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Delaware Strikes Back: Newcastle Partners and the Fight for State Corporate Autonomy

MICHAEL W. OTT*

ABRAHAM. Do you bite your thumb at us, sir?

SAMSON. I do bite my thumb, sir.

ABRAHAM. Do you bite your thumb at us, sir?

SAMSON, *to Gregory*. Is the law of our side if I say 'Ay'?

GREGORY. No.

SAMSON, *to Abraham*. No sir, I do not bite my thumb at you, sir, but I bite my thumb, sir.¹

INTRODUCTION

For the better part of the twentieth century, Delaware has dominated the American corporate boardroom.² However, recent corporate scandals have awoken the federal giant. With the Securities and Exchange Commission's (SEC) new mandate under Sarbanes-Oxley, is the era of Delaware's corporate dominance at an end?

Historically, Congress has left the regulation of the internal governance of corporations to the states.³ Under the internal affairs doctrine, "[s]tates . . . create corporations . . . prescribe their powers, and . . . define the rights that are acquired by purchasing their shares."⁴ Once a business chooses a state in which to incorporate, only the laws of that state govern the internal affairs of the corporation.⁵ Therefore, corporate managers have an incentive to incorporate in the state that the managers believe will provide the cheapest legal and business environment. At the same time, states receive tax revenue for each corporate charter granted.⁶ The internal affairs

* J.D. Candidate, 2007, Indiana University School of Law–Bloomington; B.A., 2003, The College of William and Mary. Thanks to Professor Joshua Fairfield, Eric McKeown, Charles Persons, Katie Williams, Derek Molter, and Andrea Button for their insightful comments. Special thanks to my parents, Paula and Bob Ott, for their support. Thanks Dad for suggesting the topic; you have always been an outstanding role model and teacher, and I continue to look up to you in everything I do.

1. WILLIAM SHAKESPEARE, *ROMEO AND JULIET* act 1, sc.1.

2. Professor Ahdieh has gone so far as to declare that Delaware enacts the nation's corporate law. Robert B. Ahdieh, *From "Federalization" to "Mixed Governance" in Corporate Law: A Defense of Sarbanes-Oxley*, 53 *BUFF. L. REV.* 721, 736 (2005).

3. See *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69, 90–91 (1987); see also *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1112 (Del. 2005); J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 *U. RICH. L. REV.* 317, 321–22 (2004).

4. *CTS*, 481 U.S. at 91.

5. *Id.* at 90.

6. Delaware charges \$89 to file a one-page certificate of incorporation, \$9 for each additional page, and \$30 for each certified copy. For a full schedule of fees, see DELAWARE

doctrine has, therefore, created an environment in which all fifty states compete for a share of the corporate chartering business.⁷

In the debate about the effect this competition has on state laws, two schools of thought exist. The first argues that since management makes the ultimate decision where to incorporate (or reincorporate), states amend their corporate codes to favor management at the expense of shareholders.⁸ This school calls the competitive push to please management the “race for the bottom.”⁹ The second school of thought argues that businesses choose to incorporate in states that are best able “to adapt [their] corporate code[s] to changing business circumstances.”¹⁰ This school believes that adaptability of state law creates a more efficient business environment, decreases costs, and, ultimately, increases value for shareholders.¹¹ This school terms the competition a “race . . . to the top.”¹²

For the better part of the last century, the state of Delaware has dominated this competition. Delaware has a reputation for being most responsive to corporate needs.¹³ Over fifty percent of all publicly traded companies¹⁴ and sixty percent of Fortune 500 companies are incorporated in Delaware,¹⁵ though Delaware’s 843,000 residents account for only 0.28% of the population of the United States.¹⁶ If there is, as many commentators have suggested, a “race” to capture the franchise taxes of American corporations,¹⁷ Delaware has won. Delaware is usually the first state to respond to the needs of the market, but even when it does not, its ability to imitate allows quick adoption of successful corporate innovations from competitor states and erases any incentives for Delaware corporations to reincorporate elsewhere.¹⁸ Delaware’s success

DEPARTMENT OF STATE: DIVISION OF CORPORATIONS FEE SCHEDULE 1 (2006), <http://www.state.de.us/corp/newfee.pdf>. In 2004, Delaware collected \$568,190,000 on corporate licenses. U.S. CENSUS BUREAU, STATE GOVERNMENT TAX COLLECTIONS: 2004 (2004), <http://www.census.gov/govs/statetax/0408destax.html>. For further discussion, see *infra* notes 128–30 and accompanying text.

7. See ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 5 (1993).

8. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974).

9. *Id.*

10. ROMANO, *supra* note 7, at 9.

11. *See id.* at 14–16.

12. *Id.* at 14.

13. *Id.* at 16.

