roundtable v. SEC, 905 F.2d 406, 411–12 (D.C. Cir. 1990) ("In 1934 Congress acted on the premise that shareholder voting could work, so long as investors secured enough information and, perhaps, the benefit of other procedural protection. It did not seek to regulate the stockholders' choices. If the Commission believes that premise misguided, it must turn to Congress.").

56. *See* Robert B. Thompson, *Delaware, the Feds, and the Stock Exchange: Challenges to the First State as First in Corporate Law*, 29 DEL. J. CORP. L. 779, 781 (2004) (suggesting a proposed mission statement for Delaware corporate law).

dit committee of a board of directors be made up entirely of independent directors, including one who is a "financial expert";[57]

- Stock exchange listing standards, ostensibly promulgated by nongovernment actors but realistically reflecting an SEC push, have extended these minimum director qualifications to require that a majority of the entire board be independent, that a board have two additional committees (compensation and governance) made up entirely of independent directors, and that a board include a lead director if the firm's chief executive officer is also board chairman;[58]

- Sarbox inserts federal influence into defining the role of officers, previously the exclusive domain of state law, by requiring that the chief executive officer and the chief financial officer must certify the firm's financial statements,[59] and by specifying mandatory forfeiture of certain bonuses of officers after a restatement of financial results;[60]

- Other parts of Sarbox go deeper into filling the officer space, previously left entirely for directors to define, by addressing the role of the firm's chief legal officer and others in responding to whistle blowing;[61]

- The 2002 legislation also bans entity loans to insiders, not just filling space that state law had left empty, as was true for many of the items described above, but reversing what had become the prevailing state law position;[62]

- The SEC proposed (but did not enact) rules that would have expanded the shareholders' ability to nominate candidates for director positions and to propose changes in the company's election rules.[63]

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57. Sarbanes-Oxley Act of 2002 §§ 301, 407, 15 U.S.C. § 78j–l(m) (Supp. V 2006).

58. *See, e.g.*, NYSE Euronext, Listed Company Manual §§ 303A.01–.13 (2008).

59. *See* Sarbanes-Oxley Act of 2002 § 401(a). This followed SEC action pursuant to its investigatory powers that required top officers of almost one thousand companies to certify their financial results.

60. *See id.* § 304.

61. *See id.* § 307.

62. *Compare id.* § 402, *with* DEL. CODE ANN. tit. 8, § 143 (2001). *See* EDWARD P. WELCH ET AL., 1 FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 143.1 (2001) (noting that the early statutory provision prohibiting corporate loans to directors and officers was abandoned in 1963).

63. Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26, 206, 68 Fed. Reg. 60,784 (proposed Oct. 14, 2003) (proposing a rule that would have required public companies to provide a mechanism to include director nominations from shareholders where evidence suggested companies had been unresponsive to shareholder opinions in the 14a-8 process, 17 C.F.R. 240.14a-8 (2008)); *see also* Shareholder Proposals, Exchange Act Release No. 56,1160, Investment Company Act Release No. 27,913, 72 Fed. Reg. 43,466, 43,470, 43,475 (proposed Aug. 3, 2007), *available at* http://www.sec.gov/rules/proposed/2007/34-56160.pdf (proposing

In addition to these areas, federal law is having an increased substantive impact on governance through ostensibly disclosure-based rules. For example, the still new SEC disclosure rules regarding executive compensation have been the most important legal change relating to that topic, dwarfing the impact of state law on that subject.[64] The Bear Stearns crisis of early 2008 and the proposals for extensive overhauls of federal control of financial and business activity which followed, illustrate hurdles that exist for any continued substantial state law regulation of our economy. In a world more saturated than ever by seemingly instant information, politicians are pressed to provide immediate responses.[65] In an economy where so few transactions are off the grid of an interconnected global market, state law less often seems the appropriate level for government response. Such a setting seems ripe for continuation of the trend toward increased federal control of corporate governance as described above.

B. Disclosure as Creating New Space for Delaware

Given the trends described in the prior section, any state law pushback to this federal trend is notable, and one embedded within disclosure, the traditional focus of federal law, is even more surprising. In a series of cases since early 2007, Delaware courts have used federal disclosure requirements as the basis for state law litigation that puts the Delaware courts at the center of resolving important corporate governance issues.

