

DELAWARE: HOME OF THE WORLD'S MOST EXPENSIVE RAINCOAT

*Jonathan Macey**

Legal opinions are many things to many people. In academia they are used as data points to support certain theories about the law and to reject others. And so it is with the most anticipated decision in corporate governance in a decade: the August 9, 2005 ruling of Delaware's Chancellor Chandler in *In re The Walt Disney Co. Derivative Litigation*.¹

My idea is that this case tells us a great deal more about the jurisdictional competition for corporate charters and about the nature of the judicial process in Delaware than it tells us about corporate governance. In fact, my idea is that the opinion is purposefully vague about the contours of corporate law and corporate governance, which, I will argue, may have been the point of the exercise.

I. WHAT WE KNOW

Several important things are immediately clear, even before we begin reading the opinion. We know, for example, that the case dragged on for years before a decision was reached, which is not always the case in Delaware. And we know that after an excruciatingly long trial (thirty-seven days over a three-month period), in which masses of lawyers and twenty-four different witnesses generated 9,360 pages of trial transcript, the defendants won a complete victory. We also know (from the table of contents) that the majority of the lengthy opinion (174 pages) is devoted to a recitation of the facts, which is odd, since the facts were notoriously well-known by everybody remotely interested in the case, or vaguely familiar with the practice of corporate law.

We learn more, but not much more, from reading the opinion. We learn that the opinion adds startlingly little to our previous stock of

* Sam Harris Professor of Corporate Law, Corporate Finance & Securities Law, Yale Law School. I am grateful to Roberta Romano for very useful comments on an earlier draft.

1. No. 15452, 2005 Del. Ch. LEXIS 113 (Del. Ch. Aug. 9, 2005).

knowledge about corporate law. We also learn that the opinion, seemingly intentionally, provides almost no guidance for future litigants.

The deep meaning of the *Disney* derivative litigation can be easily summarized: Delaware is a good place to be incorporated from the perspective of companies and their shareholders; it's even better from the perspective of the lawyers who sue Delaware companies and who represent them in such suits. The Delaware judiciary has created an environment in which lawsuits are plentiful, legal fees are high, and attorneys' fees generously awarded, but where directors, in the end, are protected from liability by the slow and steady hand of the Delaware judiciary.

The outcome in the case was fairly predictable. In fact, my colleague Henry Hansmann predicted it. Illinois College of Law professor Larry Ribstein even wrote an ersatz opinion shortly before the real opinion was released opining on the issue of whether the evidence at trial supports the complaint's allegations and meets the standards for liability under the business judgment rule and section 102(b)(7) of the Delaware Code that closely tracks the one ultimately issued by Chancellor Chandler. Ribstein wrote that "[a]fter a thorough trial in which the facts were ably and fully presented on both sides, I conclude that this record does not support relief."²

In other words, the evidence supports Roberta Romano's well-known argument that one of the major selling points that Delaware has to offer companies is the predictability of its law.³ Specifically, Romano has shown that "Delaware is so successful in the corporate charter business" because it (like many other states) offers an attractive and flexible mix of corporate law rules, and then most importantly, it provides a credible commitment that it will continue to supply this desirable mix of rules in the future.⁴

II. COMPETING THEORIES

Thus, consistent with Romano's theory, it appears that people knew with a fair degree of precision what the outcome of the *Disney* litigation would be. In light of this fact, one must wonder why it took so much time and so much money to generate the result that everybody was

2. Larry E. Ribstein, *A Disney Preview*, at http://busmovie.typepad.com/ideoblog/2005/07/a_disney_preve.html (July 10, 2005).

3. See, e.g., Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225 (1985) [hereinafter Romano, *Some Pieces of the Incorporation Puzzle*]; see also ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993).

4. Romano, *Some Pieces of the Incorporation Puzzle*, *supra* note 3, at 243-59.

expecting all along. If the various theories of jurisdictional competition for corporate charters do not have anything to say about this, then they are seriously incomplete.