14. A publicly traded company is “[a] corporation whose shares are traded to and among the general public.” BLACK’S LAW DICTIONARY 367 (8th ed. 2004).

15. State of Delaware, Division of Corporations Home Page, <http://www.state.de.us/corp/default.shtml> (last visited Jan. 12, 2006).

16. *See* Delaware State & County QuickFacts from the U.S. Census Bureau, <http://quickfacts.census.gov/qfd/states/10000.html> (last visited Jan. 12, 2006) (listing population estimates for 2005).

17. For further discussion of this debate, see *infra* Part I.C.

18. For further discussion of this debate, see *infra* Part I.C. Delaware’s utter dominance of this competition suggests that it may be more appropriate to call this “race” a “clone war.” Since no state can realistically beat Delaware at its own game, the best a state can hope to do is clone the Delaware business environment and hold on to businesses already incorporated in the state.

at monopolizing the market for franchise fees has led some to refer to Delaware's corporate code as its "chartering business."¹⁹

The story of American corporate law is not, however, exclusively state-dominated. After the stock market crash of 1929, the federal government enacted legislation that federalized securities laws.²⁰ Since that time, there has been an uneasy "agreement" between the states and the federal government. The states regulate the internal governance of a corporation, and the federal government, through delegation to the SEC, regulates a company's external affairs—that is, the relationship between the company and the market.²¹

However, the federally created boundary between internal and external affairs is rather artificial. For example, the SEC has heavily regulated the requirements for holding an annual meeting, the quintessential internal affair.²² As one may expect with artificial distinctions, courts are frequently left to sort out the unclear lines of demarcation.²³

With its lead secure against competition from other states, Delaware's greatest concern is that the federal government will intervene and preempt its corporate law, thus destroying Delaware's chartering business in one fell swoop.²⁴ Delaware has far more corporate franchise tax income to lose from federal preemption than any other state.²⁵ Therefore, Delaware has warily eyed the SEC and Congress whenever confronting a question that might draw federal scrutiny.²⁶

Since the Enron and WorldCom accounting scandals in 2002, the threat of total federal preemption of state regulation of internal corporate governance has become immediate. In response to these scandals, Congress enacted the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").²⁷ This Act gave the SEC new power to regulate various aspects of the internal governance of corporations.²⁸

19. See, e.g., Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 592 (2003).

20. The most notable examples are the Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2000)) and the Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78nn (2000)).

21. See Mark J. Loewenstein, *The Quiet Transformation of Corporate Law*, 57 SMU L. REV. 353, 354 (2004).

22. See *infra* note 56 and accompanying text.

23. See Roe, *supra* note 19, at 610.

24. See William W. Bratton, *Delaware Law as Applied Public Choice Theory: Bill Cary and the Basic Course After Twenty-five Years*, 34 GA. L. REV. 447, 464–65 (2000); Roe, *supra* note 19 (explaining that the federal government has almost always been Delaware's greatest competitor).

25. See Bratton, *supra* note 24, at 457 ("Delaware, as the entity most dependent on corporate law revenues, is the contracting state most prone to view that possibility as a threat.").

26. See Roe, *supra* note 19, at 604–07.

27. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 & 29 U.S.C. (2006)).

28. See Ahdieh, *supra* note 2, at 723–24; Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 81, 101–03 (2005) ("The SEC's new activism with respect to corporate governance can thus be analyzed as the latest maneuver in a long running battle between federal and state authorities over the regulation of public corporations.").

With the ongoing federal intrusion into traditionally state-controlled law, it was only a matter of time before the Delaware courts encountered a direct conflict between Delaware and federal corporate law. This question arose in November of 2005 in *Newcastle Partners v. Vesta Insurance Group*.²⁹ While the Delaware court probably arrived at the correct result, in the process it “bit its thumb” at the federal government and implied that Delaware’s corporate lawmaking power is equal—or even superior—to that of the federal government.

This Note discusses the Court of Chancery of Delaware’s action in *Newcastle Partners*, and concludes that it is the first volley in what could be a long power struggle between Delaware and the SEC. Part I delineates the historical development of corporate law over the last century by starting with corporate law as it existed before the Great Depression and continuing through the enactment of Sarbanes-Oxley. Part II examines more closely Delaware’s role at the center of the incorporation business. Finally, Part III dissects the *Newcastle Partners* opinion and concludes that the opinion achieves the right result, but under the wrong conceptual framework. The framework chosen by the Court of Chancery—the internal affairs doctrine of conflicts of law—suggests that Delaware has corporate law-giving power equal *or superior* to the federal government’s. While the result achieved in *Newcastle Partners* is correct, Delaware risks the fury of the SEC and the federal government if it extends this reasoning to future cases. To avoid these results, the SEC must soon take an opportunity to assert its ultimate authority over state corporate law.