1. Disclosure in State Law: Affirmative and Negative Obligations

Disclosure obligations imposed by law can be either affirmative or negative. Positive obligations are reflected in the mandatory disclosure obligations, such as those traditionally required by the SEC pursuant to the Securities Exchange Act of 1934.[66] Negative disclosure obligations refer to legal liability that accrues for inaccurate disclosure or failure to disclose usually based on common law fraud or fiduciary duty.[67] The federal government provides hundreds of pages of regulations itemizing the disclosures required of a company in a proxy statement or other-

changes to rule 14a-8, 17 C.F.R. 240.14a-8 and suggesting a new rule 14a-17); Shareholder Proposals Relating to Election of Directors, Exchange Act Release No. 56,914, Investment Company Act Release No. 28,075, 72 Fed. Reg. 70,450, 70,453 (Dec. 11, 2007) (to be codified at 17 C.F.R. pt. 240), *available at* http://www.sec.gov/rules/final/2007/34-56914.pdf.

64. 17 C.F.R. § 229.402 (2008).

65. *See* Massimo Calabresi, *The Politics of Paulson's Proposals*, TIME, Mar. 31, 2008, *available at* http://www.time.com/time/nation/article/0,8599,1726762,00.html (discussing the sweeping changes proposed by the Secretary of the Treasury for the financial regulatory system after the collapse of Bear Stearns).

66. Securities and Exchange Act § 13(a), 15 U.S.C. § 78m(a) (2000).

67. Rule 10b-5 codifies such a common law-based obligation. 17 C.F.R. § 240.10b-5 (2008).

wise.[68] Rule 10b-5 provides a powerful negative obligation in terms of broad liability for mandated or voluntary disclosure that is inaccurate, incomplete, or omitted.[69]

In contrast, Delaware's statute has almost no specific affirmative disclosure requirements and only rare instances where there is even a general requirement for affirmative disclosure. In the absence of a request for shareholder action, Delaware's statute does not require directors to provide any information about the firm and its financial conditions.[70] When shareholder voting is required, as for approval of a merger, the statute requires only notice but not conveyance of information beyond a bare minimum.[71] Section 144 permits disinterested directors or shareholders to avoid automatic voidability of a corporate transaction involving interested insiders, only if disclosure of the material facts regarding the conflict and transaction has been made.[72]

Delaware's principal disclosure requirement derives from its courts' development of a fiduciary duty in the space where the statute is silent. "When directors of a Delaware corporation seek approval for a merger, they have a duty to provide the stockholders with the material facts relevant to making an informed decision"[73] and "to [disclose] fully and fairly . . . when it seeks shareholder action."[74]

An effort to expand this fiduciary duty-based disclosure obligation beyond the context in which shareholder action is sought was blocked by the Delaware Supreme Court's refusal to recognize a state common law action against directors for fraud on the market in *Malone v. Brincat*.[75] Notably, the court explained the failure to expand Delaware's disclosure law by deferring to federal law: "[T]here is 'no legitimate basis to create a new [state law] cause of action which would replicate, by state decisional law, the provisions of . . . the 1934 Act.'"[76] Outside of a request for shareholder action, the court seemed to hold open the possibility of a derivative action or a very limited direct action for directors' false communication to shareholders, as contrasted with the market. However, limi-

68. *Id.* § 229.10–.915 (Regulation S-K requires disclosure for a variety of specific triggering transactions found in the securities laws.).

69. *Id.* § 240.10b-5. The express language of the rule speaks to affirmative misrepresentations and half-truths, and courts have used the common law to extend the rule to reach omissions when there is a duty to speak. *See* Chiarella v. United States, 445 U.S. 222, 235 (1980).

70. Malone v. Brincat, 722 A.2d 5, 11 (Del. 1998).

71. DEL. CODE ANN. tit. 8, § 251(c) (2001 & Supp. 2006) (requiring that notice to shareholders contain the merger agreement or a brief summary as the directors may deem advisable).

72. *See id.* § 144(a)(2). A similar disclosure is required for alternative cleansing provided in action by directors in the prior subsection. *See id.* § 144(a)(1).

73. *See In re* Topps Co. S'holders Litig., 926 A.2d 58, 64 (Del. Ch. 2007).

74. *See, e.g.*, Arnold v. Soc'y for Sav. Bancorp, Inc., 650 A.2d 1270, 1277 (Del. 1994) (citing Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992)). A key early decision for disclosure occurred in a tender offer setting. *See* Lynch v. Vickers Energy Corp., 351 A.2d 570, 573 (Del. Ch. 1976); *see generally* Lawrence A. Hamermesh, *Calling Off the* Lynch *Mob: A Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087 (1996).