A. The Race-to-the-Top

The Race-to-the-Top theory was the premier entry of the law and economics movement into the debate about corporate federalism. Important facets of this theory are reflected in the work of scholars like Dan Fischel,⁵ Roberta Romano,⁶ and Ralph Winter.⁷ This theory posits that decisions about where to incorporate will tend to be made in the best interests of shareholders because an array of market forces (for example, capital market competition, competition in the managerial labor market, product market competition) compels managers and directors to incorporate in the state that best serves the shareholders' interest in wealth maximization. The corporate federalists conclude that Delaware retains its position at the forefront of the competition among the states for corporate charters because it provides the legal environment that is most conducive to maximizing shareholder wealth.

The recent opinion in the *Disney* derivative litigation is not consistent with the Race-to-the-Top hypothesis. The decision draws a sharp distinction between the activist role of courts in policing against obvious conflicts and the passive role of the courts in dealing with basic mismanagement.⁸ Indeed, the court is frankly pessimistic about the capacity of courts to deal with garden variety corporate governance problems at all. The court opines that even patterns of conduct that "fall far short of what shareholders expect and demand from those entrusted with a fiduciary position" and behavior that "does not comport with how fiduciaries of Delaware corporations are expected to act" cannot be sanctioned because it was "not in violation of law."⁹ Thus, the opinion in *Disney* is deeply inconsistent with the Race-to-the-Top theory, because it rejects the fundamental assumption imbedded in it that the states have

5. See, e.g., Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982).

6. See, e.g., Romano, *Some Pieces of the Incorporation Puzzle*, *supra* note 3.

7. See, e.g., RALPH K. WINTER, GOVERNMENT AND THE CORPORATION 28-42 (1978); Corporate Governance Proposals Debated by Lawyers, Economists, 15 SEC. REG. & L. REP. (BNA) 1823 (Sept. 30, 1983) (remarks of Judge Ralph K. Winter); Ralph K. Winter, *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 289-92 (1977).

8. *In re Walt Disney Co.*, No. 15452, 2005 Del. Ch. LEXIS 113, at *5-9 (Del. Ch. Aug. 9, 2005).

9. *Id.* at *199-200.

value to add to shareholders beyond merely keeping managers' hands out of the corporate coffers.

B. *The Race-to-the-Bottom*

Where the Race-to-the-Top theory posits that Delaware law seeks to advance shareholders' interests, the Race-to-the-Bottom theory laments the fact that the "pygmy" state of Delaware "prescribes, interprets, and indeed denigrates national corporate policy as an incentive to encourage incorporation within its borders"¹⁰ Proponents of the Race-to-the-Bottom theory assert that markets do not work very well, that shareholders stupidly persist in investing in companies only to be systematically ripped off by rapacious managers who run public companies to benefit themselves; shareholders' interests be damned. The Race-to-the-Bottom theory therefore posits that the way to win (indeed, the way that Delaware has won) the jurisdictional competition for corporate charters is by pandering to managers, that is, by creating a regulatory environment in which managers can divert corporate resources to themselves without fear of legal sanction.

Just as the recent opinion in *Disney* is not consistent with the Race-to-the-Top hypothesis, it also is flatly inconsistent with the Race-to-the-Bottom thesis. Directors do not like to be sued. And they do not like to be made the object of public scorn and ridicule. The fact that this high profile litigation survived a motion to dismiss on the basis that there was a possibility that the Disney board had failed to adhere to its fiduciary duty of "good faith" is not consistent with a theory that asserts that the Delaware judiciary panders to management.¹¹ After all, it would be easy for another state to bar this sort of lawsuit altogether, saving managers and directors the professional embarrassment of a lengthy trial in which the judge found that Michael Eisner's (Disney's) "lapses were many,"¹² and in which he hopes "that this case will serve to inform stockholders, directors and officers of how the Company's fiduciaries underperformed."¹³

10. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 701 (1974).

11. See *In re Walt Disney Co.*, 825 A.2d 275 (Del. Ch. 2003); see also Mark Saltzburg, *Disney Board Acted Properly on \$140 Million Ovitz Payout, Delaware Judge Rules*, CORPORATE GOVERNANCE HIGHLIGHTS No. 16-33, Aug. 12, 2005 (describing Chancellor Chandler's 2003 opinion in *Disney* on the defendants' motion to dismiss).

12. 2005 Del. Ch. LEXIS 113, at *198.

13. *Id.* at *227.