I. HISTORICAL DEVELOPMENT OF CORPORATE LAW OVER THE LAST CENTURY

The last century saw modern corporate law develop from trust-busting and the creation of federal antitrust laws in the late nineteenth century to Enron, WorldCom, and the accounting scandals of the early twenty-first century. This history is primarily the story of Delaware law responding to both horizontal (competing states) and vertical (federal) pressure.³⁰

A. Pre-SEC Corporate and Securities Law and the Wilson Presidency

The corporate-chartering business began in the late nineteenth century as states began to liberalize their corporate codes.³¹ First, states removed statutory limitations on corporate duration, size, and purpose.³² Eventually, states amended their corporate codes to shift authority within corporations from shareholders to managers.³³

At the turn of the twentieth century, the premier corporate law policy debate centered on big trusts such as Standard Oil. Standard Oil sought to control the oil

29. 887 A.2d 975 (Del. Ch.), *aff’d*, 906 A.2d 807 (Del. 2005) (unpublished table decision).

30. Compare ROMANO, *supra* note 7, at 9–11 (discussing how the fifty states compete with Delaware for the corporate-chartering business) with Bratton, *supra* note 24, at 457–58 (explaining how the threat of federal intervention provides incentives for Delaware to respond to shareholder needs over management’s wishes).

31. See Brown, *supra* note 3, at 335.

32. *Id.*

33. *Id.*

market by purchasing oil companies throughout the United States. However, states did not allow in-state corporations to own stock in out-of-state corporations.³⁴ In response, Standard Oil organized a cartel to control oil prices.³⁵ After the cartel proved unstable, Standard Oil entered into a series of trust agreements through which it could control most of the American oil industry.³⁶

Some states, such as Ohio, did not like the trust, and sought to insulate the Ohio branch of Standard Oil from the trust agreement. The Ohio Attorney General successfully attacked the trust in the Ohio Supreme Court on the grounds that Ohio, as the incorporating state, had not given Standard Oil of Ohio the right to enter into a trust arrangement.³⁷ Other states took this opportunity to attempt to attract the corporations being driven out of states like Ohio. New Jersey stepped onto the scene as the first state to attract a large number of corporations through the “liberalization” of its corporate law.³⁸

New Jersey “liberalized” its corporate law to allow New Jersey corporations to buy stock in out-of-state corporations.³⁹ This allowed New Jersey to attract large corporate combinations such as Standard Oil. Other states saw New Jersey’s success and raced to adopt its corporate innovations.⁴⁰ Delaware was among those states that followed New Jersey’s lead, but “firms were happy with New Jersey and generally stayed put.”⁴¹

However, national politics brought New Jersey’s dominance to a sudden end; surprisingly, the key to Delaware’s eventual supremacy was the presidential candidacy of Woodrow Wilson.⁴² During the 1912 presidential campaign, Theodore Roosevelt campaigned against Woodrow Wilson, the governor of New Jersey, on the grounds that Wilson had talked about cleaning up the corporate law of New Jersey, but had not acted.⁴³ This prompted Wilson to push the New Jersey legislature to adopt more restrictive corporate law.⁴⁴ Once New Jersey changed its law, the majority of businesses incorporated in New Jersey reincorporated in neighboring Delaware.⁴⁵

B. The Securities Act of 1933 and Securities Exchange Act of 1934

After the stock market crash in 1929 and the resulting depression, Congress, disgruntled by the resulting laxity of state corporate law, took it upon itself to plug

34. See Roe, *supra* note 19, at 608.

35. *Id.*

36. *Id.*

37. *Id.* (citing *State ex rel. Attorney Gen. v. Standard Oil Co.*, 30 N.E. 279 (Ohio 1892)).

38. See *id.* at 609.

39. *Id.*

40. See *id.*

41. *Id.*

42. *Id.* at 609–10.

43. *Id.* at 609.

44. *Id.* at 609–10.

45. See Cary, *supra* note 8, at 664; Roe, *supra* note 19, at 610. It should be noted that the excesses of the trust era led to the first important federalization of state corporate law. In response to the initial liberalization by New Jersey, in 1890 Congress passed the Sherman Act, ch. 647, 26 Stat. 209 (1890) (codified as amended at 15 U.S.C. §§ 1–7 (2000)). Roe, *supra* note 19, at 609. This Act substantially limited the abilities of corporations to combine when the combination would restrain interstate trade.

holes in state regulations through which management could retain control of a corporation to its advantage.⁴⁶ Specifically, Congress believed that the increased power of managers had led to an environment in which managers kept shareholders in the dark about many important aspects of the business, thus enabling managers to remain in office and to profit at the expense of shareholders.⁴⁷ In response to this, Congress passed the Securities Act of 1933⁴⁸ (“1933 Act”) and the Securities Exchange Act of 1934⁴⁹ (“1934 Act”). The 1933 Act regulated the primary market—the market in which securities issuers initially sold securities to the general public.⁵⁰ The 1934 Act created the SEC to administer the securities laws through the issuance of regulations, regulated proxy solicitations, and regulation of the secondary market—the market for the resale of securities.⁵¹

Federal securities law is based on the principle of disclosure.⁵² “Full disclosure regulation is based on the often quoted theory that ‘[p]ublicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.’”⁵³ This emphasis on disclosure over substantive regulation, while hotly debated at the time of its enactment,⁵⁴ has become the gospel of the federal and state balance in the corporate

46. See Brown, *supra* note 3, at 336–37.

47. See *id.* at 336.

48. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2000)).

49. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78nn (2000)).

50. WILLIAM A. KLEIN ET AL., BUSINESS ASSOCIATIONS: AGENCY, PARTNERSHIPS, AND CORPORATIONS 403 (5th ed. 2003).

51. *Id.* at 403–04. Many sections of the 1934 Act are practically devoid of any substance. Congress delegated responsibility for the substance of the law to the SEC. For example, the regulation dealing with proxy solicitations states:

It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, *in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors*, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78l of this title.

15 U.S.C. § 78n(a) (emphasis added). Therefore, the conflict is never so much between the states and Congress as it is between the states and the SEC. Moreover, the 1934 Act limits its periodic disclosure requirements to corporations with total assets over \$1,000,000 and more than 500 shareholders. 15 U.S.C. § 78l(g)(1).

52. Karmel, *supra* note 28, at 82. For example, 15 U.S.C. § 77f (2000 & Supp. II 2002) requires the registration of securities. “Any security may be registered with the Commission under the terms and conditions hereinafter provided, by filing a registration statement.” 15 U.S.C. § 77f(a). “The information contained in or filed with any registration statement shall be made available to the public under such regulations as the Commission may prescribe.” 15 U.S.C. § 77f(d).

53. Karmel, *supra* note 28, at 82 n.5 (alteration in original) (quoting LOUIS D. BRANDEIS, OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT 92 (1914)).

54. See *id.* at 82–83.

regulation debate.⁵⁵ The SEC, the agency that regulates securities, has limited power beyond the ability to enforce this disclosure system.

However, even with its seemingly limited mandate, the SEC has, in fact, promulgated a great deal of regulation dealing with the internal governance of a corporation. For example, the SEC has heavily regulated the proxy solicitation process. To elect a board of directors, a corporation often has to solicit proxy votes from its shareholders to reach quorum. The SEC, concerned that companies did not provide shareholders with information adequate to make an informed vote, required corporations to publish an annual report before they could solicit proxies. In response to this regulation, many companies stopped soliciting for proxy votes and, instead, began relying on management votes and a smaller number of shareholders to reach quorum. The SEC then required companies to issue an annual report before they could elect directors, regardless of the corporation's intent to solicit proxies. The result of these regulations is that the SEC dictates what information a corporation must disclose before it can engage in the quintessential internal affairs act: shareholder control of the board of directors.⁵⁶

C. Professor Cary and the "Race to the Bottom" Debate

Some, such as Supreme Court Justice William O. Douglas, believed that the federal securities laws of the early 1930s did not go far enough to solve the excesses of the Roaring Twenties.⁵⁷ Although there was a push to include federal incorporation as part of the New Deal, the push ultimately failed.⁵⁸ Under the haze of prosperity of the post-World War II boom, the federal incorporation movement went into a period of deep hibernation.

In the 1970s, under the shadow of the turmoil surrounding the Watergate scandal, Professor Bill Cary of Columbia University picked up the federalization gauntlet. In a highly influential article,⁵⁹ Professor Cary argued that the competition among the states for corporate franchise fees had become a "race for the bottom,"⁶⁰ and, therefore, the federal government should become involved in the regulation of the internal governance of publicly held companies.⁶¹

55. See Roe, *supra* note 19, at 596; cf. ROMANO, *supra* note 7, at 3–4 (discussing federal disclosure requirements in relation to state securities laws and highlighting the corporate governance versus disclosure distinction).

56. See Roe, *supra* note 19, at 612 (quoting ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 148 (1999)). The SEC's proxy regulations are the basis of the conflict in *Newcastle Partners v. Vesta Insurance Group*, 887 A.2d 975 (Del. Ch.), *aff'd*, 906 A.2d 807 (Del. 2005) (unpublished table decision), and are discussed more fully *infra* Part III.

57. See Karmel, *supra* note 28, at 83.

58. For a contemporaneous argument against federal incorporation, see Harris Berlack, *Federal Incorporation and Securities Regulation*, 49 HARV. L. REV. 386 (1936).