75. *Malone*, 722 A.2d at 13.

76. *Id.* (quoting Arnold v. Soc'y for Sav. Bancorp, Inc., 678 A.2d 533, 539 (Del. 1996)).

tations on the ability to bring class actions have rendered this possibility effectively moot.[77]

Even for disclosures required by fiduciary duty when a shareholder vote is specified in the corporation's statute, Delaware still defers to federal regulators to determine the content of disclosure. Illustrative is a recent Delaware decision in which the plaintiffs challenged the proxy disclosure that had revealed that a special committee member's invitation to join the board had come from the CEO, but had not disclosed that the target's CEO, in turn, served on the board of the company where the special committee member was chief executive.[78] The Vice Chancellor noted that "[f]ederal regulations and exchange rules address disclosure of this kind in a detailed manner that balances the cost of disclosing all past relationships against the need to give stockholders information about some prior relationships that, while not rendering directors nonindependent of each other, are important enough to warrant disclosure. Those bodies of authority should not be lightly added to by our law."[79] Not only does Delaware defer on questions of specific disclosure requirements, but it has also imported the federal definition of materiality under Rule 10b-5's prohibition of fraud into its fiduciary duty requirements for disclosure prior to shareholder votes.[80] This federal element, originally borrowed from fraud under state common law, now returns to state fiduciary duty law with federal law determining the particular content.[81]

2. *Fiduciary Duty Disclosure to Protect Shareholder Space in the Corporate Governance System*

Given this pattern, one would not necessarily expect that disclosure would be the area where Delaware has gained the most traction in pushing back against the juggernaut of federal law, but a series of cases decided within a few months of one another in 2007 illustrate how disclosure is in fact a growth area for Delaware. These cases are not the first cases to fill out the state law area of disclosure. In 1985, in *Smith v. Van Gorkom*, the court's requirement for extensive disclosure in a shareholder vote setting led the losing lawyers to seek a further hearing be-

77. *Id.* at 14 (citing Gaffin v. Teledyne, Inc., 611 A.2d 467, 474 (Del. 1992) (stating that actions may not be maintained without a showing of class issues that predominate over individual issues)) (requiring a plaintiff to articulate a remedy appropriate for the individual). Even if Delaware law were more receptive to such a suit, federal law passed in 1998 excludes state law class action disclosure suits for securities relating to nationally traded securities except for derivative suits or where state courts had already provided a fiduciary duty class action for disclosure. *See* Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3221.

78. *See In re* Netsmart Tech., Inc. S'holders Litig., 924 A.2d 171 (Del. Ch. 2007).

79. *Id.* at 206.

80. *See* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del. 1985) (applying the well-settled standard of materiality as set out in TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

81. *See* Robert B. Thompson, *Federal Corporate Law: Torts and Fiduciary Duty*, 31 J. CORP. L. 877, 877–78 (2006) (discussing the differences and overlap between fraud and fiduciary duty).

cause "the Majority has, in effect, created a whole new Delaware disclosure law which parts company with established federal securities laws."[82]

What the recent cases show is that disclosure is a necessary but not a sufficient condition for effective shareholder action. There must also be room for the shareholder action to be effective. This shareholder space is established by state corporate law through the voting and other rights specified in the statute and through fiduciary duties that limit director actions that could intrude into the shareholder space. *Unocal* acts as a bar to takeover defenses that disproportionately interfere with shareholder action as contemplated by the statutory governance system.[83] *Revlon* signals a more affirmative obligation of directors to get the best price for shareholders when the company is for sale.[84] The Delaware courts have been able to combine the disclosure and substantive aspect of shareholder rights more effectively than federal courts are able to, providing a venue best able to address all parts of a corporate governance dispute.