C. *Vertical Federalism*

Mark Roe has made a relatively new entry into the debate about jurisdictional competition for corporate charters, arguing that the competition for the corporate chartering business is vertical (between Delaware and the federal government) rather than horizontal.¹⁴ This theory is wholly unconvincing. The United States Constitution permits federal law to preempt state law. Thus, if there was a jurisdictional competition between the federal government and the states, of the sort that exists among the states, the federal government would already have won it. In other words, as I have previously observed, while the states are, obviously, aware of the existence of the government and its power to preempt the states, the states interact with the federal government by exerting *political* pressure on the federal government to permit the states to continue to charter and to regulate corporations.¹⁵

Theories about jurisdictional competition for corporate charters posit that states compete for the revenues associated with such chartering. Roe ignores the fact that corporations must charter in some state. This chartering generates the tax revenue and other benefits that the states desire. Corporations (with a few notable exceptions, like banks) cannot charter at the federal level. So Roe's argument is a non-starter. Delaware, therefore, does not feel any pressure from the federal government because corporations could not charter federally even if they wanted to.

Roe even acknowledges that, while long ago there was some idle chatter about federal chartering of firms in interstate commerce, this idea is "not realistic today."¹⁶ Roe is at least right about this: the federal government is not threatening to enter the jurisdictional competition for corporate charters. Oddly, Roe seems oblivious to the fact that this observation is in fact a concession that wholly undermines his assertion that Delaware feels competitive pressure from Washington.¹⁷

14. See Mark Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003).

15. See Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation*, 76 VA. L. REV. 265 (1990). Even on Roe's own terms, his argument fails. Looking at those episodes in history where the federal government has encroached on the states' regulation of corporate governance, the Foreign Corrupt Practices Act, the Williams Act, the federal proxy rules, and Sarbanes-Oxley, there is no evidence that the states in general or Delaware in particular did anything to try to block this legislation.

16. Roe, *supra* note 14, at 597.

17. Roe at one point attempts to bolster his argument by claiming that Delaware feels pressure from Washington not because of threatened competition, but because their feelings are hurt by the criticism that they have endured! Roe writes amusingly that "[t]hrough the last serious effort at federal incorporation disappeared some thirty years ago, Delaware players still chafe from the

Any remaining doubt that Delaware feels pressure from Washington was dispelled recently by Delaware's Chancellor Strine who observed that the federal government's recent legislative initiative reeks of "the sour scent of hypocrisy" that "wafted from some important congressional chambers" in the brewing of the "strange stew" riddled with "narrow provisions of dubious value."¹⁸

Roe's argument might have a little punch if there were any realistic chance that federal legislation might lower the opportunity costs to corporations of not incorporating in Delaware. But there is not. As Romano observed, firms charter in Delaware to minimize litigation risk. Federal incursions into corporate governance such as Sarbanes-Oxley or the Foreign Corrupt Practices Act do not affect this calculation. We are left with the banal point that the federal government long has had the *power* under the Commerce Clause and the Supremacy Clauses of the United States Constitution to preempt Delaware law. However, we have no indication why this power will manifest itself in a competition over the content of substantive law rather than in a demand by politicians in Washington for political support in exchange for forbearance from regulation.¹⁹

III. THE MACEY-MILLER PUBLIC CHOICE THEORY

Among the competing theories about the nature of the jurisdictional competition for corporate charters, it appears clear that the theory that Geoffrey Miller and I articulated in 1987 continues to provide the most robust and complete explanation for the outcome in the *Disney* litigation.²⁰ Our hypothesis, which is based on the interest-group theory of legislation,²¹ and draws heavily on Roberta Romano's work,²² posits that the stable, predictable, and sophisticated body of corporate law in Delaware comes with a heavy price, extracted by powerful interest

criticism they then endured" decades ago (unsurprisingly, Roe's assertion here is not supported by citation). *Id.*

18. Stephen Taub, *Influential Delaware Judge Slams Sarbox*, CFO.COM, July 6, 2005, at <http://www.cfo.com/article.cfm/4149256>.

19. See generally Macey, *supra* note 15.

20. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987).

21. See Jonathan R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 227-30 (1986); Sam Peltzman, *Towards a More General Theory of Economic Regulation*, 19 J.L. & ECON. 211 (1976); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

22. See sources cited *supra* note 3.

groups within the state, particularly lawyers, who enjoy the dominant position within the culture that generates corporate law rules.²³

Our theory well explains the juxtaposition between the early decision on the motion to dismiss, which held so much promise for the plaintiffs, and the resounding defeat for the same group two years and millions of dollars in attorneys' fees later.

