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# Law and Corporate Governance

Robert Bartlett<sup>1</sup> & Eric Talley<sup>2</sup>

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**Abstract:** Pragmatic and effective research on corporate governance often turns critically on appreciating the legal institutions surrounding corporate entities – yet such nuances are often unfamiliar or poorly specified to economists and other social scientists without legal training. This chapter organizes and discusses key legal concepts of corporate governance, including statutes, regulations, and jurisprudential doctrines that “govern governance” in private and public companies, with concentration on the for-profit corporation. We review the literature concerning the nature and purpose of the corporation, the objects of fiduciary obligations, the means for decision making within the firm, as well as the overlay of state and federal law pertaining to how that decision-making authority is exercised within publicly traded companies. A core feature of this analysis is that while the basic structures pertinent to corporate law and governance are familiar and in some ways predictable, they are also in a constant state of flux, shaping and being shaped by institutional adaptations of firms, regulators and courts. This chapter is most appropriate for social science researchers and/or students who are new to the legal dimensions of firm governance.

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## I. Introduction

Few topics in financial economics over the last two decades have proven as alluring and as elusive as corporate governance. Its allure is self-evident: since the turn of the twenty-first century, a growing chorus of pundits, commentators and scholars have argued that high quality corporate governance “matters” in creating value (e.g., La Porta et al. 1999; Gompers et al 2003; Bebchuk et al. 2009). Accordingly, a burgeoning host of regulatory reforms at multiple levels have followed suit, focusing on a variety of governance considerations in corporate settings. Yet the topic has simultaneously proven elusive—a condition no doubt driven (at least in part) by the multifaceted means through which corporate governance functions, amalgamating disparate aspects of financial structure, incentives, monitoring, formal authority, real authority, and legal rights/obligations under a single banner—resulting in a conceptual patchwork that defies simple ontology.

The chief enterprise of this chapter is to explore and elucidate the core *legal* dimensions of corporate governance, providing a resource for economists and other social scientists who are interested in the topic generally, but do not have extensive training in law. Specifically, this chapter endeavors to organize and discuss key legal institutions that help shape corporate governance practices in the United States, including statutes, regulations, and legal precedents that effectively “govern governance” in private and public companies. We demonstrate how the core legal institutions that affect corporate governance introduce important incentives, constraints, and even objectives that interact significantly with extra-legal factors, thereby affecting how corporate governance “works” (or doesn’t) in practice. Consequently, economists and other social scientists interested in understanding and/or reforming corporate governance cannot afford to ignore or assume away the legal and regulatory structures that provide its foundation.

Because of the slippery nature of corporate governance, any serious attempt to take on the topic must also endeavor to be clear about defining what institutions and practices are—and are not—included within it. For the purposes of this chapter, we cross our emphasis on legal institutions with a standard (and still dominant) agency cost model within financial economics due originally to Jensen & Meckling (1976), which defines agency costs as comprising the sum of:

- a. Direct monitoring costs of principals over agents;
- b. Costs of incentives to better align agents’ interests with principals’; and
- c. Residual costs left over after monitoring and incentives play out.

Against this backdrop, it is natural to view the *legal* aspects of corporate governance as relating to part (a) in the above list: the formal institutions through which corporate “principals” (broadly construed) engage in direct monitoring of “agents” (also broadly construed).<sup>3</sup> And indeed, this is a large part of our working definition too. However, any legal definition of corporate governance must also accord attention to an aspect of part (b) from the above list: the liability risks that provide incentives through the legal rights and obligations of various corporate constituencies. Our inquiry thus combines both of these descriptive items. On the other hand, our working definition *excludes* a variety of institutions that are mediated not by the laws and regulations of governance, but rather by markets, such as the discipline provided through the pricing of products and securities, and the express monetary compensation structures of corporate decision makers (such as CEOs). Relatedly, our legal-centric approach also will tend to exclude sources of “real” as opposed

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<sup>3</sup> We use the terms “principal” and “agent” in this chapter in a manner similar to how economists deploy them (for an overview, see Arrow 1985). These terms—while originally inspired from formal concepts in the law of agency (itself a common-law precursor to corporate law)—have evolved along somewhat different paths from one another.

to formal authority, though it is clear that the two have important interactions (e.g., Aghion & Tirole 1997). In keeping with Jensen & Meckling (1976), we also confine ourselves to viewing firm governance as pertaining to the internal decision-making apparatus among corporate constituencies; therefore, we exclude from consideration much of the mandatory disclosure regime (and the liabilities arising from it) that fall under the U.S. securities laws.<sup>4</sup> And finally, our definition excludes the role of reputational markets in shaping corporate decision-making behavior.

Several caveats pertain to our legal-institutional portrait of corporate governance. The first concerns who and what represents the “principal” and “agent” in the Jensen & Meckling (1976) framework. Typical governance disputes tend to fall into two major categories, which we call *vertical* and *horizontal*. In vertical disputes, the key organizational challenges come from a manager-agent (such as a CEO or board) who exercises significant control over a corporate entity, but does not fully internalize the full economic stakes, which are principally borne by non-managerial stakeholder-principals (usually shareholders). Vertical agency costs are perhaps most consistent with canonical economic frameworks of corporate structure (particularly of public companies). However, governance disputes can also be horizontal in nature, pertaining to attempts by competing stakeholders to wield influence over corporate decisions (Bartlett 2006). Here, managerial incentive problems are pushed off stage, and greater focus is trained on how a corporation’s governance structure operates to distribute control rights among competing stakeholders who are simultaneously agents and principals (e.g., different classes of shareholders, creditors versus equity investors, short-term versus long-term investors). As we demonstrate below, the relative importance of vertical versus horizontal concerns is traditionally related to the size and maturity of the firm. Young, privately-held corporations have tended to confront horizontal governance challenges, while mature, widely-traded firms have tended to confront vertical governance challenges. While this traditional characterization largely still holds sway, an interesting recent trend in governance of U.S. firms of all sizes and status is the growth in horizontal governance challenges—a transition that scholars of corporate governance would do well to notice.<sup>5</sup>

Second, our emphasis in this chapter will be on for-profit corporations, lavishing far less attention on other business entities (such as partnerships, LLCs, benefit corporations, REITs, non-profits, and so forth). Although these alternative legal forms are interesting in their own right, the overall institutional “template” for governance is far more developed in corporate contexts, and in any event this template is routinely “imported” to inform other contexts by analogy.

Third, the nature of governance within any corporation will tend to be an assortment of background legal rules, contracts, and formal governance documents (such as charters, bylaws, term sheets, etc.) For relatively young and small firms involving a more modest set of competing constituencies and interests, contracts play a particularly important role; and indeed, most of the important governance attributes in such firms tend to be shaped through contractual private ordering arrangements. Within larger firms, however, where contracting

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<sup>4</sup> More specifically, we refrain from discussing most of the periodic reporting requirements of firms that are subject to the Securities Exchange Act of 1934 (the “Exchange Act”), as well as the registration and disclosure obligations of firms selling securities under the Securities Act of 1933 (the “Securities Act”). While these disclosure mandates affect the ability of shareholders to monitor managers, shareholders’ ability to utilize them to influence firm management (as opposed to pricing the firm’s securities) requires a more invasive set of proactive “tools” which we view as more central to the legal regulation of corporate governance. We do not, however, exclude the entirety of federal securities law from our analysis, since certain important components of U.S. securities law have, over the last quarter century, evolved to implicate corporate governance directly, at least within publicly traded firms. See Section 3 for more details.

<sup>5</sup> Outside the U.S., horizontal conflicts among shareholders in public companies are well known due to the significant fraction of firms with controlling shareholders and the concomitant incentives to extract private benefits of control (La Porta et al. 1999).

and coordination costs are relatively higher, background legal rules and formal governance documents carry substantially more of the weight of shaping governance, for intuitive reasons, often out of practical necessity.

Finally, we offer a necessary (if irritating) lawyerly disclaimer: The material below is meant to serve as a handy, high-level reference point and summary of legal dimensions of corporate governance for social scientists interested in the legal dimensions of the topic. Corporate governance law can (and has) spawned book-length exegeses on the granular details of many of the topics touched on below, and we cannot do justice to that fractal complexity in a single chapter. Accordingly, this contribution is best viewed as a jumping-off point for those interested in this topic.

Our analysis proceeds as follows. Section 2 provides a high-level overview of the institutional structure of corporate organization, enumerating basic governance documents and default rules pertaining to intra-firm monitoring and fiduciary duties. Section 3 explores, in the light of this institutional structure, the thorny issue of defining the organizational objective (or “maximand”) that corporate governance institutions should be viewed as serving. We note that while “shareholder value maximization” is widely asserted to be the goal of corporate governance, this objective routinely faces challenges and manifests ambiguity, both as a matter of theory and of practical implementation. Section 4 takes a deeper and more detailed dive into specific governance rules pertaining to the relationship between the board of directors and the shareholders who oversee it. In this section, we demonstrate the surprising point that shareholders’ default governance rights are actually quite limited by design, at least under the default legal structure for corporations—a limitation that privately held corporations can have an easier time contracting around than can public companies. Section 5 considers some of the deeper issues pertaining to corporate governance challenges within privately held and publicly traded companies. We document there that the predominant challenges faced by each type of company have historically been quite different, and consequently the sorts of governance attributes and regulations that have emerged for each type of firm differ accordingly. Section 6 discusses recent challenges in corporate governance disputes, including an interesting ongoing convergence of “private company” and “public company” governance challenges, and the difficulty legal actors have had in dealing with these challenges. Section 7 concludes.

## II. The Formal Legal Nature of the Firm and the Mechanics of Corporate Governance

For social scientists interested in the institutional structures of corporate governance, it is important to understand that from a legal perspective, firms that incorporate are created and operated pursuant to a formal process—a process dictated (at least in the first instance) by an enabling public statute. This statutory framework, in turn, significantly determines the basic structure that a firm’s corporate governance regime takes on. And, while it is frequently possible to “contract out” of such default structures, the process of doing so—which amounts to a private modification of the statutory framework—can sometimes prove cumbersome. This section outlines several of the prominent features of corporate governance that are provided under corporate statutory codes, as well as the means for contracting out of them.

### The Legal Characteristics of Corporate Structure

As an initial matter, it makes sense to define why the legal formality of incorporation plays such an important role in determining the structure of corporate governance. By tradition (or at “common law,” as legal actors put it), operating businesses were treated as either sole proprietorships or general partnerships – entities quite distinct from modern corporations. In fact, even today the default legal status of any business

that fails to go through the formal steps of incorporation is still that of a sole proprietorship or general partnership. And to be sure, many such entities can be found today, particularly among small businesses and certain professional firms where incorporation is disallowed or highly restricted (e.g., law, medicine, accounting). In many respects, these common-law business forms are extremely flexible, but they also tend to place extreme limitations on efficient operation (both in scale and scope). Indeed, the common-law governance rules pertaining to partnerships entail (*inter alia*):

- Unlimited personal exposure of partners to corporate liabilities, and thus partners are jointly liable for the contractual liabilities of the partnership and jointly and severally liable for its torts.
- Similarly, partnerships may themselves inherit the personal liability of individual partners.
- Ownership transfers are often difficult to accomplish, in many jurisdictions requiring unanimous consent of the existing partners (a default requirement that is not too surprising given the shared liability nature of partnership status).
- Tax and securities laws often exacerbate the transferability issue with partnerships, either heavily constraining access to public securities markets or negating the pass-through tax benefits of partnership status.
- Most partnerships have a generally limited life span (either because the termination date is baked into the governing agreement, prescribed by background rule (e.g., the death of a partner), or implied through judicial interpretation (e.g., time to recoup investments)).
- Firm governance can be awkward: The default rule on partnerships dictates significant decentralization of decision making, with the default governance regime resembling something akin to Jeffersonian Democracy, in which partners make all decisions by majority vote, giving rise to collective action problems.

While many of these provisions can be changed through explicit provisions in a partnership agreement, it is important to remember that unlimited liability, one of the most important provisions, is immutable, and for other provisions, every contractual override entails the costs of foreseeing, negotiating and drafting countervailing provisions.

Incorporating a firm provides a host of alternative liability and governance attributes that are provided pursuant to the applicable jurisdiction's statutory authority. These attributes often include the following:

- Unlike partnerships, liability of corporate shareholders is generally limited to their equity investment in the firm; thus, should the firm become insolvent, shareholders are not residual obligors for the shortfall.
- Likewise, the corporate entity is largely shielded from the personal debts of shareholders.<sup>6</sup>
- Ownership claims are, as a default rule, freely transferrable in a corporate entity, and are not generally subject to the approval of other shareholders—a feature no doubt facilitated by the aforementioned liability limitations.
- Corporate entities are presumed to have unlimited life (even ownership of shares changes over time).
- Corporate management is largely centralized in a “board of directors” whose members are elected periodically by shareholders entitled to vote.

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<sup>6</sup> See Hansmann & Kraakman (2000).

- By default, the governance structure of corporations reserves significant decision making power to an elected board of directors instead of equity owners.
- Corporations are required to have formal corporate governance documents, including (i) a certificate of incorporation (or “charter”), which functions—much like a state’s constitution—as the supreme authority for governing the company; and (ii) corporate by-laws, which are a more detailed set of implementing provisions that are trumped by contrary terms in the charter.

Beyond these formal differences, several other attributes of corporate structure play important roles in determining and shaping the corporate governance playing field. We highlight several of them below.

## Regulatory Competition and Tailoring Corporate Governance

The role of federalism under United States law – where power not explicitly claimed by the U.S. federal government is reserved to the states – turns out to have unique implications for corporate governance. Unlike many foreign jurisdictions, where incorporation is determined pursuant to national-level laws, the vast majority of corporations in the U.S. are formed pursuant to *state* statutes, and thus subject primarily to state rather than federal law. Moreover, with some limitations (discussed below), firms are free to incorporate in whichever state they wish – even if they do little or no business in that state. Effectively, then, through its statutory language and judicial system, each state offers what amounts to a “menu entry” of default corporate governance attributes. Once an incorporated entity has opted into a given jurisdiction, its governance will largely be determined by that state’s prescribed law (even for courts outside that state), under a legal tradition that has become known as the “Internal Affairs Doctrine” (IAD).<sup>7</sup> Consequently, the landscape of differing corporate law and governance choices represented by each state’s laws represent a type of competition over which corporations can self-select, and jurisdictions implicitly compete to attract them. Regulatory competition over corporate chartering has long been an interest of legal scholars; the social welfare implications of this regulatory competition, moreover, are still far from settled.<sup>8</sup> What is clear, however is that by the mid-20<sup>th</sup> century, the state of Delaware long ago emerged as the alpha dog in this contest, a perch it occupies up to today, claiming a significant market share of incorporations of U.S. public companies—around 55% (See Rauterberg & Talley 2017).

In addition, regardless of state of incorporation, much of the work done by corporate statutes is to establish a background framework of standardized, off-the-rack rules of corporate governance, differing *not only* in their substantive content but *also* in the measures required to alter them. Many such rules—indeed likely most of them—permit a corporation the latitude to opt out, specifying its own tailored alternative (*i.e.*, they are “default” rules in contractarian language). This observation raises three important caveats for social scientists who study corporate governance to keep in mind. First, the absence of an explicit corporate governance provision in a company’s governing documents *does not* imply the absolute absence of the governance device in question. Rather, it more usually implies that the corporation has simply opted to accept the governance regime already provided by default in the jurisdiction’s statutory scheme. Second, and conversely, when the state’s corporate law imposes an unchangeable (*i.e.*, “immutable”) rule, the existence of

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<sup>7</sup> There are a few notable exceptions to the IAD that are worth keeping in mind. For example, certain states (such as California) have far-reaching “long arm” statutes, which dictate that even those corporations organized outside of that state may be subject (if doing sufficient in-state business and not publicly traded) to certain of the domicile state’s corporate laws as well. (E.g., Cal. Corp. Code. § 2115.) The permissible breadth and reach of these statutes has been in a longstanding state of limbo. See *Vantage Point Venture Partners v. Examen, Inc.* 871 A.2d. 1108 (Del. 2005) (declaring California’s statute unconstitutional under federal law, though without the authority to make such a holding binding on other states).

<sup>8</sup> See Hadfield & Talley (2006) and Talley (2015) for a review of this literature.

an explicit corporate governance provision announcing a contrary rule is simply unenforceable, and thus of questionable relevance.<sup>9</sup>

And finally, even when the corporate governance regime provided by state law provides for opting out, the various rules can differ considerably in what it takes to do so. In Delaware, for example, some default governance rules are easily changed, through measures as simple as a board resolution.<sup>10</sup> Others can only be changed through amending the corporation's charter,<sup>11</sup> an involved process that generally requires both board action and a shareholder vote. Yet other rules sit in the Goldiloxian middle, requiring the modification of a mid-level governance document (such as the corporate by-laws). Viewed in the light of the heterogeneity of opt-out rules, the real difference between default and immutable rules may be more one of degree than kind: that is, immutable rules (of which there are some) may represent merely the limiting case of default rules that are *infinitely* costly to modify.