59. Cary, *supra* note 8. In 1991, the *Yale Law Journal* published a list of the *Yale Law Journal* articles most-cited between 1956 and 1989. Professor Cary's article ranked as the fourteenth most-cited article. Fred R. Shapiro, *The Most-Cited Articles from The Yale Law Journal*, 100 YALE L.J. 1449, 1462 (1991).

60. Cary, *supra* note 8, at 666.

61. *Id.* at 701–02.

The race model of state corporate law assumes that each state, to maximize franchise tax revenues, adopts laws to attract businesses to incorporate within their state. Whenever one state adopts a new, more attractive law, other states will “race” to adopt an even more attractive law. Professor Cary argued that since managers ultimately choose where to incorporate, states have an ongoing incentive to adopt laws that are the most permissive toward managers. As the race reached its conclusion, the country would be left with an environment in which no state polices the actions of business managers—the bottom, as far as Professor Cary was concerned.⁶²

Professor Cary acknowledged that Delaware was the leader in corporate “innovation,” and, therefore, the winner of this race.⁶³ He argued that Delaware’s primary public policy regarding business had been to relax manager fiduciary standards and standards of fairness as much as possible to foster incorporation in Delaware.⁶⁴ Cary contrasted this pro-management attitude with contemporaneous federal case law and concluded that the federal government was much more concerned than Delaware about the rights of shareholders.⁶⁵ Cary stopped short of proposing federal incorporation, but suggested the creation of federal minimum standards for manager fiduciary duties and internal corporate governance.⁶⁶

Cary’s article prompted a great deal of response. Judge Ralph Winter of the Second Circuit, while a professor at Yale, argued that Cary’s analysis was fundamentally flawed.⁶⁷ Judge Winters accepted the “race” premise, but he argued that if Professor Cary’s contentions were true, then businesses incorporated in Delaware would have a fundamental economic disadvantage.⁶⁸

(1) If Delaware permits corporate management to profit at the expense of shareholders and other states do not, then earnings of Delaware corporations must be less than earnings of comparable corporations chartered in other states and shares in the Delaware Corporations must trade at lower prices. (2) Corporations with lower earnings will be at a disadvantage in raising debt or equity capital. (3) Corporations at a disadvantage in the capital market will be at a disadvantage in the product market and their share price will decline, thereby creating a threat of a takeover which may replace management.⁶⁹

Judge Winter agreed that the states did race; however, the result of this race was that states minimized the cost of doing business and, thus, maximized value for shareholders. Judge Winter called this race a “race to the top.”⁷⁰

62. *See id.* at 666–68.

63. *See id.* at 668–70.

64. *Id.* at 670.

65. *See id.* at 692–96.

66. *Id.* at 700–02.

67. Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 256 (1977) (“With all due respect both to Professor Cary and to the almost universal academic support for his position, it is implausible on its face.”).

68. *Id.* at 255–56.

69. *Id.* at 256.

70. *Id.*

The “race for the bottom” and “race to the top” debate dominated corporate legal policy discussions for most of the rest of the century.⁷¹ However, starting in the mid-1980s, it became clear that neither theory was completely satisfactory.

D. The Takeover Boom and Delaware’s Odd Behavior

As early as 1968, the issue of corporate takeovers had become important enough that Congress deemed it necessary to enact the Williams Act.⁷² The Williams Act added disclosure requirements for an offeror seeking to acquire a block of more than five percent of any class of security by tender offer and additional disclosure requirements for any purchaser whose holdings exceed five percent of the outstanding securities after an acquisition.⁷³

The takeover boom hit its peak in the 1980s.⁷⁴ In reaction to the high frequency of takeovers, a number of states passed anti-takeover legislation to protect the current management of state corporations from “corporate raiders.”⁷⁵ During this period, two things happened that do not fit into the “race” dynamic. First, Delaware lagged far behind in passing anti-takeover legislation.⁷⁶ If Professor Cary’s theory is correct, then Delaware should have raced to provide expansive protection for management interests. Specifically, Delaware should have enacted a statute that would protect current management’s control of the corporation.⁷⁷ If Judge Winter’s theory is correct, and

71. See, e.g., ROMANO, *supra* note 7, at 14–31 (siding with Judge Winter and updating the argument through 1993).

72. Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended in scattered sections of 15 U.S.C. (2000 & Supp. II 2002)).

73. *Edgar v. MITE Corp.*, 457 U.S. 624, 628 n.2 (1982).

74. See generally JAMES B. STEWART, *DEN OF THIEVES* (1991) (chronicling the business scandals of the mid-to-late 1980s, including the high-yield bond boom and bust, the downfall of Drexel Burnham, and the insider trading scandals).