Our theory also explains other peculiarities about the decision, although the odd juxtaposition between the opinion in the Motion to Dismiss and the opinion after trial is quite supportive of our hypothesis. For one thing, the opinion is noteworthy for its encouraging tone towards future lawsuits. As one commentator presciently observed, despite finding for the defendants, in writing its decision "the court has put a 'please file claims' sign on their door,"²⁴ and even hinted that future suits might be treated differently.²⁵

Moreover, there is the tone of the opinion, in which the directors are repeatedly chastised for failing to live up to best practices as they apply to corporate governance issues. It will be worth a lot of professional fees to directors to avoid being pilloried the way that the directors and top officers of Disney were pilloried in this opinion. In other words, from the perspective of our theory, this opinion is noteworthy because it manages to side with the defendants while simultaneously giving them significant incentives to cloak their decisions in a dense shroud of process and to take other steps that will generate high fees for lawyers, investment bankers, and other advisors (who, incidentally, are precisely the same people who advise companies to incorporate in Delaware in the first place).

So, the opinion in *Disney* tends to support the Macey-Miller interest-group theory of Delaware corporate law. That theory predicts that Delaware law will be generally pro-defendant in order to attract chartering, but will do so in such a way that demand for the services of lawyers and other professional advisors remains strong. Along these lines, we observe that the litigation in this case is not over. The plaintiffs have vowed to appeal. Fees will be generated. We predict a settlement that will bring nothing of any value to Disney shareholders, but may well result in a generous fee award for the intrepid plaintiffs' attorneys who brought this case.

23. Macey & Miller, *supra* note 19, at 473.

24. Thaddeus C. Kopinski, *Ovitz Ruling Highlights Executive Pay Debate*, ISS GOVERNANCE WEEKLY, available at <http://www.issproxy.com/governance/publications/2005archived/150.jsp> (last visited Sept. 1, 2005).

25. *Id.*

Consistent with our theory, the plaintiffs' attorneys who brought this case are already setting the stage for their fee petition, which will revolve around the issue of whether there was a substantial benefit conferred on the corporation as a result of this litigation. This is what the lawyers for the plaintiffs may be referring to when they assert in the face of this resounding defeat that:

[t]his lawsuit has already positively impacted how corporate America manages its affairs, making clear that company resources cannot be used to line the pockets of senior executives. In addition, the Disney case has impelled America's boardrooms into closer scrutiny of chief executive officers' usurpation of managerial and supervisory duties—duties that boards have an obligation to companies and shareholders to oversee

. . . .

Because of our strong belief in the enforcement of fiduciary responsibilities on the part of officers and directors under Delaware law—and our conviction that these responsibilities were not met in this case, we are committed to appeal the decision by Chancellor Chandler

. . . .

It would be unfortunate for shareholders and employees of public companies if this decision is read by corporate managers as a license to act in disregard of their duties to engage in the deliberate processes required by fiduciaries.²⁶

Race-to-the-Bottom, Race-to-the-Top, vertical competition, interest-group theory: these are the alternative theories that exist to explain United States corporate law in general, and Delaware's dominance in particular. The theory I developed twenty years ago with Geoffrey Miller continues to provide the most convincing account of Delaware's appeal to those who advise corporations about where to file their charters. Delaware is a great place for shareholders and managers to locate a corporation. The state has what has been identified as important "first-mover" advantages over other states that, in turn, give the state a significant degree of market power in the jurisdictional competition for

26. See PRNewswire, *Plaintiffs Led by Milberg Weiss Will Appeal Decision on Michael Ovitiz' Severance Payout From Disney*, at <http://www.kvoa.com/Global/story.asp?S=3702366> (last visited Aug. 18, 2005) (quoting plaintiff attorneys Seth Rigrodsky, Joshua Vinik, and Melvyn Weiss, respectively).

2005]

DELAWARE CORPORATE LAW

1139

corporate charters.²⁷ The lion's share of the economic rents that this market power make possible are collected by the lawyers who advise Delaware companies.

27. See Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1923 (1998).