## Federal Law's Overlay

In addition to the state law contours of corporate governance, there can be additional governance rules applied to companies through an assortment of regulatory authorities. Perhaps the most significant is federal securities law, the bulk of which only applies to companies whose shares are traded on a national U.S. exchange or to companies who have a sufficiently large number of shareholders (generally, more than 2,000) to trigger mandatory registration with the Securities and Exchange Commission (SEC) even in the absence of an exchange listing.<sup>12</sup> These regulations are designed to facilitate the stable operation of robust capital markets for ownership shares, and they contain a host of requirements related to registration and disclosures for publicly traded shares, as well as an assortment of anti-fraud and insider-trading prohibitions. While admittedly only a sliver of all incorporated entities are public, public companies comprise a considerable fraction of value among U.S. corporations, and federal disclosure requirements have, over time, contributed to a wealth of granular data about public companies. Their economic importance and observational transparency, therefore, have caused publicly traded corporations to garner significant attention among those interested in corporate governance.

Although the more-than-proportionate attention accorded to public companies is generally justified on the grounds of their outsized economic significance, it is important to note that during the last several years

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<sup>9</sup> For example, Delaware largely forbids Delaware corporations from (i) disempowering shareholders from amending corporate bylaws (DGCL § 109) or voting to approve charter amendments (DGCL § 242); (ii) stripping the board of its power to propose charter amendments (DGCL § 242); (iii) adopting a “loser pays” provision in either the charter or bylaws to govern shareholder litigation (DGCL §§ 102(f), 109(b)); and (iv) excluding Delaware as a forum for litigation over corporate governance disputes (DGCL § 115).

<sup>10</sup> Examples include declaration of dividends, implementing a poison pill, selling a secondary share offering (if below the limit set by the charter), and disclaiming various classes or categories of business opportunities as belonging to the corporation.

<sup>11</sup> Examples include adopting or abandoning cumulative voting, authorizing or deauthorizing the board from amending bylaws, and waiving liability for monetary damages for directorial negligence.

<sup>12</sup> Our dichotomy of “public” and “private” firms follows this regulatory definition which is set forth in Section 12 of the Exchange Act. Note that certain firms may be publicly traded in the over-the-counter market and yet not be subject to Exchange Act reporting requirements. This phenomenon is due to the fact that, for purposes of counting shareholders, one counts only “holders of record,” which can exclude hundreds (even thousands) of individuals and institutions who hold stock in the company if their shares are held indirectly through the Depository Trust Corporation (described in Section 4). These firms will largely follow the governance structure that we describe for “public” firms; however, they will not be subject to the proxy regulations that we discuss in Section 4. Finally, we note that it is also possible for firms to be privately held but nevertheless subject to Exchange Act reporting requirements. This can occur, for instance, if a company has issued debt securities that subject the company to Exchange Act reporting, as occasionally occurs with firms that have undergone a leveraged buyout (LBO). Because equity ownership of these companies will typically be spread across a relatively few shareholders, the governance arrangements of these companies will generally follow the governance structure that we describe for “private” firms.



the population of public companies in the U.S. has declined precipitously relative to their private counterparts, as substantial consolidation and exit of public companies has far outpaced the rate of initial public offerings of new issuers (Kahle and Stulz, 2017). In fact, a discernible trend in recent years is for privately-held (often venture-capital-backed) corporations to remain in the private realm longer, and going public at a much later stage than was heretofore the norm, if at all.<sup>13</sup> This increasing concentration of economic value in private companies poses somewhat of a challenge for corporate governance scholars, both empirically and theoretically. Empirically, we simply know less about privately held companies, and many of the existing data sources are proprietary. Theoretically, the types of governance disputes that have typically affected private and public companies are slightly different. While public companies' governance structure has tended to focus on "vertical" incentive problems and agency costs pertaining to managers who do not bear the economic risk of their decisions, privately held firms tend historically to grapple with "horizontal" governance dilemmas, involving disputes among competing shareholders (or classes of shareholders) who seek to enhance their influence and control relative to other shareholders.

To the extent this trend continues, the study of governance in privately held firms is likely to become more critical to important policy debates. Corporate governance scholars face a challenge in this regard, given the relative paucity of empirical data on the patterns, practices and authority structures in private companies. That said, as we demonstrate below, the nature of governance disputes within public companies has itself begun to migrate in recent years to "horizontal" disputes between shareholders (e.g., activists versus long-term investors), which bear many of the same markers of private company disputes. Thus, while access to reliable private-company data remains a priority for the field, public companies are increasingly becoming representative petri dishes for the types of governance disputes that affect all types of incorporated entities. We return to some of the important governance distinctions between private and public companies below.

## Fiduciary Duties as Corporate Governance Rules

It is natural to think of corporate governance institutions as setting forth explicit mechanical rights of control such as monitoring rights and voting rights that are either (i) enumerated in the central governance documents of the corporation, or (ii) provided by either immutable or un-waived default rules within the relevant jurisdiction's corporate statute. This view is helpful, but ultimately incomplete from a corporate lawyer's perspective, as it omits a critical enforcement angle on governance that overlays the operation and execution of nearly every corporate governance rule: fiduciary duties. Board members, officers, and even significant block shareholders, in addition to wielding considerable influence in a corporation's decision-making apparatus, also are the obligors of fiduciary duties to the corporation. Such fiduciary duties can matter a significant amount: even an act that appears to be completely consistent with the formal mechanics of a governance rule may still trigger liability and/or negation if it is consummated in violation of a corporate insider's fiduciary duties.<sup>14</sup>

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<sup>13</sup> The ability for private firms to avoid registering as public companies is largely a product of the Jumpstart Our Business Startups Act of 2012 (the JOBS Act), Pub. L. No. 112-106, 126 Stat. 306, 310-12 (codified in scattered sections of 15 U.S.C.). Prior to the JOBS Act, companies having greater than \$10 million in assets and more than 500 shareholders of record were required to register with the SEC under Section 12 of the Exchange Act. The JOBS Act modified the requirement for SEC registration by increasing to 2,000 the number of shareholders a company must have before it is required to commence filing periodic reports with the SEC. Moreover, the JOBS Act excludes for this purpose any shares held by individuals who received their shares pursuant to a conventional employee stock option plan (or other employee stock plan). This latter provision ensures that even where a company compensates its employees with equity, it will be able to decide if and when it will cross the public/private divide.

<sup>14</sup> The fact that significant block shareholders owe fiduciary duties is an important (and somewhat unique) attribute of American corporate law. In many jurisdictions outside the United States, significant shareholders (even controllers) owe scant duties to the

There are three important features of fiduciary duties that warrant brief discussion here. First, what types of fiduciary duties exist? Second, how do they interact with corporate governance rules? And third, how does one determine whether a fiduciary duty has been breached? We address each in turn.

Consider first a typology of fiduciary duties. Most corporate law scholars concur that there are two principal flavors of fiduciary duties that most corporate fiduciaries must bear in mind: the Duty of Care (DoC) and the Duty of Loyalty (DoL). The Duty of Care pertains predominantly to managerial negligence committed by corporate fiduciaries. Although liability for officers, directors, and dominant shareholders has been found infrequently in this area, concern over duty of care liability has, episodically, affected corporate law in a variety of ways. Put simply, the DoC is not a general-purpose doctrine for managerial negligence, but instead pertains to *process* oriented aspects of decision making – that is, was the relevant actor negligent in becoming informed and/or using reasonable protocols to evaluate a decision (regardless of which decision she ultimately took)? This distinction between substance and process is important: courts have been exceedingly reluctant over the years to second-guess the substantive merits of a fiduciary’s business decisions, fearing (often correctly) that business acumen is far beyond the ordinary wheelhouse of judicial actors. Rather, it is only the procedural protocols that fiduciaries put in place that courts are willing to second guess. The avoidance of substantive assessments of a fiduciary’s decision is sometimes captured under the guise of the so-called “business judgment rule,” a legal presumption that a corporate fiduciary acted with appropriate care and skill—a presumption that is rebuttable in a DoC case only upon showing gross negligence in the decision-making process. This presumption is, in practice, difficult to penetrate.

In addition to its protective cloaking by the business judgment rule, the fiduciary duty of care is itself a (partial) default rule under Delaware’s corporate governance regime. In particular, corporations are permitted to nullify or waive monetary liability for directors who breach the DoC with an enabling provision in their charters – an artifact of a statutory reform promulgated in the late 1980s after a notable victory for shareholders of a Delaware company.<sup>15</sup> That said, the ability to nullify the duty of care is limited in several ways – for example, it extends only to litigation against directors (not officers or dominant shareholders), and it does not apply to claims that seek only injunctive relief. Nevertheless, the waivability of a significant aspect of the fiduciary duty of care is a relatively recent phenomenon in Delaware law.

A second principal fiduciary duty for Delaware corporations is the Duty of Loyalty (DoL) which prohibits corporate fiduciaries from taking actions or entering into transactions in which they have material conflicts of interest of a monetary nature. Self-dealing transactions, profiting off of confidential corporate information, and appropriating new business opportunities in the firm’s line of business are all potential violations of the DoL, potentially giving rise to liability risk. In each of these instances, the fiduciary financially benefits (directly or indirectly) from the decision in a manner disproportionate to any benefit she enjoys due to the pro-rata value of the shares that she happens to hold in the company. For example, a DoL issue arises when a company’s CEO (who might hold a small fraction of the stock of the corporation) causes

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remaining residual claimants. However, within the U.S., shareholders whose block of ownership is deemed sufficiently significant are charged with utilizing their power in a manner consistent with their having fiduciary duties to the entire corporation. (The line that delineates when a shareholder’s ownership becomes sufficiently “dominant” to introduce fiduciary duties is not concrete and absolute, but most commentators agree that it has consistently lay somewhere in the 20-30% range (measured by voting power), on the theory that such a significant stake can provide considerable “negative” control over corporate activities, such as through an effective veto threat).

<sup>15</sup> Smith v. Van Gorkom 488 A.2d 858 (Del. 1985). In *Van Gorkom*, the board of TransUnion was successfully sued for failing to become informed of the reasonable fair value of the corporation before agreeing to its sale with non-market-tested terms. There the court established “gross negligence” to be the applicable standard for a DoC action.

the firm to enter a substantial transaction with another company that is substantially owned by the CEO.<sup>16</sup> In an interesting (and in some ways confusing) twist, a few recent Delaware cases have found a breach of duty of loyalty even in the *absence* of a financial conflict of interest, when a fiduciary fails to act in good faith to advance the best interests of the corporation; at present, however, it remains unclear how durable the contours of “bad faith” prove.<sup>17</sup>

Unlike cases alleging managerial negligence, the business judgement rule does not apply upon a showing of a conflicted transaction. Rather, the offending fiduciary is held to a relatively strict standard prohibiting conflicts of interest—one that affords a defense for the actor only if her behavior was “entirely fair” to the corporation. That is, if the fiduciary’s actions—notwithstanding the conflict—were not materially detrimental to the corporation’s welfare both in process and in substance. Although it is possible to prevail against this standard (see our discussion of the *Trados* case below), it is a particularly onerous one, and the necessity of an entire-fairness defense exposes the fiduciary to perhaps the greatest degree of legal peril; for it is she who must carry the burden of proof to convince the presiding court of the justifiability of her actions.

The onerous nature of an entire fairness defense has, over time, given rise to an alternative means by which corporate fiduciaries can attempt to defend or preempt its clutches: through cleansing the process of the decision. If the *sine qua non* of a DoL cases is conflicted decision-making, the argument goes, then the conflicted fiduciary may be able to sidestep the conflict by ceding approval authority over the conflicted decision to independent and disinterested parties. In fact, Section 144 of the Delaware General Corporation Law (the DGCL) lays out two procedural cleansing approaches for conflicted directors, each of which can function as an alternative to entire fairness: full disclosure to and approval by disinterested directors (or a duly constituted subcommittee thereof); or full disclosure to and approval by disinterested shareholders (usually through a shareholder vote of the disinterested shareholders).<sup>18</sup> Should a conflicted director successfully navigate either of these procedural cleansing steps, courts have routinely held that the director can recapture the protection of the business judgment rule as to the decision or transaction in question.

The model of “full disclosure and disinterested approval” has proven to be an immensely powerful concept in corporate governance circles, even beyond its statutory mandate. Over the years, courts have utilized the same model not only to provide a process defense to directorial conflicts, but also to allow for cleansing of conflicts for officers and dominant shareholders. In the case of dominant shareholders, courts are understandably somewhat more uneasy about the effectiveness of procedural cleansing devices, and have thus generally required that the fiduciary seek disinterested approval from *both* directors and shareholders in order to enjoy business-judgment-rule protection. (In fact, courts have also consistently held that the disclosure-and-approval model can extend out of the DoL context too, and provides a defense to a fiduciary who has previously violated her duty of care.)

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<sup>16</sup> See, e.g., *See Americas Mining Corp. v Theriault*, 51 A.3d 1213 (Del. 2012) (upholding a \$2 billion judgment against a controlled mining company that forced a merger with its controlled public subsidiary on terms found to be manifestly one sided).

<sup>17</sup> In *Stone v. Ritter* 911 A.2s 362 (Del. 2006), the Delaware Supreme Court held that acts taken in “bad faith” could breach the duty of loyalty. According to the Court, a fiduciary breaches her DoL in this regard where “the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of known duty to act, demonstrating a conscious disregard for his duties.” *Id.* at 369. In distinguishing between a breach of the DoC and such a “bad faith” breach of the DoL, the Court in *Lyondell Chemical Co. v. Ryan*, 970 A.2 235, 243-44 (Del. 2009) stated: “[I]f the directors failed to do all that they should have under the circumstances, they breached their duty of care. Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty.”

<sup>18</sup> Although the section does not explicitly state that shareholder approval must be made by “disinterested” shareholders, courts have consistently required disinterested approval, whether through the means of other board members or shareholders.

Unlike managerial negligence, legal tradition has largely viewed the duty of loyalty to be strongly non-waivable in advance; and thus, for example, a corporate charter or by-law would not be permitted to waive all liability for its officers, directors and/or dominant shareholders stemming from future financial conflicts. However, in 2000, Delaware significantly departed from tradition, amending its statutes to enable corporations to waive a critical component of loyalty—the corporate opportunity doctrine—which forbids corporate fiduciaries from appropriating new business prospects for themselves without first offering them to the company.<sup>19</sup> Today, Delaware corporations and managers are free to contract out of a significant portion of the duty of loyalty, and thousands have already done so (Rauterberg & Talley 2017).<sup>20</sup>

## Legal Enforcement and Shareholder Litigation

Finally, because of the legal nature of fiduciary duties, it is worth spelling out how they are enforced in practice through litigation. Formally, fiduciary duties are owed not to shareholders *per se*, but rather to “the corporation”, and thus a breach of any fiduciary duty gives rise to a potential legal claim against the offending fiduciary that belongs to the corporation. This formality creates a legal conundrum of sorts, particularly when the offending party or parties sit at the very hub of authority in the firm, including authority over whether to pursue legal claims against negligent or disloyal fiduciaries. It would hardly be surprising if corporate boards proved reluctant to authorize litigation against themselves or a subset of board members, officers, or significant block shareholders.

The principal mechanism to contend with this incentive problem is the shareholder derivative lawsuit—a procedural device that allows a self-appointed shareholder to act as a champion on behalf of the corporation’s interest, and effectively force the corporation to sue its own fiduciary(ies). Should the shareholder champion prevail, any remedy (non-monetary or monetary) generally goes to the corporation, and thus the shareholder profits only “derivatively” through the change of value in her shares. While perhaps necessary in some respects, derivative actions have also proven to be controversial, largely because in the context of publicly traded companies, these suits are typically driven by plaintiff attorneys who can pocket significant sums for legal fees (usually at the company’s expense) from pursuing derivative litigation on behalf of the corporation. As a result, courts usually place significant procedural limits on derivative litigation, requiring heightened pleading standards, continuity of ownership for the filing shareholder, and convincing evidence that the company’s board was itself untrustworthy in deciding whether the company should itself pursue litigation.

In certain types of cases, shareholders may have an option to avoid the derivative litigation process altogether and instead sue a fiduciary directly, alleging the breach of a legal duty owed directly to them (rather than derivatively through the corporation). Shareholders may benefit from specific entitlements granted to them through a shareholder agreement, stock certificate, governance document, or other legal writing that gives them a right to proceed individually (or as a class action) against the offending fiduciary without need to characterize it derivatively. While direct actions avoid many of the procedural hurdles of derivative actions, they tend to be a less reliable vehicle for plaintiff attorneys to recover legal fees at the end of the process. The dividing line between derivative and direct actions is a fuzzy one, and in practice plaintiffs frequently have the *de facto* ability to choose how to characterize their cause of action.

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<sup>19</sup> See Del. Code Ann. tit. 8, § 122(17) (2017) (codifying this amendment).

<sup>20</sup> In the ensuing years, eight other states have followed Delaware’s lead, granting their own incorporated entities the statutory authority to execute corporate opportunity waivers. (See generally Rauterberg & Talley 2017).

The fiduciary duty element of corporate governance is an important one – for nearly every institution of governance must itself be administered, largely by the corporate fiduciaries it is meant to control. Consequently, the neglect, misuse, or distortion of more garden variety governance rules tends to be deterred ultimately through the threat of litigation. And indeed, courts have long used principles based on the duties of care and loyalty to assess the propriety of a variety of alleged “abuses” to corporate governance practices perpetrated by management, boards, activist shareholders, and others.<sup>21</sup> Social scientists interested in corporate governance, therefore, would be wise to heed how liability exposure under fiduciary principles shapes incentives in the administration of corporate decision making.