Litigation involving the Topps Company, maker of baseball and other trading cards, illustrates the state law realm of disclosure in a context that reflects the recent mergers and acquisitions market.[85] After being threatened with a proxy fight and giving dissidents three seats on the board of directors, Topps' second- and third-generation family management agreed to a friendly LBO merger with an entity led by former Disney CEO Michael Eisner. Topps' chief competitor in the sports card business, The Upper Deck Company, expressed willingness to make a 10% higher bid, but the Topps board continued in its plan to put the Eisner merger to a vote of the shareholders. The litigation challenged various deficiencies in the disclosure and alleged violations of the directors' *Revlon* duties. Vice Chancellor Strine found three areas of the proxy statement requiring additional disclosure: (1) the assurances that Eisner gave to Topps' top management about their future; (2) changes made by the firm's investment bankers' valuation methodology that drove the value down from an earlier draft; and (3) facts not in dispute as to Upper Deck's interest in Topps.[86] For another set of disclosure allegations, what the vice chancellor described as "'he said, she said' stuff," no judicial remedy was required; rather, the market could be relied on to police these kinds of deficiencies.[87] The opinion notes that a contest for control meant that "a failure to present information may be rendered harmless by disclosure from others."[88]

82. Brief of Defendant at 14, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (No. 225).
83. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).
84. Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 182 (Del. 1986).
85. *In re* Topps Co. S'holders Litig., 926 A.2d 58, 64 (Del. Ch. 2007).
86. *Id.* at 73–74, 77.
87. *Id.* at 81.
88. *Id.* (quoting Spielman v. Gen. Host Corp., 402 F. Supp. 190, 194–95 (S.D.N.Y. 1975), *aff'd*, 538 F.2d 39 (2d Cir. 1976)).

As Vice Chancellor Strine's distinction makes clear, disclosure issues separated from their context within shareholder action are not the court's principal concern. Rather, the importance of alleged deficiencies in disclosure is measured by whether there are substantive barriers to the shareholders acting as contemplated in the statute or barriers to the market providing possibly corrective disclosure. Thus, disclosure cannot be effectively evaluated without looking at directors' substantive duties—obligations such as those found in *Revlon*. On the *Revlon* issue itself, the vice chancellor found no violation of fiduciary duty in the directors' decision not to conduct a full auction or in its negotiations in the merger itself. But the court faulted the board's failure to deal with Upper Deck and particularly its use of a standstill agreement to foreclose its stockholders from receiving an offer from Upper Deck.[89] The court found this likely to be a *Revlon* violation if proven at trial and enjoined the vote on the Eisner merger until the standstill was removed and Upper Deck could present its case to the shareholders.[90]

Of the two grounds for the injunction, the *Revlon* ground is more important than the disclosure ground. Vice Chancellor Strine emphasized the importance of judicial action to protect shareholders against being asked to act without full disclosure,[91] but even more, he emphasized the need for the court to block director action that interfered with the market actions that would bring target shareholders the best price for their shares.[92] It is this combination of disclosure and fiduciary duty that lets Delaware leverage its impact among regulators of corporate governance.

Litigation involving the Caremark/CVS/Express Scripts acquisition battle also illustrates how Delaware courts fold disclosure into more substantive statutory provisions to deliver an integrated result.[93] In that case, the management of Caremark, a leading pharmacy benefits manager, preferred a vertical combination with CVS, America's largest retail pharmacy, over a horizontal combination with Express Scripts, another large pharmacy benefits manager.[94] For the Caremark managers, the vertical combination had the obvious advantage of preserving their jobs as CVS had agreed that each management team would continue to run its own business within the combined entity.[95] Chancellor Chandler rejected seven of the eight disclosure deficiencies alleged in the Caremark proxy statement leading up to the vote of its shareholders on the CVS

89. *Id.*
90. *Id.* at 92–93.
91. *Id.* at 92 (stating that Topps stockholders making an important decision on uninformed basis justifies injunctive relief).
92. *Id.* at 93 n.31 ("[M]arket forces must be allowed to operate freely to bring the target's shareholders the best price available for their equity." (quoting Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 184 (Del. 1986))).
93. La. Mun. Police Employees' Ret. Sys. v. Crawford, 918 A.2d 1172, 1189 (Del Ch. 2007).
94. *Id.* at 1178.
95. *Id.* at 1179.

merger.[96] The court found a likely deficiency only for the failure to disclose that a significant portion of the firm's investment bankers' fees was conditioned on the initial approval of the transaction.[97] More significantly, the court found that a $6 special dividend added to the CVS bid in order to compete with the higher Express Scripts offer removed the transaction's exemption from the statutory requirement that Caremark shareholders receive appraisal rights.[98] The court ultimately held that the vote had to be enjoined for failure to give the shareholders the statutorily required notice of their appraisal rights.[99]