75. Illinois passed a statute requiring any party offering to acquire an Illinois corporation to register with the Illinois Secretary of State. ILL. REV. STAT., ch. 121 ½, ¶¶ 137.51–137.70 (1979), *invalidated by* *Edgar v. MITE Corp.*, 457 U.S. 624 (1982). In 1986, Indiana amended its corporate code with the Control Share Acquisitions Chapter, 1986 IND. ACTS 149 (codified as amended at IND. CODE § 23-1-42). If a corporation chooses to opt into this section, voting power will not vest in any party that obtains more than 20%, 33⅓%, or 50% of the outstanding stock of the corporation until the remaining shareholders consent by resolution. IND. CODE §§ 23-1-421 to -9(b) (2005).

76. *Roe*, *supra* note 19, at 625–26 (“Other states were producing one pro-managerial anti-takeover law after another, only to see them get knocked down at the federal level as preempted by the Williams Act or the Constitution’s dormant commerce clause. Delaware, meanwhile, waited and passed only a mild anti-takeover law late in the decade.”).

77. *Cf. Cary*, *supra* note 8, at 668–70 (discussing the reasons for Delaware’s primacy). An anti-takeover statute is usually designed to place barriers in the way of a corporation that tenders a hostile (uninvited) takeover offer. See, e.g., ILL. REV. STAT., ch. 121 ½, ¶¶ 137.51–137.70 (1979). This protects the current management of a company because it gives them more grounds upon which to contest the offer. Since current management can decide where to incorporate a company, and assuming that the current management is interested in protecting its control of the resulting corporation, it follows that current management would seek to incorporate in the state that has the strongest anti-takeover statute.

states move in the direction of adopting laws that will maximize shareholder value, then why did Delaware move in the opposite direction of the vast majority of states?

Second, Delaware initially signaled in *Smith v. Van Gorkom* that it was willing to impose a stronger fiduciary duty on current management.⁷⁸ *Smith v. Van Gorkom* involved a friendly takeover, initiated by the management of the target company. Van Gorkom, Chairman and CEO of the target—nearing mandatory retirement—approached corporate takeover specialist Jay Pritzker with a proposed takeover price and financing structure in hand, “without consulting either his Board or any members of Senior Management except one: Carl Peterson, [the target’s] Controller.”⁷⁹ There was no evidence to suggest that Van Gorkom did anything more than pick a number out of thin air to arrive at a takeover price that he thought would attract Pritzker’s attention.⁸⁰ Within weeks, Van Gorkom had presented Pritzker’s interest to the Board of Directors.⁸¹ After a two-hour meeting, and based solely on Van Gorkom’s oral presentation, supporting representations, and an attorney’s legal advice that failure to accept the offer might result in a lawsuit, the directors approved the merger agreement with a few minor amendments.⁸² After word of the proposed merger got out, some shareholders balked at the proposal and brought a lawsuit, claiming that the directors had breached their duties of loyalty and care by failing to reach an informed business judgment.⁸³

The Delaware Supreme Court found for the plaintiffs and concluded that the Board of Directors had failed to adequately inform themselves of either Van Gorkom’s potential conflict of interest or the intrinsic value of the company.⁸⁴ Therefore, the court concluded, over a dissent, that the Board had been grossly negligent in reaching its decision.⁸⁵

Commentators found this decision “surprisingly aggressive in [its application] of the duty of care to board approval[] of proposed mergers.”⁸⁶ Not surprisingly, so did corporate directors.⁸⁷ In response to the opinion, Delaware enacted legislation allowing corporations to limit the liability of their directors for breaches of the duty of care as long the directors acted in good faith and did not commit intentional misconduct.⁸⁸

If, as Professor Cary’s analysis suggests, Delaware’s sole public policy is the promotion of management’s interest at the expense of corporate shareholders,⁸⁹ why did the Delaware Supreme Court even take this step? The rule of this case would require current management to spend more time and money providing information for the shareholders—a result which clearly favors the shareholders at the expense of management. Moreover, if, as Judge Winter suggests, competition between states will

78. See 488 A.2d 858 (Del. 1985).

79. *Id.* at 866.

80. See *id.*

81. *Id.* at 868–69.

82. *Id.* at 869.

83. *Id.* at 870–71.

84. *Id.* at 874.

85. *Id.*

86. Bratton, *supra* note 24, at 465.

87. KLEIN ET AL., *supra* note 50, at 338.

88. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001); see also KLEIN ET AL., *supra* note 50, at 338.

89. See *supra* text accompanying note 64.

promote laws that maximize value for shareholders,⁹⁰ how can Delaware's response to *Van Gorkom* be justified when it would allow directors in fact situations similar to *Van Gorkom* to present takeover proposals to the shareholders without even conducting valuation studies?