At the same time, when one backs away from the myriad granular details of the fiduciary duties of care and loyalty, an overarching conceptual dilemma remains: Who (or what) are the intended beneficiaries of fiduciary duties? As noted above, fiduciary duties are owed to “the corporation,” and thus their compliance will often require assessing whether an alleged breach actually violates “corporate interests.” But how does one measure and quantify such interests, and thereby detect a breach? This question is much debated in corporate law and governance, often to a standstill.<sup>22</sup> Moreover, while courts have proven willing (perhaps by necessity) to conjure up a provisional answer at times, their commitment to that answer has wavered and meandered over the years. We take up this topic in the following section.

### III. The Objective (or “Maximand”) of the Corporation

Before we outline the roles played by investors, directors, and managers in corporate governance, it is necessary to air a challenge that has long vexed legal actors in this domain: What is the corporation supposed to “maximize”? To the extent one views corporate governance about advancing a company’s fundamental purpose, it is a question that goes to the very heart of the governance objective. Yet it is also a question that has no obvious answer on *a priori* grounds.

In many ways, the difficulty of the question is a function of the historical development of U.S. corporate law. Following the Revolutionary War and through the mid-1800s, state legislatures controlled the authority to allow businesses to incorporate and commonly restricted what projects a company could lawfully pursue. The ability to operate a business with limited liability was viewed as a government privilege, inducing legislatures to grant incorporation requests sparingly on an individual basis. In general, successful application for a corporate charter required a demonstrated corporate purpose that would benefit the public good, such as building public infrastructure projects (Pollman 2011). Given the capital-intensive nature of these enterprises, the limited liability structure of the corporation was viewed as useful for allowing these companies to raise significant amounts of capital, since they could not (by definition) appropriate the full social value of their efforts. In exchange for this benefit, however, legislative grants of incorporation typically required that corporate charters specify a purpose for the business. Actions taken by the business that were deemed outside of this articulated purpose would be deemed beyond the corporation’s power (“*ultra vires*”) and thus invalid. For these early corporations, understanding a corporation’s purpose was thus a straightforward question of looking to its charter.

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<sup>21</sup> See *Blasius v. Atlas*, 546 A.2d 651 (Del. Ch. 1988) (holding that deliberate directorial manipulation of governance rules, if done with the purpose of frustrating the shareholder voting franchise, is subject to strict judicial scrutiny), approved by *MM v. Liquid Audio*, 813 A.2d 1118 (Del. 2003); subsequently criticized by *Mercier v. Intertel*, 929 A.2d 726 (Del. Ch. 2007). Although heightened scrutiny for governance decisions remains good law in Delaware, it is generally presumed to be analyzed today under the Unocal doctrine (discussed below).

<sup>22</sup> We direct readers interested in exploring these debates to the spring 2006 symposium issue of the *Journal of Corporation Law* which provides a representative collection of the prevailing perspectives.

By the 1850s, however, concerns that this rigid system of incorporation paved the way for corruption and political favoritism had given way to a new model of incorporation based on “enabling” state corporate statutes. These statutes eliminated the need for legislative approval to incorporate a business and provided incorporators the ability to form a company for any legal purpose. This opened up the possibility of incorporating a broader set of entrepreneurial enterprises. In this regard, these statutes also reflected the political winds of a Jacksonian America insofar that the corporate form was viewed as a tool that could promote an individual’s economic and personal independence (Mark 1987). By the end of the 1800s, enabling statutes that permitted general incorporation had become the norm, ushering in the existence of perpetual corporations whose purpose is “to engage in any lawful act or activity.”<sup>23</sup>

Yet, while these statutes stripped away any need for a company to declare a formal purpose, they left intact a legal structure in which the board of directors possessed general authority over the corporation’s business and affairs, a feature that persists today. To be sure, boards are to exercise this authority subject to any shareholder voting rights specified in the corporate statute (such as the ability to vote on fundamental corporate changes, as discussed below). Moreover, the class of transactions over which shareholders possess veto rights can be expanded in the charter and/or bylaws. But even if the board’s authority might be limited in some respects, it nevertheless holds residual control rights over the destiny of the enterprise. Freed from having to pursue any specific objective and endowed with loosely constrained discretion, the board of directors of a corporation must still confront the ultimate existential question: *What is the purpose of the corporation (and thus the implicit objective of the board)?*

### Judicial Efforts at Providing Answers

Notwithstanding the centrality of this question for directors of modern corporations, a notable (and for many, frustrating) feature of American corporate law has been the repeated reluctance of courts to provide a definitive and enduring answer. While a common theme among economists and corporate finance textbooks is that the “primary objective of the firm [is] ... the maximization of the value of the common stockholder’s ownership rights in the firm” (Bierman & Smidt 2012; Friedman 1970),<sup>24</sup> it is only recently that Delaware courts (which, as noted above, are the most influential in U.S. corporate law) have begun to embrace this conception. And even in these cases, they have done so tentatively—and perhaps for good reason, as we show in Section 6.

As one might expect, cases requiring courts to evaluate the exercise of board discretion have a long pedigree. Some of the earliest efforts to provide guidance on these issues involved what would be viewed today as minority oppression cases (Smith 1998). In examining whether directors could be personally liable for a breach of their fiduciary duties to minority stockholders, courts frequently evoked the language of trustees and beneficiaries to analyze directors’ duties. According to these cases, just as a beneficiary has standing to bring claims against a trustee, so too could a shareholder bring a fiduciary duty claim against directors. These cases made clear that shareholders were the beneficiaries of directors’ conduct, providing an early legal foundation for theories of a “shareholder primacy” model of corporate governance.

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<sup>23</sup> This language is taken from the form Certificate of Incorporation available on the website of the Delaware Secretary of State. See <http://www.corp.delaware.gov/incstk.pdf>. Notably, the DGCL requires corporations to specify in their charters the purpose (if any) of the entity. The use of this form language in a document that is designed to be customizable is thus indicative of the pervasive view of corporations (even within the Delaware Secretary of State) that corporations have no special purpose.

<sup>24</sup> See also Copeland & Weston (2005) (“The most important theme... is that the objective of the firm is to maximize the wealth of its shareholders.”) Brigham and Gapenski (2013) (“Throughout this book we operate on the assumption that the management’s primary goal is stockholder wealth maximization which translates into maximizing the price of the common stock.”)

In addition to establishing the possibility for direct liability to shareholders, however, these early cases also made clear that directors had a related—and seemingly superior—obligation to protect the value of the corporation itself. By the 1930s, this view of director duties would ultimately find its expression in the seminal Delaware case of *Guth v. Loft, Inc.*<sup>25</sup> In holding a director liable for appropriating a corporate opportunity, the court used the now-classic incantation that directors’ fiduciary duties run to “the corporation and its shareholders.”<sup>26</sup>

While cases such as *Loft v. Guth* would appear to provide guidance for directors looking for a clear standard of conduct, the guidance is useful only when there is a perfect correspondence between the interests of the corporation and its nominal residual claimants (Hart 1989). Not surprisingly, cases articulating this standard have commonly involved situations alleging director self-dealing such as in *Loft v. Guth* itself, where the conflict of interest was between a director’s personal interest and those of the corporation (and, as a result, its residual claimants). In contrast, in cases where the interests of “the corporation” and the shareholders potentially diverged, courts have tended to oscillate on which interests directors should privilege.

Indeed, such an outcome occurred in *Dodge v. Ford*<sup>27</sup>—perhaps the most celebrated case for articulating the shareholder primacy norm. In general, the facts of the case involved an allegation that the board of the Ford Motor Company breached its fiduciary duties by withholding payment of special dividends in favor of pursuing a significant expansion of the company’s business operations. In requiring the company to pay the dividend, the case famously declared:

A business corporation is organized and carried on primarily for the benefit of the stockholders. The powers of directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself.<sup>28</sup>

This language has commonly been used for the proposition that directors have an obligation to make decisions that are in the best interest of shareholders (Smith 1998).

Close inspection of the opinion, however, reveals greater complexity. In fact, the court was *unwilling* to invalidate a decision of Ford’s directors that arguably privileged the interests of the corporation writ large rather than the short-term interests of its common shareholders. More specifically, the shareholder complaint against the Ford Motor Company sought to accomplish two items: (1) requiring the payment of a special dividend and (2) enjoining Ford from using surplus capital to undertake a business expansion. While the court sided with the plaintiffs on the former request, it refused to go along with the latter. The court’s refusal to enjoin Ford’s expansion specifically invoked the long-term interests of the firm, and the expertise of Ford’s management team (relative to the court’s) to meet such interests:

It is recognized that plans must often be made for a long future, for expected competition, for a continuing as well as an immediately profitable venture. The experience of the Ford Motor Company is evidence of capable management of its affairs.<sup>29</sup>

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<sup>25</sup> *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939) (affirming *Loft, Inc. v. Guth*, 2 A.2d 225, 238 (Del. Ch. 1938)).

<sup>26</sup> 2 A.2d at 238.

<sup>27</sup> *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919).

<sup>28</sup> *Dodge*, 170 N.W. at 684.

<sup>29</sup> *Id.* at 684.

Notably, even the order for the company to pay the special dividend of \$20,000,000 was approved only after the court concluded that the company had failed to advance any legitimate business purpose for retaining so much capital given the expected capital requirements of the business expansion. (And indeed, a plausible reading of the dividend ruling is that the court was motivated as much by Ford's evident desire to starve a potential competitor—the Dodge brothers—of needed startup capital.)

Likewise, within Delaware jurisprudence, courts have historically left vague the contours of the notion that directors' duties run to "the corporation and its shareholders." Do courts meant to say that directors should maximize the value of the firm, which can sometimes (but not always) be accomplished by maximizing the value of its residual shareholders? One can certainly read some of the cases in this fashion. For instance, the Delaware Supreme Court stated in *Revlon, Inc. v. MacAndrews & Forbes Holdings Inc.*<sup>30</sup> that once a board has decided to sell a company, it has "an obligation to seek the best value reasonably available for the stockholders where there is a pending sale of control." While the language may read like an endorsement of shareholder primacy, the standard applies only when selling the entire corporate enterprise, and in this setting, theory plausibly dictates that maximizing shareholder value is tantamount to maximizing the value of the entire firm.<sup>31</sup> And thus, the Court in *Revlon* oscillates between describing directors' duties as being about the "the maximization of the company's value at a sale for the stockholders' benefit" and about directors simply "getting the best price for the stockholders at a sale of the company."

Moreover, even for cases like *Revlon* that imply a duty to maximize shareholder value exclusively, the case law remains recondite as to when such duties kick in and how they are discharged. Later refinements to the *Revlon* doctrine (such as *Paramount Communications, Inc. v. Time Inc.*<sup>32</sup> for example), hold that a board's "Revlon duties" apply only when a board has decided to sell control of the corporate enterprise, and that a board wishing to maintain the status quo can use a variety of permissible pretexts, including protecting non-stockholder considerations such as corporate culture, in the name of creating long-term value. In the 2010 chancery case *eBay Domestic Holdings, Inc. v. Newmark*,<sup>33</sup> the Delaware Chancery Court suggested that *Paramount* allows boards to consider non-stockholder interests that the board believes will "ultimately promote stockholder value." Here, even in a case that seems to embrace shareholder primacy, the difficulty of defining how to maximize shareholder value over different time horizons is patently manifest. Moreover, it is difficult to see why a board that focuses on generating long-term stockholder value cannot accomplish this goal by maximizing long-term firm value, once again calling into question whether the court was using stockholder value as simply a proxy for firm value. (We revisit several of these themes in the context of hostile takeovers and activist proxy challenges in the next section).

The uncertainty about whether directors' duties run to the corporation or to shareholders also erupts in a cluster of important cases addressing directors' duties in the so-called "zone of insolvency." For firms in financial distress, boards must commonly decide between actions that benefit creditors (e.g., liquidating a firm

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<sup>30</sup> 506 A.2d 173 (1986).

<sup>31</sup> Under the Miller–Modigliani theorem, the total value of the firm must equal the total market value of all of its securities, or in the case of a company with only debt and equity outstanding:  $\text{Value}_{\text{firm}} = \text{Value}_{\text{debt}} + \text{Value}_{\text{equity}}$ . Because debt must be paid off or assumed in the sale of a company, maximizing  $\text{Value}_{\text{equity}}$  will yield a transaction that maximizes  $\text{Value}_{\text{firm}}$ . To be sure, debt can be assumed in a transaction that shifts value from debtholders to shareholders (e.g., where the acquiring firm takes on additional debt that stands in parity with the target's preexisting debt). See Warga & Welch (1993). The prospect of such acquisitions, however, should result in debt covenants (such as change-in-control puts) that diminish the possibility of such bondholder-to-stockholder wealth transfers, thus ensuring that when a board follows *Revlon* it will maximize overall firm value.

<sup>32</sup> 571 A.2d 1140 (Del. 1989).

<sup>33</sup> 16 A.3d 1 (Del. Ch. 2010).



with little or no payout to stockholders) and those that benefit stockholders (e.g., continuing a firm but putting at risk the company's remaining assets). Such tradeoffs raise precisely the issue of whether directors should maximize the value of the firm or the value of the residual claim held by shareholders. Issues surrounding financial distress and fiduciary obligation became especially focused among legal actors following the 1991 Chancery Court case of *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*<sup>34</sup> In a famous footnote, the court suggested (albeit in non-binding *obiter dictum*) that within the zone of insolvency, directors' fiduciary obligations run to the "community of interests that the corporation represents" even if the resulting conduct was inconsistent with conduct that would maximize returns to stockholders.<sup>35</sup>

In the years following *Credit Lyonnais*, uncertainty reigned about the meaning of this language as courts grappled repeatedly with claims by creditors of distressed firms that corporate decisions harmed creditors while benefiting stockholders, thus breaching fiduciary duties. In 2007, the Delaware Supreme Court finally sought to clarify the content of directors' duties near insolvency in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*.<sup>36</sup> Ultimately, the Gheewalla court rejected the notion that directors' duties must shift to the corporate "community of interest" at any point before actual insolvency. Yet it also continued to conflate directors' duties as running to both the "corporation" and "shareholders." According to the court,

[W]hen a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.<sup>37</sup>

Perhaps unsurprisingly, legal commentary following *Gheewalla* has continued to reflect an aspect of uncertainty with respect to how directors should comport themselves in the zone of insolvency when faced with a conflict between maximizing firm value and maximizing stockholder value.<sup>38</sup>

## Why the Ambiguity?

The proclivity of courts to vacillate and play coy about the specifics of a corporation's deemed maximand is no doubt frustrating for both directors making decisions and researchers who study such decisions. Yet it is also symptomatic of a legal system that seeks to juggle several complicated policy objectives. First, courts are aware of the difficult business decisions that directors and officers must make, which often require a skill set beyond the expertise of legally trained judges. But in addition, judicial actors are also tasked with holding corporate agents accountable as faithful fiduciaries. This latter consideration helps explain why courts have been reluctant to impose on directors a simple omnibus duty to maximize the value of the corporation. As summarized in a recent Delaware Chancery decision:

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<sup>34</sup> *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. 12150, 1991 WL 277613, at \*34 n.55 (Del. Ch. Dec. 30, 1991).

<sup>35</sup> *Id.* at \*34 n.55.

<sup>36</sup> *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

<sup>37</sup> *Id.* at 101. Indeed, *Gheewalla* represents a particularly stark example of an opinion that oscillates between depicting directors' duties as running primarily to the corporation and primarily to shareholders. *Compare id.* at 101 ("It is well settled that directors owe fiduciary duties to the corporation."), *with id.* at 100 ("The directors of Delaware corporations have 'the legal responsibility to manage the business of a corporation for the benefit of its shareholders owners.'").

<sup>38</sup> *Compare* Willett (2009) (arguing that the "necessary consequence of *Gheewalla*, construed in light of other relevant authorities, is that where a business strategy may generate a return for equity holders, the board must favor that strategy and reject alternatives"), *with* Fletcher et al. (2008) § 1035.60, at 32 n.8 (noting that after *Gheewalla*, Delaware was among jurisdictions that "hold[s] that duties at or near insolvency are owed both to shareholders and creditors").

[W]hile tolerably clear in the abstract and sometimes in real-world settings, the enterprise value standard ultimately complicates rather than simplifies the difficult judgments faced by directors acting under conditions of uncertainty. . . . The enterprise value standard compounds the number of valuation alternatives that must be solved simultaneously and the resulting multivariate fiduciary calculus quickly devolves into the equitable equivalent of a constituency statute with a concomitant decline in accountability.<sup>39</sup>

The concern is closely tied to the same considerations that underlie the business judgement rule. Ultimately, courts are poorly positioned to assess and trade off competing claims made by different corporate constituencies or to evaluate the time horizon over which to maximize firm value. They must therefore accord corporate managers some deference in how to go about pursuing the corporate objective (whatever it is). But in so doing, courts run the risk of giving directors unbridled discretion over the corporation. It is this desire to hold directors accountable (at least sometimes) that makes shareholder wealth maximization so enticing for courts. As stated in the same Chancery Court opinion, “absent the shareholder wealth maximization norm, the board would lack a determinate metric for assessing options.”<sup>40</sup>

Within Delaware, courts’ steadfast articulation of fiduciary duties as running to both the corporation and its shareholders provides an element of cover for resolving these potentially conflicting objectives. When confronted with a suspect board decision not deserving of the business judgment rule (e.g., due to director conflicts-of-interest), the articulation of director duties as running to shareholders provides a ready yardstick for evaluating board decision-making. In contrast, when confronted with a board decision reflecting good faith deliberation, the articulation of these duties as running to the corporation provides a basis for deferring to the board’s claims that they are maximizing firm value. In short, just as courts oscillate between scrutinizing and deferring to managerial decision-making, they oscillate between defining director duties as running to shareholders and to the corporation.