The court focused on insuring the shareholder's fully informed vote, emphasizing the value of "permitting informed shareholders to speak directly to their fiduciaries without further intervention by this Court."[100] At the same time, the court placed great faith in appraisal to cure any remaining problems with the process, at least at the preliminary injunction stage.[101] Appraisal and the ability of the shareholders to vote in a fully informed manner permit shareholder self-help[102] and temper the need for judicial intervention.[103]

Where there is only one bidder, as opposed to the two active bidders in each of the two prior cases, full disclosure can go so far as to cure possible *Revlon* breaches. In litigation relating to Netsmart Technologies, management and a special committee of independent board members had approved and sent to the shareholders a merger with two private equity firms.[104] Vice Chancellor Strine found that while the pre-agreement negotiations included discussions with four possible private equity bidders, they did not include possible strategic buyers, and that failure was a breach of the board's *Revlon* duties.[105] In addition, the proxy statement was materially incomplete for failing to disclose projections used by the firm's investment banker in preparing a discounted cash flow ("DCF") valuation, including information relevant to the terminal year value that is an important factor in a DCF analysis.[106]

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96. *Id.* at 1185–91.
97. *Id.* at 1190–91.
98. *Id.* at 1191–92.
99. *Id.* at 1191; *see also* DEL. CODE ANN. tit. 8, § 261(b)(2) (2001) (providing that shareholders are not entitled to appraisal where they own shares in a publicly traded company and by the terms of the merger receive only stock in a publicly traded company, but that if shareholders receive another type of consideration, they are entitled to appraisal).
100. *Crawford*, 918 A.2d at 1192.
101. *Id.*
102. *Id.*
103. *Id.* at 1185. The court concludes its opinion with an explicit warning not to infer that appraisal and disclosure "somehow excuses" violations of fiduciary duty, noting the possibility of litigation after a preliminary injunction. *Id.* at 1192.
104. *In re* Netsmart Tech., Inc. S'holders Litig., 924 A.2d 171, 175 (Del. Ch. 2007).
105. *Id.* at 199.
106. *Id.* at 202. The court found the disclosure document was not deficient for omitting earlier projections of the firm's executive vice president and as to disclosure regarding past overlap on a third company board of a member of the independent committee and the company's CEO. *Id.* at 200–01, 205–06.

With only one bidder, whose offer was to be put to the shareholders for a vote, the court was willing, in effect, to let full disclosure and the vote cure any *Revlon* deficiencies. The court was unwilling to require a search for strategic buyers where the delay would pose a risk that the existing buyer would walk away or materially lower its bid.[107] The court's unwillingness to impose that risk itself is visible in the opinion, preferring instead to let the shareholders, with full disclosure, decide for themselves. "If they are confident that the company's prospects are sound and that a search for a strategic buyer or higher-paying financial buyer will bear fruit, they can vote no and take the risk of being wrong."[108]

As in *Caremark*, the *Netsmart* court cites the possibility of appraisal as dampening the need for a broader injunction based on breach of fiduciary duties if full disclosure has been made.[109] The court distinguished this case from a context in which the company was fully shopped so that the resulting merger price would be deemed the most reliable fair value in an appraisal proceeding (and where, presumably, the courts would not seek to compete with the market's valuation process).[110] In contrast, given the lack of a full market check in *Netsmart*, and the company's micro-cap status, the court suggested a potentially greater role for appraisal.

The court remains willing, borrowing a sports analogy, to "throw the injunction flag" where there has not been complete disclosure: "[W]hen stockholders are about to make a decision based on materially misleading or incomplete information, a decision not to issue an injunction . . . [means] the stockholders' chance to engage in self-help on the front-end would have been vitiated and lost forever" and would maximize the chances of having to resort to a damages or appraisal action, "the crudest of judicial tools."[111]

The fourth case of the group, litigation involving Lear Corporation's merger with an entity affiliated with Carl Icahn, Lear's 24% shareholder, presents the context in which courts will be most inclined to focus on disclosure to the exclusion of other relief.[112] Though there was a special committee of independent directors, the committee left it to the CEO to negotiate the price with Icahn but did not disclose the CEO's own motivation that "could rationally lead that negotiator to favor a deal at less than optimal price, because the procession of a deal was more im-

107. *Id.* at 209.

108. *Id.* at 209–10 (noting that directors and officers control less than 15% of the vote, so that the other shareholders, most of whom are institutional investors, "are well-positioned to carry the day").