The answer is that both "race" models fail to account for Delaware's responsiveness to the threat of federal intervention. Delaware feared that if it followed the lead of its sister states and adopted a pro-management, anti-takeover statute, then the federal government would come in and preempt the entire field.⁹¹ In *Edgar v. MITE Corp.*,⁹² the United States Supreme Court had already declared one anti-takeover statute unconstitutional under the dormant Commerce Clause.⁹³ It was not until after the Supreme Court backed off of its pro-takeover stance in *CTS Corp. v. Dynamics Corp.* that Delaware began to move in a sharply anti-takeover direction.⁹⁴

States with only a few large publicly traded corporations can effectively legislate below the federal radar.⁹⁵ However, Delaware is not one of those states. As home to more than half of all publicly traded corporations,⁹⁶ any pro-management Delaware initiative is bound to draw federal attention. And if the federal government does act, Delaware has a great deal to lose.⁹⁷

E. Enron, Sarbanes-Oxley, and the Federal Intervention

The ultimate problem that led to the "race for the bottom" argument is the agency cost inherent in separating ownership and management in a corporation. Because of this separation, the two parties' interests may deviate.⁹⁸ "Race for the bottom" proponents simply argue that the states have chosen one side (management) at the expense of the other (shareholders).

This clear-cut distinction broke down slightly in the 1990s through the prolific use of stock options. Institutional investors and other large shareholder groups pushed to align the interests of management with those of shareholders by compensating management with stock options.⁹⁹ Therefore, each manager would have a personal incentive to maximize the value of the stock.¹⁰⁰ With this realignment, it became harder to argue that states allowed management to profit at the expense of shareholders, and the "race" analogy lost some of its strength. If the interests of two private groups were

90. See *supra* text accompanying notes 68–69.

91. See *Roe, supra* note 19, at 628.

92. 457 U.S. 624 (1982).

93. See *id.* at 643. The statute at issue in this case was an Illinois statute that required an acquiring company to register all takeover offers with the Illinois Secretary of State when the target company had a defined minimum connection with the state, regardless of where the company was incorporated. *Id.* at 627–28.

94. See *Roe, supra* note 19, at 628, 631–32. For further discussion of *CTS*, see *infra* notes 189–97 and accompanying text.

95. *Roe, supra* note 19, at 628, 631–32.

96. See *infra* notes 114–15 and accompanying text.

97. See *infra* Part II.B.

98. See *ROMANO, supra* note 7, at 1–2.

99. See *Karmel, supra* note 28, at 104.

100. See *id.*

truly aligned, then why should the government get involved in regulating their relationship at all?

Stock options aligned management and shareholder interests in terms of the bottom line: stock price. More importantly, stock options mollified shareholder concerns about management actions. Since stockholders saw the increasing stock price and sunny financial reports, they had little incentive to monitor the managers and directors closely. However, managers were still concerned with far more than the bottom line. For example, corporate managers were still very concerned with the threat of a hostile takeover.¹⁰¹ Therefore, states still had incentives to satisfy management.¹⁰²

The 1990s were a period defined by the term “irrational exuberance.”¹⁰³ The prolific use of stock options—the very idea that institutional stockholders championed as the perfect tool to align management and shareholder interests—was “a key cause of the 1990s stock market bubble and its collapse.”¹⁰⁴ Stock options create a huge incentive for management to increase the bottom line and, therefore, increase the stock price, just as the institutional investors intended. However, stock options also create an equally large incentive for corporations “to manipulate accounting principles and financial statements” in order to inflate the bottom line and, thereby, increase stock prices.¹⁰⁵

After the accounting scandals at Enron and WorldCom became public in 2002, states were immediately blamed for lax governance standards that supported an environment in which boards of directors did not monitor the actions of corporate officers.¹⁰⁶ In response to these scandals, Congress passed the most far-reaching federal corporate statute to date, the Sarbanes-Oxley Act of 2002.¹⁰⁷

101. See *supra* Part I.D.

102. See Bratton, *supra* note 24, at 458.

103. Jay Mathews, *Greenspan Sends Stocks Seesawing; Dow Plunges After Comment, Rebounds*, WASH. POST, Dec. 6, 1996, at A1 (“Greenspan voiced out loud what many Wall Street analysts have been saying for months—that stocks are priced at levels that are out of line with their companies’ intrinsic value—and his apparent endorsement of that idea opened the door to selling.”).