We close this discussion with two observations. First, notwithstanding longstanding judicial equivocation about corporate purpose, courts (especially Delaware courts) have been far less hesitant in indicating that, absent special provisions in a company’s charter, the corporate maximand should at least involve some form of profit maximization. This vision appears clearly in the Delaware Chancery Court’s 2010 opinion in *eBay v. Craigslist*. There, the Chancery Court was asked to determine whether the founders of Craigslist could dilute eBay’s ownership interest in the company in the name of preserving a corporate culture that explicitly avoided maximizing corporate profits. According to Chancellor Chandler:

Having chosen a for-profit corporate form, the Craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders. . . . Thus, I cannot accept as valid . . . a corporate policy that specifically, clearly, and admittedly seeks *not* to maximize the economic value of a for-profit Delaware corporation for the benefit of its stockholders.<sup>41</sup>

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<sup>39</sup> *In re Trados, Inc.*, 73 A.3d 17, 41 n.16 (Del. Ch. 2013). The reference to a “constituency statute” refers to the fact that several states outside Delaware have promulgated statutes that grant boards the immutable right to account for a variety of non-shareholder interests -- such as employees’, debt holders, and even surrounding communities -- in discharging their fiduciary obligations. In such states, it is often difficult to tell what managerial actions fail to serve at least some allowed constituency’s interests, thereby making managerial accountability all the more challenging.

<sup>40</sup> *Id.*

<sup>41</sup> *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 34 (Del. Ch. 2010) (emphasis in original).

Individuals who wish to subordinate profit maximization to other goals should accordingly look to non-corporate forms of organization that are more accommodating of these objectives such as the non-profit corporation and, more recently, the Benefit Corporation.

Second, whatever value courts see in shareholder wealth maximization as a “determinate metric” for evaluating board behavior, they have also acknowledged the havoc this metric is capable of wreaking with regard to allocational efficiency. As the residual claimant in a firm’s cash flows, shareholders’ preference for volatility will mimic that of a holder of a call option on the company’s assets. As a result, shareholders will prefer inefficiently high-risk strategies as a firm nears financial distress, resulting in a wealth transfer from creditors to shareholders as shareholders gamble with creditors’ money. It is for this reason that cases generally restrict references to shareholder wealth maximization to solvent firms and instruct directors of insolvent firms to focus on the welfare of creditors as the new residual claimants of the firm. As stated by one court, “when the firm is insolvent, directors are free to pursue value maximizing strategies, while recognizing that the firm’s creditors have become its residual claimants and the advancement of their best interests has become the firm’s principal objective.”<sup>42</sup>

By confining this “fiduciary shift” to insolvent firms, however, courts leave open the possibility for shareholder wealth maximization to cause mischief in solvent firms. Most notably, where a struggling company’s capital structure includes multiple layers of equity, common stockholders (who represent the most junior claimants) will want the board to gamble with the company’s remaining capital at the expense of the senior claimants, just as in an insolvent firm. To be sure, the business judgment rule should ordinarily protect a board’s decision to refrain from this gamble, thereby averting the risk that a court will evaluate the board’s conduct according to the “determinate metric” of shareholder wealth maximization. But what if the board itself represents the interests of the senior stockholders, thus losing the deferential treatment of the business judgment rule and inducing a court to scrutinize the board’s decision-making? In such a setting, even if the board is seeking the maximization of firm value, might a court require a board to maximize shareholder welfare over corporate value? As we discuss below, recent Delaware case law suggests the answer may very well be yes.

## IV. The Corporate Governance Toolbox

As should be clear from the preceding sections, the governance of a corporation is fundamentally a question about the decision-making that occurs within a corporation’s board of directors. This authority flows directly from state corporate statutes. In Delaware, for instance, Section 141(a) provides that the “business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors...” As a default matter, the board of directors is therefore the situs of all power over the corporation, ensuring that control of the board will be the axis over which governance disputes are fought.

While state corporate statutes envision the board as having general authority for running the corporation, it is important to keep in mind two considerations. First, a board will generally delegate much of this authority to other organizational bodies and individuals. Second, the board may need to seek shareholder approval for certain corporate actions. As we argue in this section, understanding how corporate governance

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<sup>42</sup> *Trenwick, America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 175 (Del. Ch. 2006).

works from a legal perspective requires an understanding of how and when boards can delegate their authority, as well as how and when shareholders can exert their oversight. We consider each in turn.

## Board Delegation of Authority

In addition to wielding managerial power directly, corporate boards are also able to delegate, such as by forming committees within the board consisting of one or more directors to undertake particular functions. For instance, boards frequently form a compensation committee to which the board delegates authority for setting the compensation of officers and for authorizing the issuance of any equity compensation to individual employees. A board can also form special *ad hoc* committees to address particular matters as they arise. For instance, a board may create a special litigation committee of disinterested directors to investigate and determine whether the prosecution of a derivative claim is in the best interests of the company.

While committees are strictly optional, exchange listing requirements commonly require a company to form specific committees in order to list its securities on the venue. Companies that choose to list on the New York Stock Exchange (NYSE), for instance, must have an audit committee (responsible for overseeing a company's financial reporting and annual audit), a nominating committee (responsible for nominating directors to the board each year and evaluating director performance), and a compensation committee. In contrast, for companies that seek a Nasdaq listing, a company need only have an audit committee. For any of these required committees, NYSE and Nasdaq listing requirements require the committee to consist entirely of directors meeting an "independence" requirement, eliminating (most importantly) any director who is also an employee of the company.<sup>43</sup> (These independence requirements are largely a product of the Sarbanes-Oxley Act (SOX), which sought to increase the influence of independent directors on the boards of publicly traded firms. SOX effected this reform by requiring exchanges to modify their listing standards to require that a majority of a company's directors consist of independent directors and that every company have an independent audit committee, discussed below.)

Boards also delegate their authority over the day-to-day operations of the company to various executive officers who, in turn, are vested with the authority to delegate their power to lower-level employees. In general, the board will authorize the creation of specific executive officers (e.g., a president to serve as chief executive officer) by resolution or within the by-laws of the company, leaving the creation and appointment of other company officers to these officers' discretion. As such, while boards formally hold authority over all aspects of a company's operations, boards exercise this power largely through their ability to hire, monitor, and discipline senior management. Moreover, despite this delegation, boards continue to have the authority over the business and affairs of the company and remain free to exercise this power through a board resolution directing the company to take a specific action.

Although a board will typically delegate general management authority to a president as chief executive officer, the board must retain sole authority over certain corporate actions. At a minimum, these will include certain "fundamental" corporate actions that require board approval under state corporate statutes. For instance, these statutes generally require board approval (and shareholder approval, as discussed below) for, among other things, a merger, liquidation, or amendment of a company's charter. However, board approval can also be reserved for other corporate actions on a firm-by-firm basis. Such limitations on an officer's power will customarily be set forth in a company's by-laws. By default, actions requiring board approval

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<sup>43</sup> For Nasdaq-listed companies, if a board chooses to form a compensation or nominating committee, Nasdaq listing requirements require these committees to be composed entirely of independent directors.

under state corporate statutes require the approval of a simple majority of the board. However, as noted previously, where the corporate action in question financially benefits a director, obtaining the approval of a majority of non-conflicted directors can help ensure that a court will apply the business judgment rule if petitioned to review the board's conduct. Finally, procedural rules regarding how a board makes decisions (e.g., quorum rules, required notices, authority to call a meeting, ability to act by written consent, etc.) are generally set forth in the company's by-laws (also discussed below).

## Shareholder Voting Rules

While boards hold general authority over a company's business and affairs, the exercise of this authority is limited by several shareholder rights. As noted in Section 2, one of these rights is the ability to sue the company (and even individual directors) for breaching their fiduciary duties to the corporation. Another, however, is through direct governance power: i.e., the ability to exercise voting rights in two domains: (1) the election of directors and (2) the approval of certain corporate actions.

With respect to the election of directors, state corporate statutes generally require companies to hold an annual shareholder meeting at which directors will be elected to the board.<sup>44</sup> By default, this requirement means that shareholders have the right once a year to elect or replace all directors. However, state corporate statutes generally permit boards to be divided into classes such that only one class of directors is elected at each annual meeting, so long as the classification is made in the company's charter or a bylaw adopted by shareholders. In Delaware, for instance, DGCL Section 141(d) permits a company to divide its directors into a maximum of three classes. Should a Delaware company create three classes of directors, shareholders will be allowed to elect or replace just one-third of the board each year; replacing the whole board would accordingly take three years if pursued by means of the annual shareholder meeting.

In addition to electing directors, shareholders are also entitled to vote on a limited number of corporate actions as specified in either a company's charter or the state corporate statute. For Delaware companies, the DGCL requires that the following actions be approved through a board resolution followed by a shareholder vote:

1. Amending or changing the corporation's charter (§242)
2. Selling all or substantially all of the corporation's assets (§ 271)
3. Merging or consolidating with another corporation (§ 251)
4. Dissolving the corporation (§ 275)

Notably, because the DGCL requires classification of the board to occur by means of an amendment to the Certificate of Incorporation or a shareholder-approved by-law, the foregoing approval rights enable shareholders to veto any proposal to create a classified board.

In addition to having shareholders approve certain actions proposed by the board, a company's charter or the state corporate statute can also grant shareholders the power to impose directly on the company certain corporate governance changes. For example, Section 141(k) of the DGCL permits shareholders of

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<sup>44</sup> See, e.g., § 211(b) of the DGCL. In any meeting of shareholders, including its annual meeting, a company will generally establish a "record date" for purposes of determining the shareholders entitled to vote. Under Delaware corporate law, the record date must be no more than 60 nor no fewer than 10 days before the meeting date. See DGCL § 213. Likewise, state corporate law (and often, a company's bylaws) will require companies to provide adequate notice of any shareholder meeting to all persons holding shares in the company as of the record date. In Delaware, the DGCL requires notice of any shareholder meeting be provided not more than 60 nor fewer than 10 days prior to the meeting. DGCL § 222.

Delaware companies to remove any director or the entire board either with or without cause, provided the board is not classified. For a classified board, this removal power is limited to removals for cause—a standard that Delaware courts have made extremely difficult for shareholders to meet.

Additionally, Section 109 of the DGCL also grants shareholders the power to amend or repeal any bylaws. As noted above, a company's bylaws (like a company's charter) set forth various rules that govern the conduct of a company, such as the number of directors, the authority of specific officers, and the procedural rules that govern decision-making by directors and shareholders.<sup>45</sup> Under the DGCL, a company may in its charter grant the board the authority to make unilateral changes to the bylaws, which companies typically do as it allows the board flexibility to modify select operating rules as circumstances change. The fact that shareholders always retain the right to change or repeal bylaws places a check on this authority, and it also allows shareholders to initiate governance reform absent board support.<sup>46</sup>

Despite these default voting rights, it would be a mistake to view shareholder voting as approaching anything like a fully engaged direct democracy. For one, the very ability to exercise these rights will depend on procedural rules in both the company's bylaws and the state corporate statute governing shareholder voting. While companies are required to hold an annual meeting for purposes of electing directors, a company will generally restrict business at that meeting to any agenda items that the board specifies in a notice given to shareholders in advance of the meeting.<sup>47</sup> And while Section 211 of the DGCL permits special meetings of shareholders, it limits the right to call such a meeting to the board unless otherwise provided in the charter or the bylaws (although some states, such as California, provide an absolute right to call these meetings for shareholders holding a specified percentage of voting power). Finally, while shareholders may generally act by written consent in lieu of a meeting, a company's charter can prohibit this form of shareholder voting, something commonly done among publicly traded firms.

Shareholder voting also departs from ordinary conceptions of direct democracy through the specific way in which voting power is allocated across shareholders. By default, only holders of a company's common stock are entitled to vote, with each holder being entitled to one vote per share held. However, corporations can and do opt out of this default arrangement through the authorization in their charters of equity securities having different voting rights, including no voting rights at all.<sup>48</sup> For example, it is the ability of Delaware companies to grant differential voting rights across equity securities provided in Section 151(a) of the DGCL

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<sup>45</sup> The choice of whether to include a specific provision within the bylaws or the charter is often dictated by the relevant state corporate statute. For instance, the rights, preference, and privileges of preferred stock (including any voting rights) are required to be set forth in the company's charter, while the number of directors can be set forth in either the charter or the bylaws. Because companies generally allow directors to amend bylaws unilaterally, the decision to include a provision in the bylaws rather than the charter might also be informed by whether the board should have flexibility to modify the rule without having to first consult the company's shareholders, as is required for a charter amendment. For the same reasons, a provision that shareholders seek to make "sticky" may be placed in the charter given that shareholder approval will always be required to modify it. Bylaws, unlike the charter, are also not required to be filed publicly in the state of incorporation.

<sup>46</sup> For instance, shareholders in recent years have occasionally forced companies to adopt so-called "majority voting bylaws" through shareholders-initiated voting campaigns. Under such bylaws, a nominee to the board typically can only be elected if more shares are voted for than withheld from the director's election. Section 216 of the DGCL provides that *shareholders-adopted* majority voting bylaws cannot be further amended by directors without shareholder approval.

<sup>47</sup> For those companies subject to the federal proxy rules, Rule 14a-8 may require the board to include certain shareholder proposals. We discuss Rule 14a-8 in the next subsection.

<sup>48</sup> A company must authorize any class of equity security (or any series within a class of a security) by an amendment to its charter, which must also specify the rights, preferences, and privileges of the security. The requirement that all shares of stock be authorized in the charter means any such authorization must be approved by both the board and shareholders. In addition, corporate statutes may also allow a company to bestow voting rights on other securities. For instance, DGCL § 221 permits a company's charter to confer voting rights on "the holders of any bonds, debentures or other obligations."

that has given rise to the controversial use of “super-voting” stock at companies such as Facebook. Holders of Facebook’s Class A Common Stock (including individuals who purchased in Facebook’s IPO) have one vote per share while holders of Class B Common Stock (including Facebook founder Mark Zuckerberg) have 10 votes per share. Moreover, even within a class of stock, companies may grant senior voting rights to particular shareholders based on, for example, the length of time the shareholder has held the security.<sup>49</sup>

In addition to granting certain securities (or even shareholders) favorable voting rights, a company’s charter can also require the affirmative approval of specific classes of security before the company undertakes certain actions. Likewise, the charter can also set the specific voting threshold required for any shareholder approval that might be required by either the charter or state corporate law. For example, as discussed below, we observe within the venture capital industry the common practice of companies issuing VC investors shares of preferred stock that not only carry voting rights (which itself constitutes a departure from the default voting rule for preferred stock) but also come with specific class veto rights over the company’s merger or sale, the incurrence of debt, and the issuance of additional preferred stock, among other things. Class veto rights can also arise by operation of state corporate law. For instance, Section 242(b) of the DGCL requires that any amendment to a company’s charter that adversely affects the rights of a specific class of stock receive the affirmative vote of a majority of the outstanding voting power of that class. Section 1201 of the California Corporations Code similarly requires a separate class vote on any merger or corporate reorganization.<sup>50</sup>

Finally, in addition to allowing for voting securities that have different levels of voting power, corporate law allows individual shareholders to acquire additional voting power through two other routes. First, in contrast to political democracy, shareholders are generally permitted to enter into binding voting agreements or voting trusts whereby they commit to vote their shares in favor of specified corporate actions or for specified directors.<sup>51</sup> For example, several shareholders may enter into a voting agreement that requires all signatories to vote their shares in favor of a director nominated by a particular individual or in favor of a specific corporate action proposed by one or more shareholders. State corporate law also allows a shareholder to confer on an individual (e.g., the chairman of the board of directors) the power to vote by proxy all shares held by that shareholder, which forms the basis of the proxy solicitation system that we discuss below.

Second, state corporate law or a company’s charter may also grant shareholders the right to “cumulate” votes in the election of directors. If applicable, the total number of votes a shareholder may cast in an election is determined by multiplying (a) the total number of directors who are standing for election by (b) the product of the number of shares held by the shareholder and the number of votes each of these shares is entitled to receive. In effect, the system amplifies the voting power of a single shareholder to the extent she chooses to cast all of her votes for a single director, thus increasing the voting power of small shareholders.

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<sup>49</sup> In Delaware, a company must place such a “tenured” voting provision in its charter. Delaware courts approved this form of shareholder favoritism in *Williams v. Geier* 671 A.2d 1368 (Del. 1996).

<sup>50</sup> In the absence of a state corporate law or a charter provision requiring a class vote, shareholders will generally vote as a single class of shareholders based on the voting power of the securities they hold. In the case of Facebook, for example, any shares of Class A Common Stock will be given 1 vote per share while any shares of Class B Common Stock will be given 10 votes per share.

<sup>51</sup> See, e.g., Section 212 of the DGCL.