109. *Id.* at 209.

110. *Id.* at 210 (citing Union Ill. 1995 Inv. Ltd. P'ship v. Union Fin. Group, 847 A.2d 340 (Del. Ch. 2004)).

111. *Id.* at 208.

112. *In re* Lear Corp. S'holder Litig., 926 A.2d 94 (Del. Ch. 2007).

portant to him, given his overall economic interest, than only doing a deal at the right price."[113]

The court was willing to give a very limited injunction prohibiting the procession of the merger vote until supplemental disclosure was made, but it was unwilling to find that the special committee's action in leaving the negotiation to the CEO without the committee's chairman or lead banker was a *Revlon* breach.[114] The negative answer reflected both the court's desire to trust informed shareholder decisions and its unwillingness, as reflected in the *Netsmart* case where there was only one bidder, for the court to decide in place of the shareholders "whether a guaranteed $36 per share right now is preferable to the risks of continued ownership of Lear stock."[115] The likelihood of a *Revlon* violation in *Lear* was also reduced because *Lear* involved greater market effectiveness than *Netsmart*. Lear, as a Fortune 200 company, had deep analyst coverage, unlike the microcap company in *Netsmart*. In addition, because it had eliminated its poison pill and was essentially in play once Carl Icahn came on the scene,[116] the market seemed likely to present shareholders with sufficient information about value so the shareholders could reject the merger if they did not think it high enough.[117]

Delaware cases show a yoking of disclosure obligations and fiduciary duty requirements as part of an integrated approach to protect the role of shareholders in corporate governance. Neither obligation is as straightforward as conventional wisdom might suggest. For disclosure, Delaware has neatly piggybacked on the massive disclosure developed by the SEC and required by the federal securities law. By decreeing, as a matter of fiduciary duty, that directors seeking a shareholder vote must disclose all material information, all disclosure deficiencies become potential violations of Delaware law. Though these deficiencies could be brought under federal law as well as state law, Delaware has an advantage because it alone (for the moment) provides law that insures not only that disclosure is accurate, but also that the space for shareholder voting is protected against encroachment by director or management action. This is the familiar law of fiduciary duty, more particularly the lessons of *Unocal* and *Revlon*. The result is that the SEC provides the details of mandatory disclosure, but the Delaware courts are the front line in the application of those requirements to specific corporate transactions.

113. *Id.* at 114.
114. *Id.* at 115, 122.
115. *Id.* at 123.
116. *Id.* at 123 n.22.
117. In fact, the merger failed to get sufficient votes at the meeting held on July 16, and the company announced it would continue as a stand-alone company. Plaintiffs then dropped their *Revlon* and disclosure claims as moot and saw their amended complaint attacking the revised merger agreement dismissed. *See In re* Lear Corp. S'holder Litig., No. 2728-VCS, 2008 WL 4053221 (Del. Ch. Sept. 2, 2008).

This combination within Delaware law of disclosure to protect shareholder decision making and substantive protection of the shareholder space to make decisions provides an interesting contrast to adjacent areas in which the federal government has itself sought to play both roles and Delaware has not tried to repel such a federal incursion. Early on in the history of securities regulation, the SEC recognized that the disclosure mandated by the 1934 Act would be less complete if shareholders lacked the ability to set the agenda at their own meeting and to have those items included on management's proxy solicitation, which is the means by which voting often occurs. Rule 14a-8 therefore provided a federal means for an individual shareholder to place an issue on the management's proxy solicitation.[118] Although the rule provides that such access must be a matter on which state law permits shareholders to act, a long-standing note to that rule plunges deep into substantive shareholder rights by presuming that any precatory resolution, framed as a suggestion, is within the shareholder space, despite the absence of any significant state law on this point.[119]

In a speech addressing the federal-state interaction on this issue, Vice Chancellor Strine proposed several changes to the federal rule that would make it more consistent with a shared allocation of power.[120] However, it would be more consistent with the pattern discussed in this Article for Delaware, presumably by statute, to act itself. Delaware could define substantive shareholder rights as to when a single shareholder is entitled to access to the ballot, providing a parallel combination of disclosure and defined shareholder space, as illustrated in the cases discussed in this Article.[121]

Recent SEC proposals about shareholder rights to put forward nominees for director elections provide an additional example of the interaction of disclosure protections for shareholders and a more substantive definition of the space within which shareholders are permitted to act.[122] The proposals would have added new federal regulations that

118. 17 C.F.R. § 240.14a-8 (2008).