In Delaware, cumulative voting applies only if specified in a company's charter, although cumulative voting is mandatory in other states such as California.<sup>52</sup>

### Shareholder Inspection Rights

A governance tool that shareholders also have at their disposal—one that adds discernible heft to their otherwise limited set of oversight rights—is the prerogative to inspect certain corporate governance documents. The inspection right dates back centuries in the common law,<sup>53</sup> but for Delaware corporations it is now codified in Section 220 of the Delaware code. Under this section, shareholders are permitted—upon five days' advance notice—to demand access to both (i) the shareholder list and (ii) the internal books and records of the corporation (such as board minutes, resolutions, and even e-mails). For either type of request, eligibility requires that the shareholder have a proper purpose, defined (somewhat cryptically) as one that is reasonably related to her interests as a shareholder.<sup>54</sup> Shareholders are generally presumed to have a proper purpose when requesting access to the shareholder list, but they must affirmatively demonstrate a “credible basis” for their request when demanding books and records. Such evidence might pertain (inter alia) to possible misconduct of corporate fiduciaries, mismanagement, and director/officer suitability. In either case, the corporation can justifiably deny access if it can demonstrate that the shareholder's purpose in requesting access—while facially valid as stated—was actually improper. In addition, the board can place limitations on shareholder access if needed to protect confidential board communications (e.g., ones that may be subject to attorney-client privilege).

Shareholder inspection demands have become significantly more common of late, and they are common strategies both of aspiring plaintiffs in shareholder litigation and activists seeking to challenge the company's management team. Overall, courts have proven somewhat accommodating to shareholder inspection demands and the evidence required to demonstrate a proper purpose. Nevertheless, on occasion shareholders have been denied access to a company's books and records when the request appears to be little more than a fishing expedition premised on unfounded suspicions.<sup>55</sup>

### Shareholder Voting Mechanics in Public Companies

The extent to which shareholders can influence corporate governance is also shaped in important ways by whether a company is public or private. Shareholders in publicly traded companies, whose shares may be held by hundreds or thousands of shareholders, naturally face a greater collective action problem than shareholders in a private firm whose stock ledger is likely to be much smaller and whose shareholders may know one another (or at least know one another's identities). For public companies tasked with holding an annual election of directors, the dispersion of stock ownership also raises the challenge of obtaining a sufficient number of shareholders to attend the meeting to satisfy the quorum requirement in a company's bylaws. Public companies solve this dilemma by requesting from each shareholder a written authorization appointing an individual (such as the Chairman of the Board) as the shareholder's proxy with the authority to vote on her behalf at the shareholder's meeting. The proxy, if submitted, instructs the holder of the proxy to

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<sup>52</sup> See Cal. Corp. Code § 301.5. California Corporations cease being subject to cumulative voting once a company is listed on a national securities exchange. Notably, this provision can apply to corporations incorporated outside of California due to Cal. Corp. Code § 2115 (California's “long-arm” statute described in note 7).

<sup>53</sup> *Dominus Rex v. The Fraternity of Hostmen in New Castle Upon Tyne*, 25 Str. 123, 93 Eng. Rep. 144 (K.B. 1745).

<sup>54</sup> See generally *City of Westland Police & Fire Retirement System v. Axcelis*, 1 A.3d 281 (Del. 2010).

<sup>55</sup> See, e.g., *Haque v. Tesla Motors, Inc.*, CA 12651-VCS (Del. Ch. February 2, 2017) (denying inspection rights to shareholder raising unsubstantiated suspicions of softness in demand for company's products).



vote for the director nominees that are being proposed by the board of directors, as well as for any other matters proposed by the board and which are described in the proxy solicitation materials.

For most public companies, the solicitation of proxies also triggers application of the federal proxy rules.<sup>56</sup> In general, the proxy rules seek to ensure that shareholder voting is conducted on an informed basis by requiring the filing with the SEC of a proxy solicitation statement that must contain a range of mandatory disclosures regarding the subject matter of the proposed vote and other items the SEC views as relevant for an informed vote. The federal proxy rules also provide for federal antifraud liability for any materially misleading statements or omissions in the proxy solicitation materials.

The federal proxy rules also regulate the extent to which a company can identify—and as a result, engage with—particular shareholders. To facilitate trading and clearing of securities, shareholders of public companies generally hold their shares indirectly, which further complicates a company’s ability to identify its shareholders at any given time. Under this system, the majority of a company’s outstanding shares are held directly by the Depository Trust Company (DTC), which holds them as a nominee for its participants who consist of hundreds of broker-dealers, banks, and other securities intermediaries. When a customer of one of these participants chooses to acquire a company’s stock, the participant firm makes an appropriate book entry in its account at DTC and becomes responsible for distributing all proxy materials to its customer. The participant must also vote these shares in accordance with any voting instructions provided by its customer. While the system facilitates clearing and trading, it complicates a company’s ability to identify its shareholders given that the ownership records available to a company from DTC will reflect the “Wall Street” firms at DTC whose customers hold an investment position but not the names of their customers who are the actual beneficial owners of the company’s stock. It is for this reason that shareholders of public companies are said to hold their shares in “street name.” While DTC participants must disclose the identity of these beneficial owners to a company who requests them, the proxy rules give shareholders the right to remain anonymous, further complicating a company’s efforts to communicate with its shareholders.<sup>57</sup> Moreover, when a shareholder demands access to the company’s shareholder list (see discussion above), Delaware law requires the list of record owners be produced, but does *not* require production of the list of non-objecting beneficial owners unless one is already in existence.

Public companies that solicit proxies must also contend with a greater likelihood of encountering voter apathy. When a broker fails to receive instructions from a customer who holds shares in street name, rules of the NYSE govern whether a broker is entitled to vote the customer’s shares in whatever way she sees fit.<sup>58</sup> Historically, the NYSE allowed brokers to vote uninstructed shares on a variety of corporate governance matters, including the election of directors. In recent years, however, the NYSE has scaled back the instances when brokers can vote these shares; at present, NYSE Rule 452 permits brokers to vote uninstructed shares

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<sup>56</sup> The proxy rules apply to any company that has securities that are registered under Section 12 of the Exchange Act, which limits their application to companies that are listed on a national stock exchange and companies who are required to register with the SEC because they have more than 2,000 stockholders of record and more than \$10 million in assets.

<sup>57</sup> The list of beneficial owners that a company receives from DTC will therefore reflect the information of non-objecting beneficial owners, or “NOBOs.” For certain stockholders, other aspects of the federal securities laws might allow a company to discern their identity. For example, Sections 13(d) and 13(g) of the Exchange Act may require a shareholder to disclose publicly with the SEC its ownership position in a company if it holds more than 5% of the company’s outstanding voting securities. Likewise, under Section 13(f) of the Exchange Act, institutional investment managers having investment discretion over investment accounts valued at \$100 million or more have an obligation each quarter to disclose publicly with the SEC the manager’s investment positions in individual securities, subject to certain exceptions.

<sup>58</sup> Broker voting is governed by the exchange where the broker is a member; as almost all brokers are members of the NYSE, the NYSE Rules govern the vast majority of broker voting in companies.

only on proposals that are “routine.” In general, a proposal is routine if it is uncontested and does not fall into an itemized list of matters including, among other things, the election of directors and proposals relating to significant corporate transactions. Where a broker is unable to vote uninstructed shares, the shares are classified as “broker non-votes,” which—depending on state law—may be regarded as a vote against a proposal. Hirst (2017) finds that the rising incidence of broker non-votes in recent years has made it more difficult for companies to obtain sufficient shareholder approval of charter amendments.

All of these challenges arising from the solicitation of shareholders of public firms are also faced by shareholders seeking to exercise unilaterally their shareholder voting rights. As a result, the challenges can impose considerable costs on shareholders hoping to use these rights to effect corporate change. Because the proxy materials distributed for an annual meeting are prepared by the board of directors, a dissident shareholder must prepare her own proxy solicitation materials if she wants to remove a director and/or nominate a rival slate of individuals. Moreover, the federal proxy rules apply to any “proxy solicitation,” so the dissident shareholder must also comply with the numerous mandatory disclosure obligations and the risk of an anti-fraud lawsuit by a company’s management. The SEC’s interpretation of “proxy solicitation” is also broad enough to capture not only a formal proxy solicitation but also less formal communications among investors about how investors will vote. Even outside a proxy fight, shareholders may therefore be reluctant to engage with one another for fear of triggering the proxy rules, although Rule 14a-2(b)(2) generally exempts solicitations of 10 or fewer shareholders.<sup>59</sup>

As with the company, a dissent shareholder undertaking a proxy fight must also contend with the challenge of identifying a company’s beneficial owners; however, the challenge is diminished somewhat by Rule 14a-7, which requires the corporation either (i) to mail the security holder’s soliciting materials to all shareholders, or (ii) to provide a security holder with a list consisting of all shareholders of record.<sup>60</sup> Any reasonable costs incurred by the company, however, can be recouped by it from the shareholder. Finally, while the costs of any soliciting materials produced by the company in response to a proxy fight will be paid by the company, state corporate law allows a company to reimburse the expenses of the dissident shareholder only if she prevails in the proxy fight and the company’s shareholders authorize the reimbursement.<sup>61</sup>

As an alternative to a proxy fight, a shareholder of a public company may also seek to use Rule 14a-8 to place a shareholder-initiated proposal on the agenda of a shareholder meeting that has been called by the board of directors. In general, Rule 14a-8 allows shareholders to piggyback on the company’s proxy solicitation materials when the company solicits proxies for the shareholder meeting. If a shareholder meets certain eligibility requirements (most notably, having been a record holder of at least \$2,000 worth of securities for one year) and if she makes a proposal that meets certain substantive requirements, the company must include the proposal in its proxy solicitation materials. Among other things, these substantive limitations prohibit shareholders from using the rule to nominate their own slate of directors, propose a merger, or propose an action which pertains to certain subject matter areas. Reflecting the centrality of the board in managing the corporation, this last category includes any proposals that are “not a proper subject for action by shareholders” under state law. Not surprisingly, many of the governance reforms of interest to shareholders (such as redeeming a poison pill and de-staggering a board of directors) have been successfully

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<sup>59</sup> Various types of proxy advisory firms, such as ISS and Glass Lewis, have come to represent a type of clearinghouse for such communications, a factor that likely reduces some of this liability risk.

<sup>60</sup> The company has the right to choose among these two options. To avoid providing an insurgent shareholder with the NOBO list, a company’s management will generally choose to distribute the insurgents’ materials to the company’s shareholders.

<sup>61</sup> See, e.g., *Steinberg v. Adams*, 90 F. Supp. 604, 608 (S.D.N.Y. 1950)

challenged by boards as being off-limits in a Rule 14a-8 proposal. As a result, shareholders seeking to place on the ballot a shareholder-initiated proposal relating to these topics must limit themselves to a non-binding proposal that merely *recommends* a corporation engage in a proposed course of conduct. Notwithstanding the non-binding character of these proposals, shareholders commonly use Rule 14a-8 to include them in a company's proxy materials (See Steel 2017).

Finally, shareholder voting in public companies is also shaped by the fact that both federal law and exchange listing requirements confer on shareholders additional voting rights relative to what they are entitled to receive from state law or the company's charter. For instance, both the NYSE and Nasdaq require the affirmative vote of a company's shareholders before a company can issue 20% or more of its outstanding common stock in a private offering or certain other strategic transactions.<sup>62</sup> Likewise, SEC Rule 14a-21(a) (which was adopted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010) requires companies to conduct an advisory vote of shareholders on the pay packages of top executives at least once every three years. In a similar vein, Rule 14a-21(b) additionally requires companies to conduct a separate shareholder advisory vote once every 6 years to determine how often (every 1, 2 or 3 years) a company will conduct this advisory vote.

## V. Deeper Governance Implications of Private versus Public Firms

In this section, we synthesize the summary of the law and regulation of corporate governance discussed above, revisiting the particularities of private and public firms. While overall governance principles apply equally to both private and public companies, the public/private distinction causes the analysis of corporate governance in these two contexts to differ in subtle but critical ways. We discuss several of these differences below. Our aim is to provide an overview of the governance “architecture” of these two types of companies and how these governance systems are used to allocate control over a company's assets.

### Private Companies

For the researcher of private companies, corporate governance reflects in many ways what one would expect from the literature on incomplete contracting.<sup>63</sup> Consider, for instance, Founder A and Founder B who start a company and who both plan to exert value-adding efforts and make relationship-specific investments in the firm. Even in this simple firm, each founder faces a double-sided moral hazard problem insofar that each can exert sub-optimal effort (e.g., shirk) or seek to expropriate wealth from the other. Similar risks confront the Investor who agrees to contribute capital to the enterprise.

Faced with these challenges, participants in a private firm will accordingly turn to contract to address the monitoring and bonding considerations noted by Jensen & Meckling (1976), resulting in a firm governance structure that will be largely determined by private ordering. For instance, Founders will agree to assign all business assets to the firm (thus weakening the ability to expropriate them), determine a split of cash flows and ownership claims, and commit to a buy-sell agreement giving one another a right of first refusal on any attempts to dispose of the firm's ownership claims. Meanwhile, the Investor will seek agreements with the Founders that bind the Founders to the firm (e.g., through imposing stock vesting requirements or non-competition agreements), that grant the Investor select veto rights over certain corporate behavior (e.g., a sale

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<sup>62</sup> See, e.g., Nasdaq Rule 5635(d) and NYSE Rule 713(a).

<sup>63</sup> The analysis in this subsection tracks Bartlett (2015).

of the business), and that provide the Investor with information rights so that the Investor can stay apprised of the company's affairs.

Because of transaction costs, bounded rationality, and non-verifiable information, however, it is well known that these contracts will fail to address every possible contingency (Aghion & Holden, 2011). As such, contract renegotiation may be required as the future unfolds. For instance, what if Founder A's contribution to the company (e.g., a business plan or other intellectual property) turns out to be worthless? What if development costs exceed expectations, requiring an additional infusion of outside capital? While the Coase Theorem suggests such *ex post* renegotiation should result in efficient outcomes if transaction costs are sufficiently low, a problem arises in that the party holding residual control rights over the firm's assets might hold up the other parties or otherwise engage in rent-seeking in the course of bargaining (e.g., Founder A may demand a king's ransom to leave the company.) Among other things, this behavior might thwart an efficient renegotiation from occurring or produce *ex ante* inefficiencies such as preventing the initial contracts in the first place. As initially set forth by Grossman and Hart (1986), one way parties can address this challenge is through explicit bargaining over who holds these residual control rights. In our hypothetical firm, for instance, one might imagine that Founder A, Founder B, and Investor agree that all residual discretion over the company's affairs—including the ability to terminate participants—shall be governed by majority vote.

While this basic framework goes a long way in summarizing how a private firm organizes its governance, it is important to emphasize that the decision to organize a firm as a particular legal entity adds a number of complications for understanding how private firms are governed in the real world. To begin, organization of a firm will entail selecting a legal form of organization that can have significant ramifications on the extent to which a firm's governance structure will be a product of private ordering. For instance, as discussed previously, organizing a firm as a corporation will subject the firm to a variety of default and mandatory terms that will affect firm governance.<sup>64</sup> Most importantly, these include the mandatory term that the business and affairs be vested in a company's board of directors who are subject to mandatory fiduciary duties to the corporation. While this organizational requirement allows parties a clear understanding of where to locate a company's control rights, it also means that the directors holding this power must exercise it in compliance with their fiduciary duties which might distort *ex post* renegotiation, as we discuss below.

An additional threshold challenge for understanding a private company's private ordering of governance concerns the difficulty of simply locating the contracts that undergird it. In contrast to public companies that are subject to Exchange Act reporting requirements, there is generally no obligation to file for public consumption a private company's material agreements. At the same time, a firm that chooses to incorporate as a company will find that many of these "contract" provisions will be contained within a company's organizational documents, some of which will be publicly available. But even when a particular governance provision is discovered, caution is required in assessing how it functions within the overall firm structure.

For instance, a stockholder seeking to obtain special veto rights over specified corporate actions (e.g., acquiring another firm, changing its primary line of business, incurring indebtedness, etc.) would be well-

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<sup>64</sup> In this regard, organizing as a corporation limits the extent to which a firm's participants can engage in private ordering, particularly in light of the existence of mandatory fiduciary duties. Other organizational forms can be used to achieve a "purer" form of private ordering. For instance, under Delaware law, members of a limited liability company (LLC) can opt-out of all default rules (including fiduciary duties that members might owe to one another). See, e.g., *Hite Hedge LP v. El Paso Corp.*, 2012 WL 4788658 (Del. Ch. Oct. 9, 2012).

advised to include this right as a specific provision within the Company's Certificate of Incorporation, which must be filed publicly in the state of incorporation. While a company can bind itself to a stockholder in this fashion through a simple contract, including this obligation within the charter enhances the likelihood it will be honored given that any inconsistency with the company's charter would nullify a contractual right (and with it the basis for legal relief). In contrast, a company's liability for breach of contract will often result in monetary damages, which effectively give the company the option to buy itself out of compliance. It is for this reason that the Model Certificate of Incorporation published by the National Venture Capital Association includes a variety of governance provisions typically demanded by venture capitalists when investing in private companies. These include, among other things, stockholder veto rights over specified corporate actions and the right to designate a specific number of directors.<sup>65</sup>

However, although a company's Certificate of Incorporation must be filed publicly in the state of incorporation, it would be a mistake to assume that a company's charter defines its full governance structure. In the venture capital context, for instance, understanding the full contractual governance structure would also require analysis of the company's Voting Agreement (which specifies how any board seats allocated to a class of directors by the Certificate of Incorporation are appointed among investors and founders), an Investor Rights Agreement (which specifies investor monitoring rights), and the company's bylaws (which, as discussed previously, specify board voting protocols and, often, the board size)—none of which are required to be publicly available.

In addition to the problem of accessing contracts, analysis of governance in private firms requires consideration of two additional factors that distinguish real world governance from what one might expect in a world of pure private ordering. Both relate to the fact that an individual's effort to influence company governance through either a negotiated contract right or through her presence on the company's board of directors is subject to judicial constraints that may undermine a party's *ex ante* expectations.

With respect to negotiated contract rights, a variety of doctrines can potentially undermine a negotiated contract provision where a company has granted a particular class of investors specific governance rights. Perhaps the best-known example relates to governance rights held by preferred stock investors—a class of investors in private companies that is especially common in the venture capital and private equity contexts (Kaplan & Strömberg 2003). In several cases, the Delaware courts have refused to honor what appear to be fairly clear contractual commitments by a company to refrain from certain conduct without first obtaining the approval of a specific class of preferred stockholders.

For example, in *Benchmark Capital v. Vague*,<sup>66</sup> a prominent venture capital investor (Benchmark) had invested in the Series B Preferred Stock of Juniper Financial. As part of the financing, Juniper's charter was amended to require a class vote by the Series B Preferred Stock before the company could authorize or issue any senior equity security. Notwithstanding this provision, when the company sought to raise additional financing several years later, it successfully found a way to authorize over Benchmark's objection a new class of Series D Preferred Stock having a senior liquidation preference. In short, Juniper's successful strategy focused on the fact that Benchmark had neglected to secure a veto right over a merger of Juniper *with a subsidiary*, allowing Juniper to form a subsidiary, which it then merged into itself. Under Section 251 of the

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<sup>65</sup> See Nat'l Venture Capital Ass'n, NVCA Model Restated Certificate of Incorporation, available at <http://nvca.org/download/5059/>.

<sup>66</sup> No. Civ. A. 19719, 2002 WL 1732423 (Del. Ch. July 15, 2002), *aff'd sub nom.* Benchmark Capital Partners IV, L.P. v. Juniper Fin. Corp., 822 A.2d 396 (Del. 2003).

DGCL, Juniper's merger allowed the company to amend its Certificate of Incorporation to authorize the Series D Preferred Stock and remove the Series B veto rights, notwithstanding the fact that the Series B Preferred had a *separate* veto right over ordinary amendments to the company's charter that adversely affected the rights of the Series B.

In approving the transaction, the Delaware Chancery Court held that Benchmark had secured a veto over amendments done in accordance with one provision of the DGCL (i.e., Section 242, which generally governs how companies can amend their charters), but it refused to assume this meant it had veto rights over amendments done in connection with a merger (which occurred by virtue of Section 251 of the DGCL) without express language to this effect. According to the court, as preferred stockholders, all rights must be clearly articulated and not presumed, underscoring how governance rights that are embedded in preferred stock provisions can be narrower than one might otherwise believe.

Legal constraints also limit the extent to which investors in a private company can use the board of directors as a vehicle for mediating conflicts between a company's stakeholders. As noted previously, obtaining representation on a company's board of directors can be a critical means by which a firm's participants retain the power to exercise a company's residual control rights, which will be important as they realize the need to renegotiate their relations over time.<sup>67</sup> Not surprisingly, venture capital and private equity investors commonly insist on board representation notwithstanding the elaborate contract provisions they negotiate to incentivize management and to protect their economic interests.<sup>68</sup>

While this behavior is consistent with economic theory, however, it is important to keep in mind that directors of a corporation are required to exercise their residual control rights in light of the fiduciary duties they owe to the corporation generally. As discussed in Section 2, these duties ensure that directors of corporations refrain from, among other things, absconding with a corporation's property and business opportunities. But they also complicate the standard by which to evaluate a director's conduct when seeking to renegotiate on behalf of an investor. In short, when seeking to advance a specific investor's economic interest, is an investor's designee on the board violating his or her fiduciary duty to the corporation?

As an example, consider the following hypothetical. Assume a VC has invested \$100 in a company controlled by its Founder. The VC's investment is in the form of Preferred Stock having a liquidation preference of \$100 in the event of a liquidation or sale of the firm, after which the VC and the Founder split any remaining proceeds 50/50. At the time of the VC's investment, the Founder and VC agree that the board will consist of the Founder and two designees of the VC.

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<sup>67</sup> To be sure, an investor can obtain leverage in these subsequent renegotiations through demanding in the initial contract a sufficiently broad contractual veto right over company actions. Indeed, this approach is routinely taken by lenders who are often prohibited from sitting on a company's board of directors. From a financial contracting perspective, the choice of whether an investor obtains covenants or director representation to force the company to renegotiate over time is simply a question of whether a security's cash flows justify concentrated oversight and monitoring in anticipation of frequent renegotiation (thus pointing toward director-designees) or only periodic oversight in anticipation of renegotiation upon certain events (thus pointing toward contract covenants) (Bartlett 2015; Erkens, Subramanyam & Zhang 2014).

<sup>68</sup> While a VC might attempt to specify stockholder veto rights over all actions that might raise VC–Founder conflicts, such a financing contract would still offer inadequate protection for the reasons suggested by incomplete contracting theory. At the same time, a common solution to this problem—giving residual control of the firm to VC through allowing it to control the board of directors—will be unacceptable to a Founder. For instance, a Founder may have concerns that VC's senior liquidation preferences will induce it to favor a premature sale of the company or that the Founder's liquidity constraint will allow VC to issue additional securities to VC and not to the Founder, diluting the Founder's economic interest. A compromise solution commonly used in venture capital finance is therefore for VC to share board control with the Founder, often giving a third-party “industry” director a tie-breaking vote in the event of a deadlock. (Broughman 2010).

Imagine that after several years, the company has not performed as expected. It is now in need of additional financing and is unable to secure financing from other investors. At the urging of the VC's director-designees, the company does, however, receive an acquisition offer of \$100. The Founder and the two VC directors all believe that if they continue the firm until it runs out of capital, there is a 50% chance the firm is acquired for \$150 and a 50% chance it is liquidated for \$0. Given the VC's liquidation preference, the director-designees prefer liquidation since the VC would receive \$100 with certainty as opposed to a 50% chance of receiving \$125 and a 50% chance of \$0. The Founder, in contrast, would prefer a 50% chance of receiving \$25 if the firm continues rather than nothing with certainty. What will the directors decide?

In many ways, the situation has played out exactly as one would expect from incomplete contracting theory: Given the challenges facing the company, the VC and Founder will have to renegotiate the destiny of the firm. Coasean calculus suggests liquidation is inevitable: In expectation, continuing the firm produces aggregate value of \$75, while liquidating it produces aggregate value of \$100. Accordingly, while the Founder might try to convince the VC to continue the firm, there is simply insufficient value in the company to strike a restructuring whereby the VC will be incentivized to continue it.

The challenge with this contractual framework arises from the fact that, under corporate law, the VC's director-designees owe a duty of loyalty to the corporation rather than to the VC. However, in approving the liquidation, the director-designees will be approving a transaction in which they may be deemed to have a material economic interest given their relationship with the VC. The legitimacy of the transaction may accordingly depend on whether the board has complied with the procedural safeguards involving conflicted director transactions that are summarized in Section 2. In Delaware, such transactions are permitted if approved by an informed majority of disinterested directors or stockholders, or if the VC's director-designee can otherwise establish that the "transaction is fair as to the corporation as of the time it is authorized, approved, or ratified, by the board of directors. . . ."<sup>69</sup>

In contrast to a purely contractarian governance framework, the ability of a VC to receive its full liquidation preference may therefore hinge on whether it can sustain the burden of demonstrating the fairness of the transaction. While the VC's director-designees may argue they have satisfied this standard by choosing the liquidation because it maximized the value of the firm, a court that believes directors have an obligation to maximize the value of the residual claim may see things differently. As we show below, recent case law suggests our VC's director-designees must take seriously the possibility of continuing the firm in order satisfy their fiduciary obligations to the company. We explore these cases in Section 6.

## Public Companies

While facially subject to similar governance regimes, public companies differ from their private counterparts in at least two important respects. First, because (as noted above) public companies access regulated securities markets, they are subject to a variety of regulations at the federal and exchange level in addition to state corporate law. In essence, these federal and exchange-imposed rules augment (and in some cases, supersede) state corporate law, and in so doing they often introduce governance devices that are unique to public companies. Second, because of the larger number of players (often involving thousands if not millions of shareholders), it is unrealistic to expect that ex ante private contracting (and ex post renegotiation) can play nuanced roles in mediating control rights. In its place, the formal institutions of shareholder

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<sup>69</sup> Del. Code Ann. tit. 8, § 144(a)(3) (2010).

governance tend to play a more prominent role, often interacting in non-trivial ways with the takeover market (at least for widely held public companies). We discuss each of these factors below, in turn.

### Governance Through Securities Regulation<sup>70</sup>

As noted above, securities regulations impose a panoply of different rules of engagement, disclosure or registration obligations, and anti-fraud provisions overlaying corporate law. Most of this regulatory superstructure is geared towards trading markets and not directly connected to corporate governance. For many years, in fact, the acoustic separation between corporate law and securities law was widely accepted.<sup>71</sup> Nevertheless, for much of the last half of the twentieth century, and particularly the first two decades of this century, federal law has increasingly come to encroach on an assortment of corporate governance attributes that historically would have seemed more the province of state law. Much (though not all) of this encroachment was the product of two landmark pieces of legislation (and their implementing regulations): the Sarbanes-Oxley Act of 2002 (“SOX”)<sup>72</sup> and the Dodd-Frank Act of 2010 (“Dodd-Frank”).<sup>73</sup>

The creeping federalization of corporate governance for public companies is multi-dimensional and widely acknowledged (e.g., Romano 2005, Strine 2008, and Talley 2015), drawing the attention of academic commentators, judges and regulators over recent years, along with an often fervid debate about its normative desirability. In some instances, the SOX-Dodd Frank era reforms extended or sharpened pre-existing state law mandates; more often, however, the new rules entered arenas where state law was silent and therefore implicitly permitted flexibility. Regardless of the merits in this debate, however, it is clear that the underlying conceptual model of governance that is imposed on public companies through securities regulation tends to focus on “vertical” relationships, where shareholders are viewed as relatively homogenous in their interests, effectively cabining “horizontal” conflicts of the types described in the previous subsection.

Consider a sampling of the corporate governance mandates that are enshrined in federal securities law, much of which occurred during the last two decades:

- Certification of Financial Statements: Chief executive officers and chief financial officers of U.S. issuers are required to certify the accuracy of the firm’s periodic reports, and are subject to criminal penalties for false certifications.<sup>74</sup>
- Executive Compensation Restrictions: Senior officers and directors are now precluded from receiving many types of loans from their corporations.<sup>75</sup> Moreover, such fiduciaries are now required to make a significantly more complete disclosure of the elements of their executive pay,<sup>76</sup> as well as a clear exposition of the relationship between executive compensation and the issuer’s financial performance.<sup>77</sup> In addition, in the event of an accounting restatement, the CEO and CFO must return to the issuer bonuses, incentives, or equity-based compensation they received prior to the

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<sup>70</sup> This subsection is substantially based on the analysis in Talley (2015).

<sup>71</sup> *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977) (quoting *Cort v. Ash*, 422 U.S. 66, 84 (1975) (emphasis added)).

<sup>72</sup> Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of U.S.C.).

<sup>73</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of U.S.C.).

<sup>74</sup> See *Certification of Disclosure in Companies’ Quarterly and Annual Reports*, 67 Fed. Reg. 57,276, 57,280 (Sept. 9, 2002) (to be codified at 17 C.F.R. §§ 228, 229, 232, 240, 249, 270, and 274).

<sup>75</sup> SOX, Pub. L. No. 107-204, § 403, 116 Stat. 745, 787 (2002) (codified at Securities Exchange Act of 1934 (“Exchange Act”), 15 U.S.C. § 78m(k) (2012)).

<sup>76</sup> See *Executive Compensation and Related Person Disclosure*, 71 Fed. Reg. 53,158, 53,168–70, 53,208–09 (Sept. 8, 2006) (to be codified at 17 C.F.R. §§ 228, 229, 232, 239, 240, 245, 249, and 274).

<sup>77</sup> Dodd-Frank, Pub. L. No. 111-203, § 953, 124 Stat. 1376, 1903 (2010) (codified at Exchange Act, 15 U.S.C. § 78n (2012)).



issuance of the restated financials, along with any profits they realized from the sale of corporate stock during that period.<sup>78</sup> Additional regulations regarding “pay for performance” of CEOs also appear to be in the works at the time this Chapter was written.<sup>79</sup>

- Board & Committee Structure: As discussed previously, all publicly traded U.S. firms were required under SOX to have audit committees composed exclusively of independent directors.<sup>80</sup> Later reforms from the exchanges required majority independence of public companies’ boards,<sup>81</sup> as well as independence of all members of an issuer’s compensation committee (and its advisers), the latter reform required by Dodd-Frank.<sup>82</sup>
- Broker Voting of Shares: As discussed in Section 4, broker-dealers are no longer permitted to vote “uninstructed” shares of beneficial owners who have not submitted proxy instructions related to directorial elections<sup>83</sup> and executive compensation matters.<sup>84</sup>
- Say on Pay: Under Dodd-Frank, issuers are required to conduct a non-binding vote of shareholders no less frequently than once every three years to approve the compensation of a public company’s named executive officers.<sup>85</sup>
- Proxy Access: The SEC was given authority under Dodd-Frank to alter the rules relating to shareholder proxy voting of issuers.<sup>86</sup> Shortly after its passage, the SEC promulgated several proxy access rules related to shareholder proposals and director nominations, although the most potent among them, Rule 14a-11, was subsequently challenged and (controversially) invalidated in the D.C. Circuit.<sup>87</sup> Left intact, however, was a provision explicitly permitting shareholders to propose bylaw amendments that would require granting nomination power to qualifying shareholders.<sup>88</sup>
- CEO/Chair Identities: Public companies are required to disclose whether the same person or different persons hold the positions of CEO and Chairman of the Board.<sup>89</sup>
- Fiduciary Duties: The common law fiduciary obligations imposed on officers, directors and dominant shareholders are a defining characteristic of state corporate law. Even here, however,

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<sup>78</sup> Dodd-Frank, Pub. L. No. 111-203, § 954, 124 Stat. 1376, 1904 (2010) (codified at Exchange Act, 15 U.S.C. § 78j-4(b) (2012)); SOX, Pub. L. No. 107-204, § 304, 116 Stat. 745, 778 (2002) (codified at Exchange Act, 15 U.S.C. § 7243 (2012)).

<sup>79</sup> See, e.g., Sunshine Act Meeting Notice, Sec. and Exchange Commission, (Apr. 22, 2015), <http://www.sec.gov/news/openmeetings/2015/ssamtg042915.htm> (announcing plans to consider a regulation “requiring registrants to disclose in a clear manner the relationship between executive compensation actually paid and the financial performance of the registrant”).

<sup>80</sup> SOX, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775–76 (2002) (codified at Exchange Act, 15 U.S.C. § 78j-1(m) (2012)).

<sup>81</sup> See Order Approving Proposed Rule Changes and Amendments Relating to Corporate Governance, 68 Fed. Reg. 64,154, 64,154–55, 64,175–76 (Nov. 12, 2003).

<sup>82</sup> 17 C.F.R. § 240.10C-1(b) (2014); see Listing Standards for Compensation Committees, 77 Fed. Reg. 38,422, 38,428 (June 27, 2012) (to be codified at 17 C.F.R. §§ 229 and 240).

<sup>83</sup> Order Approving Proposed Rule Change, as Modified by Amendment No. 4, to Amend NYSE Rule 452 and Corresponding Listed Company Manual Section 402.08 to Eliminate Broker Discretionary Voting for the Election of Directors, 74 Fed. Reg. 33,293, 33,293 (July 1, 2009).

<sup>84</sup> Notice of Filing and Order Granting Accelerated Approval to Eliminate Broker Discretionary Voting on Executive Compensation Matters, 75 Fed. Reg. 56,152, 56,152–54 (Sept. 15, 2010).

<sup>85</sup> Dodd-Frank, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899–1900 (2010) (codified at Exchange Act, 15 U.S.C. § 78n-1 (2012)).

<sup>86</sup> Dodd-Frank, Pub. L. No. 111-203, § 971, 124 Stat. 1376, 1915 (2010) (codified at Exchange Act, 15 U.S.C. § 78n (2012)).

<sup>87</sup> For an analysis of the challenge to Rule 14a-11, see Matthew Spitzer & Eric Talley, On Experimentation and Real Options in Financial Regulation, 43 J. Legal Stud. S121 (2014).