119. *See id.*

120. *See* Leo E. Strine, Jr., Vice Chancellor, Delaware Court of Chancery, Breaking the Corporate Governance Log Jam in Washington: Some Constructive Thoughts on a Responsible Path Forward, Lecture at Programme on Shareholder Rights, Shareholder Voting, and Corporate Performance (Mar. 21, 2008), *in* 63 BUS. LAW. 1079 (2008).

121. The Delaware Supreme Court's 2008 opinion in *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008), marks Delaware's reentry into lawmaking on this topic, spurred by the SEC's certification of questions as to whether a shareholder proposal to amend the bylaws was within state law. The court's answers seemed to simultaneously point in two directions. First, the court reaffirmed the importance of the shareholder role in the governance of the corporation, including proposing a bylaw that would encourage candidates other than board-sponsored nominees to stand for election. *Id.* at 237. Yet, the court found that to require the board to reimburse a shareholder who nominated a candidate that prevailed in an election would interfere with the board's ultimate responsibility for managing the corporation and the exercise of the board's fiduciary duty in determining whether reimbursement was permissible in particular circumstances. *Id.* at 240. The ambiguity left by the opinion seems unlikely to stifle future federal rule making.

122. *See supra* note 63 and accompanying text.

would have established a broader space for shareholder action, insuring that their disclosure rights as to director elections would be enhanced by a substantive right to nominate that is not currently defined in state law. Although the SEC backed away from such a broad application, it is still another example of how disclosure and defining the shareholder space to act are inextricably linked. Consistent with the Delaware action described in this Article, Delaware should act to more clearly define what the shareholder space is as to nominations and to bring these questions back into the realm of state, as opposed to federal, law.

III. CONCLUSION

Delaware courts continue the common law tradition of gap filling that leaves room for criticism of indeterminacy, but this approach has not exposed Delaware to any realistic challenge from another state's law. The more interesting competition is between Delaware and the federal government as to the role each will have in providing the legal rules as to corporate governance. Recent Delaware decisions have linked fiduciary duty and disclosure to insure effective shareholder participation and to make Delaware the forum for resolving these disputes using language that emphasizes the importance of full disclosure.[123]

Though such statements would not be surprising in a federal securities opinion given recurring judicial statements regarding the purpose of the 1934 Act to require disclosure so as to permit informed shareholder action, the focus of Delaware fiduciary duty law with respect to disclosure is less obvious given Delaware judicial statements asserting that it is desirable not to have Delaware replicate the federal securities statutes. Delaware has laid down a marker based on the necessity of linking disclosure to shareholders with protection of the space given shareholders to make a decision. Delaware has done this when it has been unwilling to do so in other spaces where a similar overlap occurs, such as access to the company proxy statement under Rule 14a-8 and the breadth of shareholder ability to nominate candidates for director. The look of federal-state regulation in corporate governance will depend on whether the trend, which effectively links disclosure and substantive protection of shareholder space, spreads to related areas of state law, or if, in contrast,

123. In *Netsmart*, the court emphasized giving shareholders the choice to think for themselves with full information. *See In re* Netsmart Tech., Inc. S'holders Litig., 924 A.2d 171, 209 (Del. Ch. 2007). Similarly, in *Crawford*, the court upheld the importance of allowing fully informed, disinterested shareholders to be heard. *See* La. Mun. Police Employees' Ret. Sys. v. Crawford, 918 A.2d 1172, 1192 (Del. Ch. 2007). In both *Lear* and *Topps*, the opinions focused on management action that would deprive the shareholders of the chance to make a fully informed decision. *See In re* Lear Corp. S'holder Litig., 926 A.2d 94, 124 (Del. Ch. 2007); *In re* Topps Co. S'holders Litig., 926 A.2d 58, 92 (Del. Ch. 2007). The Delaware Supreme Court's September 2008 decision to grant appeal to a chancery court decision denying summary judgment in a claim against directors in connection with the sale of a company is likely to provide the next chapter in this area. *See* Lyondell Chem. Co. v. Ryan, No. 401, 2008 WL 4294938 (Del. Sept. 15, 2008).

the SEC continues to expand from the opposite direction and provides its own combination of disclosure and substantive protection of shareholder space to act.