<sup>88</sup> After initially siding with issuers’ attempts to exclude such proposals under the provisions of Rule 14a-8(i)(9) (dealing with proposals that conflict directly with management proposals), the SEC has since retrenched to study the proper scope and application of the section. See Chair Mary Jo White, Statement from Chair White Directing Staff to Review Commission Rule for Excluding Conflicting Proxy Proposals, Sec. and Exchange Commission (Jan. 16, 2015), <http://www.sec.gov/news/statement/statement-on-conflicting-proxy-proposals.html>.

<sup>89</sup> Dodd-Frank, Pub. L. No. 111-203, § 972, 124 Stat. 1376, 1915 (2010) (codified at Exchange Act, 15 U.S.C. § 78n-2 (2012)).

several post-Dodd-Frank judicial decisions involving information management and insider trading have begun to embrace explicitly a federal standard for fiduciary duties, purportedly drawn from “federal common law.”<sup>90</sup>

- Shareholder Dilution: Public companies are required to obtain a shareholder vote before any transaction or issuance of securities that would result in a dilution of shareholders by 20 percent or more.<sup>91</sup>
- Whistleblower Protections: The SEC is required to pay bounties (of between 10 and 30 percent of the amount collected) to individuals who voluntarily provide original information leading to the successful SEC enforcement of a violation of federal securities laws resulting in monetary sanctions exceeding \$1 million.<sup>92</sup>
- Shareholder Voting and Proxy Regulation: Since the 1960s, federal law has played a significant role in regulating the process by which shareholder votes are cast in directorial elections and other shareholder referenda. A series of notice requirements and anti-fraud provisions are designed to deter unfair and/or deceptive practices in the solicitation of proxies.<sup>93</sup>
- Shareholder Proposals: An important attribute of federal securities law allows shareholders the immutable (but limited) power to place a variety of proposals before the shareholders as a group for a vote, circulated with the annual proxy solicitation at the company (and at its expense).
- Internal Controls: Perhaps the most notorious mandate introduced by SOX is a requirement to include in the firm’s annual report assessments by the chief executive officer, chief financial officer, and an outside auditor of the effectiveness of the firm’s internal controls over the accuracy of financial statements.<sup>94</sup>

It is important to acknowledge that the progressive federalization of corporate governance—while substantial—has not been absolute, and certain core tenets of state law have remained important factors in firm governance. One domain where state law arguably retains appreciable mojo is in anti-takeover jurisprudence, where the Delaware Chancery Court is an acknowledged bellwether, and where securities law has thus far remained largely peripheral.

### Contractual Complexity and the Takeover Market

A second major difference faced by public companies is an artifact of their sheer size, scale and complexity. Because they tend to be larger on a variety of fronts, public companies tend to face higher transaction costs in negotiating and renegotiating inter se accords. This is almost definitionally true for shareholders of public companies, whose identity can shift precipitously in an active securities market. The canonical private company, by contrast, may have shareholders numbering in the dozens or possibly hundreds, with very little turnover. This factor alone increases public companies’ contracting costs. But in

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<sup>90</sup> See, e.g., *United States v. Whitman*, 904 F. Supp. 2d 363, 369–70 (S.D.N.Y. 2012); *Steginsky v. Xcelera Inc.*, 741 F.3d 365, 367, 371 (2d Cir. 2014). Cf. *Starr Int’l Co. v. Fed. Reserve Bank of New York*, 742 F.3d 37, 38, 40–41 (2d Cir. 2014) (holding federal common law fiduciary duty principles trump Delaware state law when a “federal instrumentality” is the purported defendant). This trend was arguably invited by the SEC’s promulgation of Rule 10b5-2 in 2000, setting out federal standards for duties of “trust and confidence” in insider trading contexts. See 17 C.F.R. § 240.10b5-2 (2014).

<sup>91</sup> NYSE Listed Co. Manual R. 312.03 (2015). See also NASDAQ Listing R. 5635 (2009). While these rules predated Sarbanes-Oxley, both were amended in the years since.

<sup>92</sup> Dodd-Frank, Pub. L. No. 111-203, § 922, 124 Stat. 1376, 1841–42 (codified at Exchange Act, 15 U.S.C. § 78u–6 (2012)).

<sup>93</sup> Exchange Act Rule 14a.

<sup>94</sup> 17 C.F.R. 299, 308 (2011). See Management’s Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 68 Fed. Reg. 36,636 (June 18, 2003) (to be codified at 17 C.F.R. §§ 210, 228, 229, 240, 249, 270, and 274).

addition, many of the additional securities-law aspects of governance for public companies are immutable in nature, thereby constraining even further the ability of private contracting alone to spell out the contours of governance.

An important implication emanates from the canonical picture of the public company: Because the ability of contractual private ordering to steer governance is highly constrained in the public company setting, adaptation tends to take place not through the administration of tailored contractual terms but rather through using either markets for corporate control or other efforts to gain influence on the board of directors, such as through formal proxy fights.

For most of the late twentieth century, the market for corporate control was the primary vehicle for effectuating change in a public company. Given shareholders' limited oversight rights (particularly within public companies, as noted above), a disgruntled shareholder typically had to effectuate change (often in conjunction with outside financiers) through purchasing a majority of shares (and thus votes) in the company through public markets and/or a hostile tender offer. Thus, it came to be that hostile takeovers (and the legal regulation thereof) quickly rose to prominence as credible governance devices. (See Manne 1965).

From a legal perspective, perhaps the most important governance aspect of hostile takeovers is the extent to which incumbent management and boards are permitted to counteract a hostile threat. The 1980s spawned the critical pieces of the landscape that to this day regulates responses to hostile takeover threats. Legal scrutiny tends to divide into two subcategories: (1) measures undertaken by a target board to resist and/or delay a hostile bid while ostensibly maintaining the status quo; and (2) measures that cause a company to liquidate and/or sell out to a friendly third party – possibly in response to a hostile threat.

### Just Saying No

Consider first the case where a target board of directors chooses to “just say no” to a hostile suitor, hoping simply to maintain the status quo ante. Such resistance can take many forms, including “embedding” a variety of contractual penalties (to licensors and lenders, for example) that are triggered should a company ever experience a hostile change of control. More directly, a target board may adopt a now well-known antitakeover device known as a “poison pill,” which usually takes the form of an in-kind “rights” dividend, giving non-hostile shareholders a benefit (such as a multifold stock split) once a hostile bidder crosses a specified threshold (e.g., 20%) of ownership of the target company. This benefit, moreover, is not similarly accorded the hostile acquirer, and thus when a pill is triggered the hostile bidder immediately loses value through some form of extreme dilution. When active and well designed, a poison pill is virtually a show stopper for hostile acquirers.

Poison pills are disfavored by many corporate codes around the world, but are broadly allowed in Delaware, and were specifically deemed permissible in *Moran v. Household Int'l Inc.*<sup>95</sup> This acceptance is not unconditional, however: at around the same time as *Moran*, the Delaware Supreme Court laid out the conditions under which a bid-detering strategy (including a pill) would be consistent with fiduciary principles. Specifically, in *Unocal v. Mesa Petroleum*,<sup>96</sup> the Court held that a defensive measure in general is defensible so long as the target board can show (a) it was implemented independently by the board, with reasonable grounds to conclude that the hostile suitor posed a danger to corporate policy and effectiveness; and (b) the

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<sup>95</sup> 500 A.2d 1346, 1347 (Del. 1985).

<sup>96</sup> 493 A.2d 946 (Del. 1985).

defensive measure is proportional to the threat posed, and not otherwise coercive or preclusive of the possibility of a takeover at some unspecified future point.

The first part of the *Unocal* test is extremely permissive, giving the target board a fairly wide berth in justifying what constitutes a “threat to corporate policy and effectiveness.” For example, a board would be justified under *Unocal* of resisting a hostile bid if its justification for resistance appeared motivated by a desire to protect non-shareholder constituencies (such as debt holders or employees). The theory for this permissiveness is related to the rationale behind the business judgment rule – that so long as the corporation is being preserved in its current state, protecting a non-shareholder constituency today could redound to the benefit over the long term of shareholders.

Perhaps as a consequence of *Unocal*’s permissiveness on articulating a threat, much of Delaware jurisprudence on pills (and other defensive measures) concerns the conditions under which they might be preclusive or coercive (thus offending of the *Unocal* doctrine). Here, target companies have generally been enjoined from adopting defenses that can never be undone by the board,<sup>97</sup> and thus in practice virtually all poison pills have within them provisions under which the board can “redeem” the contingent rights, effectively clawing back the in-kind dividend for a small redemption fee.

The cancellability of a poison pill, in turn, has generated a standard counter-response by many would-be hostile acquirers: they will combine a takeover bid with a proxy contest for board seats, hoping to win a majority of the board through the election process, using that majority to cancel the pill and facilitate a takeover.<sup>98</sup> This strategy (and variants on it) remains popular today, though boards are often able to delay the process by utilizing a staggered board structure, in which only a fraction (usually a third) of the board comes up for election in any given year. Consequently, an outside suiter would have to wait two full election cycles—and prevail in both—before she could command a majority of the board. While not deterring hostile acquisitions altogether, the combination of a poison pill and staggered board has proven an effective delay tactic that is often enough to deter outside bidders – particularly if they anticipate bidding competition from others over the extenuated waiting period (Bebchuk, Coates, and Subramanian 2002). The net effect of this evolution, however, was to place increasing emphasis not on market transactions for gaining control, but rather on governance challenges through the shareholder proxy system. We return to the implications of this transition below, when we analyze more recent variants of poison pills related to shareholder activism.

### Playing Favorites among Bidders

Although defensive measures in general fall under the aforementioned permissive *Unocal* rule, in certain cases a board may take steps that trigger a higher degree of scrutiny. In such cases, a board goes beyond mere maintenance of the status quo, and instead counters a hostile threat with measures that (for example) liquidate the company or sell control to a bidder that is more favored by the board (and adverse to the suitor). Such measures can be seen as having a de facto effect of eliminating the ability of target shareholders to ever be able to extract a control premium from an outside bidder. In such instances, courts narrow the *Unocal*

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<sup>97</sup> See, e.g., *Carmody v. Toll Brothers* (1998) (enjoining a “dead hand” pill that could only be cancelled by then-existing board members, even if they were subsequently ousted in a proxy contest).

<sup>98</sup> In theory, a hostile acquirer could seek to replace the board of directors prior to the annual meeting by either calling a special shareholders meeting or by acting by written consent. As discussed in Section 4, however, Delaware law permits shareholders to call special meetings only if authorized in the company’s charter, and shareholders’ right to act by written consent can be removed if the charter so specifies. As noted by Bebchuk, Coates, and Subramanian (2002), few public companies allow shareholders to act by written consent or to call special meetings.

doctrine in an important way: The measurement of a “threat” is more closely tailored, and must relate to a short term threat to shareholder value (as opposed to the more holistic query discussed above). In Delaware, this standard was articulated in *Revlon v. MacAndrews and Forbes*, discussed previously in Section 3. In *Revlon*, the board of Revlon reacted to a hostile offer from Pantry Pride by negotiating a competing agreement with Forstmann Little, pursuant to which Revlon would agree unconditionally to transfer its most prized divisions to Forstmann (regardless of whether the merger closed); it moreover agreed not to actively shop the deal to other bidders and to pay a substantial termination fee to Forstmann in the event the deal fell apart. The Delaware Supreme Court invalidated these measures, concluding that the board did not demonstrate that Pantry Pride’s offer was inferior or posed a systematic threat to short-term shareholder value.

The heightened scrutiny of M&A-related actions under the *Revlon* rule has naturally generated interest in when and under what circumstances it is triggered. A variety of cases during the last 30 years have clarified when it is triggered as well as its content once triggered. As to the first question, it is now relatively well settled that the *Revlon* rule is triggered at the moment where the board proposes and takes actions setting the company on course for a “change of control” – defined as a transfer of control from a widely-held aggregation of shareholders to a single entity or unified group.<sup>99</sup> It is at this moment that shareholders of a widely held public firm plausibly give up their ability to extract a control premium in a future sale. Consequently, one might view the *Revlon* rule being triggered when a proposed sale or liquidation would be preclusive of an alternative future sale. (At the same time, *Revlon* is also broader than a defensive measure doctrine – and it is triggered with any proposed change of control, even when there is no hostile acquirer in sight).

A second important aspect of the *Revlon* rule concerns what, exactly, it requires of a board once triggered. In the initial years following the decision, many likened the *Revlon* rule to a duty to auction the company and to formulate revenue maximizing terms for such an auction. It has since become clear that Delaware courts generally will not require that type of rigor among board members, and instead concluded that *Revlon* requires only “reasonable” steps to maximize short-term shareholder value. Although no pushover by any means, the modern *Revlon* rule appears to provide a fair degree of discretion to boards in how they go about designing the sales process.

### Activists: The “New” Hostile Acquirer

As the discussion above makes clear, the fundamental tenets of Delaware corporate law over the years have made it progressively easier for boards of public companies to resist the efforts of dissenters who seek to wrest control of the company through hostile acquisitions. Indeed, the poison pill (particularly when combined with the staggered board) has virtually eliminated the possibility of outright hostile acquisitions, and at the very least requires such efforts to be combined with proxy contests for board seats. Moreover, other types of contractual anti-takeover devices have doused more water on the hostile acquisition fire, since triggering a change of control might itself trigger a substantial transfer of value outside the firm.

Consequently, a significant amount of hostile activity now circulates around attempting to manipulate governance institutions to wrest control. Proxy contests, bylaw amendments, shareholder proposals, and inspection rights have all proven useful to the activist’s tool kit. In a sense, today’s activists are the modern analog of yesterday’s corporate raiders. And, not surprisingly, they have come to occupy center stage in current corporate governance debates. We offer a few helpful recent examples in the next section.

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<sup>99</sup> See *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994).

## VI. Current Challenges for Corporate Governance

### The Increasing Importance of Private Company Governance

One of the most important developments in the capital markets in recent years is the notable decline in firms' willingness to seek a public listing of their equity securities. For instance, the number of U.S. private firms undertaking an initial public offering on a U.S. exchange have fallen from an average of over 400 per year between 1990 and 1999 to approximately 115 between 2000 and 2014. Evidence that firms are choosing to stay private longer can also be found in the growing size of IPOs that do occur. While median proceeds of IPOs during the 1990s was \$97 million in 2014 dollars, median proceeds swelled to \$302 million in 2014 dollars after 2005.<sup>100</sup> A similar trend appears in the large number of so-called unicorns—private, venture-backed startups valued at more than a \$1 billion—that have come to play an increasingly important role in today's society. To the extent corporate governance should be studied at the firms that affect the real economy, it would accordingly seem that research in corporate governance should increasingly turn to the governance of private firms.

In light of the practical differences between the governance of private and public firms noted previously, we expect research into these firms will continue to focus on the vital importance of private ordering for corporate governance. Indeed, the migration of large institutional investors such as mutual funds and sovereign wealth funds “downstream” in search of private venture-backed startup firms (see Schwartz 2017) provides reason to believe the governance structure of the largest private firms will increasingly resemble the contractual arrangements historically utilized by the venture capital industry. In general, these arrangements implement a governance architecture that is sensitive to both the “vertical” conflicts that arise between managers and investors, as well as the “horizontal” conflicts between investors that often arise from the very contract provisions aimed at addressing vertical conflicts (Bartlett 2006).

For instance, it is common practice in venture capital finance for the VC investors to acquire shares of preferred stock having a liquidation preference equal to (at least) the investor's original investment (Kaplan & Strömberg 2003). Because of the liquidation preference, an investor is assured of receiving its investment prior to any payments on the common stock, which is typically held by company founders and managers. This contractual entitlement provides strong incentives for founders and managers to maximize firm value, but at the same time, it also can produce horizontal conflicts among investors. This is especially true in the situation where a firm issues to investors multiple series of preferred stock having different levels of seniority among preferred stockholders. When a company fails to appreciate in value, investors can be expected to differ in their willingness to support the company and await a liquidity event. An illustration of this dynamic can be found in the example used previously involving the hypothetical startup company in Section 5. There, a VC's \$100 liquidation preference encouraged it to seek an immediate liquidation of the firm, whereas the common stockholders preferred to continue the firm in hopes of realizing value on the common stock claim.

As private venture-backed firms grow in size and scope, the ability of the VC governance model to resolve these conflicts will play an increasingly important role in the efficient allocation of assets within the economy. As was suggested earlier, however, recent Delaware cases call into question the capacity of the conventional VC governance model to resolve these conflicts in an allocationally efficient manner. In general, these cases suggest that a director that prioritizes the preferences of preferred stock over the maximization of common stock value may be in breach of her fiduciary duties. However, such a conception of director duties

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<sup>100</sup> These trends are discussed more fully in Bartlett, Davidoff Solomon, and Rose (2017).

sits uncomfortably in the VC governance model that largely assumes that a VC's director designees can exercise their board authority to hash out Coasean bargains among common stockholders and preferred stockholders.

An especially influential articulation of this view of director duties can be found in *In re Trados Incorporated Shareholder Litigation*.<sup>101</sup> Eventually decided in 2013, the case presented the all-too-familiar dilemma of a VC-backed start-up that neither succeeded nor failed, but simply went sideways. Over the course of 2000 through 2003, the company undertook several rounds of venture capital finance such that by 2004, the company had outstanding seven series of preferred stock having an aggregate liquidation preference of approximately \$58 million. As is typical of VC financings, the multiple rounds of finance led to a board structure heavily influenced by designees of the company's VC investors. Among the company's seven directors, two were company executives, three were principals of the VC investors, one was a preferred stock investor with close personal ties to one of the VC directors, and one was an independent industry expert.

At the center of the legal dispute was the sale of the company in 2005 to a strategic buyer for \$60 million. In 2004, the board instructed management to find a buyer for the company given its meager growth prospects, knowing that the proceeds of any such sale were likely to be absorbed by the preferred stock's \$58 million of liquidation preferences. Moreover, given that company management held common stock, the board also approved a management incentive plan (MIP) that entitled select executives to a percentage of any acquisition proceeds. In light of the paltry proceeds common stockholders were likely to receive in an acquisition, the MIP was viewed as necessary to incentivize management to find a buyer. The combination of the preferred stock liquidation preferences and the MIP, however, ensured that common stockholders received nothing in Trados's eventual sale. Common stockholders sued, alleging that the board violated its fiduciary duties by choosing to sell the company and adopt the MIP rather than continuing to operate Trados in an effort to generate value for the company's common stockholders.

In an opinion authored by Chancellor Travis Laster, the Delaware Chancery Court ultimately held that the board was not liable. However, in the course of reaching this conclusion, Laster highlighted a number of problems with the board's decision-making that are worth discussing in some detail. First, Laster noted that well over a majority of the board was conflicted in approving the transaction in light of their financial interests in either the liquidation preferences or the MIP. As such, Laster applied the more searching "entire fairness" standard of review to evaluate the board's behavior.

Next, noting that "it is *possible* that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders,"<sup>102</sup> Laster found overwhelming the evidence suggesting the board consistently disregarded common stockholder interests as it sought to secure and then execute the acquisition. He also faulted directors for not considering how to treat common stockholders fairly in designing the MIP and for failing to form a special committee to represent the interests of common stockholders. Director approval of the transaction was therefore problematic because the "defendants in this case did not understand that their job was to maximize the value of the corporation for the benefit of the common stockholders, and they refused to recognize the conflicts they faced."<sup>103</sup>

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<sup>101</sup> *In re Trados, Inc.*, 73 A.3d 17, 17 (Del. Ch. 2013).

<sup>102</sup> *Id.* at 42.

<sup>103</sup> *Id.* at 62.



Fortunately for the defendants, the plaintiffs' expert provided a valuation of Trados's common stock based largely on a comparable company analysis that Chancellor Laster found unrealistic. He therefore deferred to the defendants' expert, whose more thorough valuation revealed that the common stock had no economic value. As such, even though the board had failed to satisfy the "fair process" aspect of the entire fairness review, the common stockholders nevertheless received fair value in the merger. Accordingly, the court ultimately concluded that the board had satisfied their burden of showing entire fairness. By criticizing the board for failing to consider how to maximize common stockholder value, however, the court nevertheless put boards on notice of how they should behave in future situations that pit common stockholders against preferred stockholders regardless of which course of conduct would maximize firm value.

Indeed, two years after *Trados*, Chancellor Laster confirmed this perspective in *Fredrick Hsu Living Trust v. ODN Holding Corp. et al.*<sup>104</sup> There, a common stockholder sued a company's board of directors for pursuing a strategy of selling off the company's core assets to generate sufficient funds so that the company's primary VC investor could eventually exercise its redemption right under the terms of its preferred stock. The court viewed a majority of the board to be conflicted on account of the fact that a majority of directors were either designees of the VC investor, officers who stood to receive a bonus in the redemption, or individuals who were otherwise beholden to the VC investor. Consequently, the court applied the entire fairness standard of review and, after emphasizing the board's duty to "the stockholders in the aggregate in their capacity as residual claimants,"<sup>105</sup> refused to dismiss the complaint given that a reasonable inference could be made that the board sought to "maximize the value of the Redemption Right ... rather than seeking to maximize the value of the Company for the benefit of its residual claimants."<sup>106</sup> Together with *Trados*, *ODN* thus highlights how the common use of preferred directors by VC investors may incline courts to apply entire fairness analysis to these situations, opening the door for courts to use the shareholder primacy norm in ways that undermine the VC contracting model (at least to the extent VCs and common stockholders seek to renegotiate their relationship at the board level).

## Public Company Activism

Cases like *Trados* and *ODN* represent stark examples of how the legal landscape surrounding corporate governance has become more sharply focused on "horizontal" disputes among investors within private companies. Interestingly, however, horizontal governance disputes have also begun to permeate public company governance disputes as well. As noted above, the powerful tools that US public companies have developed to thwart hostile acquisitions has caused control contests to migrate into governance disputes and proxy contests. Within public companies, governance disputes surrounding activism have become one of the key issues of our day.

Indeed, the last decade and a half bears witness to a discernible escalation of proxy fights within public companies (see Figure 1 below). In a dramatic turn-around from decades past, proxy challenges now regularly

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<sup>104</sup> No. C.A. No. 12108-VCL, 2017 WL 1437308 (Del. Ch. April 24, 2017).

<sup>105</sup> *Id.* at 17.

<sup>106</sup> *Id.* at 40. To be sure, the *ODN* court also emphasizes that at trial, the directors of ODN could potentially avoid liability by proving that the piecemeal liquidation of the company was done in the best interest of the residual claimants (e.g., because the Company's value would never exceed the redemption value of the preferred). While we view this language as promising, the burden of showing good faith would be on the board. It is also unclear from the decision how a board's decision to liquidate the firm in favor of paying the preferred stock redemption would be in the best interests of the residual claimants since, by definition, liquidating will extinguish the common stockholder's option value in favor of distributing the company's remaining value to preferred stockholders.



achieve some measure of success (through settlement or outright electoral victory) in over two-thirds of the challenges they launch. The burgeoning success of proxy fights is arguably reflected in the contemporaneous growth of activist hedge funds, which have ballooned from under \$100 million in assets under management in 2000 to over \$140 billion today (HFR 2014).

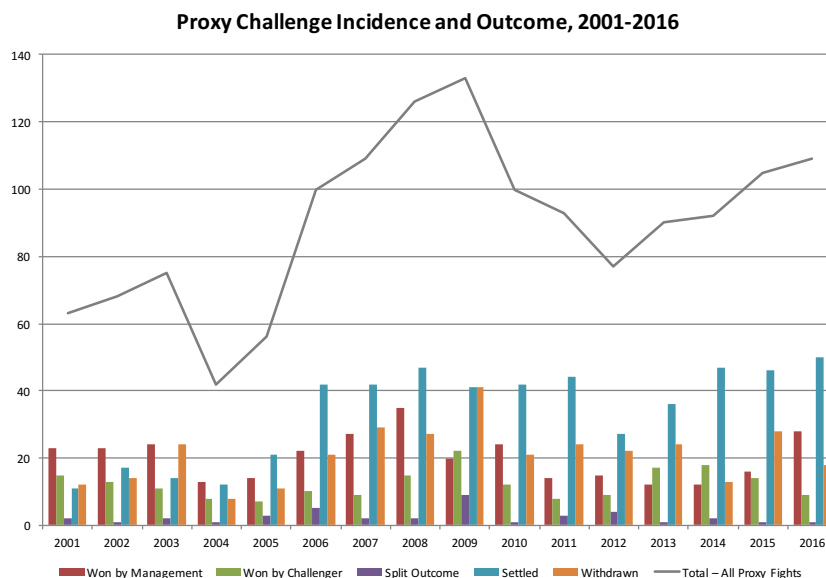


Figure 1

The debate surrounding activism bears some uncanny resemblances to the horizontal corporate governance disputes noted above. Activists, it is frequently alleged, take on the functional role analogous to preferred shareholders, privileging short term gains over more durable (but less liquid) investments in long term value, leading to business decisions that inefficiently forsake long term value for immediate gain (See, e.g., Lipton 2013). And indeed, typical compensation structures of hedge fund managers seem especially skewed towards short-term payoffs (Lim et al. 2016).

Activists, for their part, vigorously contest the allegation of short-termism, citing several empirical studies that suggest activists bolster shareholder value. Most notably, announcements of activist engagements are usually followed by positive and significant abnormal returns (Bebchuk et al. 2015; Boyson & Mooradian 2011; Brav et al. 2008, 2013, 2015; Clifford 2008; Greenwood & Schor 2009; Klein & Zur 2009). And, while some of these price increases inure to activists alone, other shareholders and investors appear to benefit too (Bebchuk et al. 2013). Further, defenders of activists maintain, activist engagements do not obviously trade short-term gains for long-term ill: companies that experience an activist engagement have been found to experience long term performance similar to non-engaged firms (albeit amid some statistical noise; Bebchuk et al. 2015).

The activism debate is one that is still a long way from being worked out conceptually, and there continue to be significant opportunities in financial economics to investigate why, within thick capital markets, heterogeneous time horizons might arise endogenously and persist among outside investors. Nevertheless, several recent judicial opinions have had to confront the corporate governance aspects of short-termism more focally, situating it within the broader landscape of fiduciary obligations and corporate objectives.

Much of this activity has been in the realm of poison pills that are specifically targeted against activist engagements.

In 2010, for example, the Delaware Supreme Court specifically approved of poison pills triggered at just under five percent – a figure that was far lower than the traditional trigger on pills (usually in the 15 to 20 percent range).<sup>107</sup> Three years later, in *Third Point LLC v. Ruprecht*<sup>108</sup>, the Delaware Chancery Court took on activist defenses more squarely. There, the board of directors of the venerated auction house, Sothebys, faced a significant challenge from activist investor Dan Loeb, the principal of Third Point Capital – who sought substantial strategic and capital structure changes to the company. After Third Point raised its stake in Sothebys to just under 10 percent of its common equity, the board responded by promulgating a relatively novel type of rights plan (or poison pill). Under its terms, passive investors amassing a stake in the company would not trigger its dilutive effects until their ownership stake passed the 20 percent threshold. However, “activist” investors (defined as those filing a Schedule 13D under federal securities laws), would trigger the pill at a far lower 10 percent threshold. The pill also granted the board considerable power to either cancel the pill or exempt specific buyers from its consequences – options that it steadfastly refused as to Third Point.

Both Third Point and other Sotheby’s shareholders filed suit in Delaware, claiming that both the promulgation of the activist pill and the refusal of the board to grant Third Point an exemption violated fiduciary duties. In a lengthy opinion by Vice Chancellor Parsons, which he described specifically as “uncomfortably close”, the court found the activist pill was permissible. Applying the *Unocal* standard, Parsons found that the Sotheby’s board faced a valid “threat” even from the prospect of an activist building a 20 percent sub-controlling stake in the company. While such a level of control fell far short of actual control, Parsons opined that it was sufficiently large to give an activist an effective veto against many corporate actions – what he termed “negative control.” In addition, the flexibility that the board had to cancel and/or grant exemptions to the pill satisfied the requirement that the defense be proportional to the threat posed. That the board chose not to make use of this flexibility to exempt Third Point, the court reasoned, was sufficiently related to the underlying threat to afford the board a full (albeit narrow) victory.<sup>109</sup>

Activist pills are but one measure that public corporations have undertaken to alter and/or deter the prospects of activist interventions. Several other activist defenses with seemingly similar motivations have also come to the fore of late. For example, a series of recent cases has wrestled with the legality of (so-called) “proxy puts”, which grant contractual counter-parties of the corporation attractive rights if control of the company ever transfers because of a proxy contest. (Most of these provisions also have additional terms that allow them to be negated by board vote, but only board members not representing an activist). Such devices effectively represent a ticking time bomb for activists, causing the firm to lose value as a byproduct of their activist strategies. Accordingly, courts in Delaware have taken a relatively skeptical view of them<sup>110</sup> – though it is still too early to predict how dead-hand proxy puts will be treated over the longer term.

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<sup>107</sup> See *Versata Enterprises v. Selectica, Inc.*, 5 A.3 586 (Del. 2010).

<sup>108</sup> 2014 WL 1922029 (Del. Ch. 2014).

<sup>109</sup> Interestingly, the Third Point case also declined to extend the (so-called) *Blasius* doctrine to the activist engagement, finding that the plaintiffs did not demonstrate that the promulgation or administration of the rights plan by the Sotheby’s board was done for the *primary purpose* of interfering with shareholder voting. It is notable that the court did not simply dismiss the *Blasius* analysis, effectively recognizing its possible relevance in other cases.

<sup>110</sup> See, e.g., *Pontiac Gen. Employees Retirement Syst. v. Ballantine*, C.A. No. 9789-VCL transcript (Del. Ch. May 8, 2015).

A still more potent weapon – and one that we have increasingly witnessed of late – is dual class capital structures in which founders and early investors hold onto outsized voting power even as equity ownership of the company is highly dispersed. Particularly in technology firms (such as Snap, Facebook and Google), these dual-class structures effectively negate much of the practical effect of corporate governance altogether, sentencing the disfavored share classes to long (and even perpetual) periods of little governance influence over the firm’s strategic trajectory. As noted above, there is very little in Delaware law or Federal law that precludes the adoption of dual class structures at the time of company formation, so long as their details are adequately disclosed in the charter. Moreover, the deliberate design and creation of a dual class company effectively means that the holders of superior shares (often founders, promoters, and early investors) “pay” for the structure, presumably through discounts in the inferior shares. Thus, it would be difficult to challenge the promulgation of a dual-class structure *ab initio*.<sup>111</sup>

## VII. Conclusion

This chapter has reviewed several of the significant legal institutions that help shape and undergird corporate governance in U.S. corporations. We have demonstrated that, along with the *mélange* of economic factors that determine governance (such as market dynamics, information constraints, reputational factors and the like), there are myriad regulatory, statutory and doctrinal attributes that profoundly affect and help determine authority relationships inside firms—institutional details whose appreciation is critical for informed corporate governance research by social scientists.

Our analysis, moreover, shows that legal aspects of corporate governance are themselves in a persistent state of flux. To take a recent example, we have advanced the thesis that “horizontal” governance disputes among shareholders are playing an increasingly important role in large U.S. corporations. Within public companies, this trend has been driven primarily by the success of legal devices such as the poison pill and the staggered board in deterring the use of hostile takeovers as a mechanism for shareholders to exert governance over public firms. The resulting rise of activism and the re-emergence of proxy contests has, in turn, forced public companies to rewrite the defensive playbook to address the risk of having an insurgent shareholder with potentially divergent preferences for deploying firm resources. In this way, the inter-shareholder conflicts that have long characterized private companies now inform debates about public company governance, requiring close attention to the legal tools used to wage and resolve these conflicts. At the same time, this convergence of governance challenges facing public and private firms has been accompanied by a secular change in ownership structure whereby economically significant firms are choosing to stay private longer—a trend facilitated in part by liberalized reforms to securities law. In this way, the legal dynamics affecting both private and public firms have shifted the primary governance challenge facing large U.S. corporations away from the vertical conflict between managers and shareholders towards these horizontal conflicts among shareholders themselves.

For economists and other social scientists, the dynamic and adaptive aspect of legal institutions suggest that legal corporate governance is *not* appropriately represented as a mere “constraint” on the task of private ordering and corporate design decisions. Rather, much like the practices of private ordering they regulate, the working pieces of corporate governance law themselves represent an equilibrium of sorts, both determining and determined by the behavior of corporate actors (Cf. Hermalin & Weisbach 2012).

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<sup>111</sup> That said, it may be more possible to challenge decisions made after an IPO that would skew control even further into the hands of the owners of superior shares. Facebook’s current plan to issue a new non-voting class of shares, for example, has been challenged by shareholders, with a trial scheduled for late 2017 (Heath 2017).

The implications of this observation are threefold. First, social scientists interested in a descriptive account of corporate governance practices must keep tabs on the evolution of legal institutions, just as they track changing practices, norms, pricing, returns, and so forth. Second, those interested in positive and normative theories of corporations must appreciate that a forced “reform” to corporate governance law will not only give rise to changes in corporate practices, but that the resulting changes may induce a new array of challenges and changes in the legal aspects of corporate governance. Lastly, empirically minded scholars must keep in mind not only the potential endogeneity of governance as noted above, but the fact that much of the available data surrounding governance comes from a unique slice of companies who are SEC reporting entities.

Topically, we predict that corporate governance research going forward will almost certainly have to contend with the increasingly “horizontal” nature of disputes among corporate participants even in public companies—resembling the types of governance crises that have long confronted non-public companies. For this reason, it would be unsurprising to discover that the issues served up by private and public company governance disputes continue to overlap considerably.

In the process, the prominence of these disputes may force a reconsideration of whether the legal governance “tools” we have outlined in this chapter are effective in resolving them. For example, dual class stock and equivalent entrenchment devices that “lock up” control in the name of promoting long-term shareholder value are likely to play an increasingly important role in the U.S. corporate governance landscape, raising profound questions about whether fiduciary duties should rescale themselves. Likewise, in many private company contexts, inter-shareholder disputes should be expected to air themselves in the board room, as directors seek to strike Coasean deals on behalf of dueling shareholders. In these settings, the underlying content of fiduciary duties may have to adapt as well, with more careful focus on whether and when a corporate fiduciary (such as a director) is allowed to serve the interests of the constituency that has nominated her for the board, rather than measuring her conduct against a corporate goal that is common to all directors.

Most of these puzzles are a long way from resolution. Indeed, it is because of this observation that corporate governance is—and will continue to be—an alluring (if still elusive) area of inquiry.

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