104. Karmel, *supra* note 28, at 104.

105. See *id.* at 104–05 (citing John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 275 (2004)).

106. See Andrew Skouvakis, Comment, *Exiting the Public Markets: A Difficult Choice for Small Public Companies Struggling with Sarbanes-Oxley*, 109 PENN. ST. L. REV. 1279, 1281 (2005) (citing Joann S. Lublin, *Inside, Outside Enron, Audit Panel is Scrutinized: Links to Company of Certain Members are Called Too Cozy*, WALL ST. J., Feb. 1, 2002, at C1); Albert B. Crenshaw, *Pension Funds Seek Tougher Audit Rules*, WASH. POST, Feb. 5, 2002, at E1 (“Council members emphasized yesterday that they regard boards of directors and other aspects of corporate governance as the key to preventing further Enrons—even more than auditor reforms. ‘Issues of corporate governance . . . have clearly come to roost,’ said Damon Silvers of the AFL-CIO.”) (omission in original); Editorial, *Cleaning Up the Boardroom*, N.Y. TIMES, Mar. 8, 2002, at A20 (“[Bush’s proposal] fails to address one of the biggest corporate governance problems revealed by Enron, the need to hold boards of directors more accountable. One of the most important lessons of Enron is the havoc that can result when oversight by corporate boards of directors breaks down.”).

107. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 & 29 U.S.C. (Supp. II 2002)).

In an attempt to prevent future scandals, Sarbanes-Oxley implemented significant changes in at least three important areas. First, the Act established the Public Company Accounting Oversight Board “to oversee the audit of public companies that are subject to the securities laws . . . in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports.”¹⁰⁸ Second, it created new independence requirements for members of the audit committees of publicly-traded companies’ boards of directors.¹⁰⁹ Finally, and most notoriously,¹¹⁰ the Act required that both the principal executive officer and the principal financial officer certify the accuracy of all periodic reports filed under the Securities Exchange Act.¹¹¹

Congress drafted these laws to be consistent with the traditional role of federal law in corporate regulation as one of disclosure, rather than regulation of internal affairs. However, even though these laws mainly consisted of disclosure and audit requirements, they have a substantial effect on internal corporate governance. The new independence requirements are substantive regulations of the makeup of the board of directors. The certification requirement also has a substantial effect on internal corporate governance because it requires CEOs and CFOs to establish and maintain new internal financial controls and evaluate the effectiveness of those controls.¹¹²

The federal threat to Delaware’s dominance in the regulation of internal corporate affairs was recognized even before Sarbanes-Oxley and the accounting scandals at Enron and WorldCom.¹¹³ However, since 2002, the threat of federal preemption of Delaware’s state business has never been greater.

II. DELAWARE’S MONOPOLY ON THE STATE INCORPORATION BUSINESS

Delaware is the sixth least populous state in the country,¹¹⁴ yet fifty percent of all publicly traded companies and sixty percent of all Fortune 500 companies have incorporated there.¹¹⁵ What is it about Delaware that continues to attract the majority of American corporations? More importantly, what does Delaware stand to lose if the federal government preempts the state chartering business?

A. Reasons for Delaware’s Success

To maintain its lead, Delaware has invested in a highly specialized and experienced corporate judiciary, a deep body of case law, and a stable corporate code.¹¹⁶ These assets allow Delaware to stay ahead of competing states through successful innovation

108. Sarbanes-Oxley Act of 2002 § 101.

109. Sarbanes-Oxley Act of 2002 § 301.

110. See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1540 (2005) [hereinafter Romano, *Quack*].

111. Sarbanes-Oxley Act of 2002 § 302.

112. Romano, *Quack*, *supra* note 110, at 1540.

113. See Bratton, *supra* note 24 (written in 2000).

114. State of Delaware, Delaware Economy and People, <http://www.state.de.us/gic/delfacts/people.shtml#Pop> (last visited Nov. 9, 2006) [hereinafter Facts].

115. See *supra* notes 14–15 and accompanying text.

116. Bratton, *supra* note 24, at 448–52.

or imitation.¹¹⁷ First, any litigation involving the interpretation of Delaware corporate law is channeled into the Delaware Court of Chancery. The Court of Chancery consists of one chancellor and four vice chancellors.¹¹⁸ The chancellors are appointed to twelve-year terms by the governor.¹¹⁹ Because of the amount of business in the state, the corporate bar is very influential.¹²⁰ The bar has a great deal of influence in Delaware judicial appointments; therefore, those appointed often have significant backgrounds in business law.¹²¹ This strong judiciary, when combined with Delaware's long history as incorporation king, has allowed Delaware to develop a very influential body of case law.¹²²

Most importantly, corporations can trust that Delaware corporate law will remain stable. Delaware can only amend its corporate code with a two-thirds supermajority of both houses of the legislature.¹²³ This stability provides Delaware corporations with a great degree of predictability—something very important to corporate managers and the corporate bar. However, this stability has also led some to sarcastically suggest that Delaware's corporate code boils down to a single principle:

Directors of Delaware corporations can do anything they want, as long as it is not illegal, and as long as they act in good faith . . . provided that “legality” is understood to be defined in terms of adherence to process rules and bad faith is understood to be very hard to prove.¹²⁴

Delaware's size is also a major factor in its success.¹²⁵ Since Delaware is so small, it is not subject to as much pressure from labor unions and consumer groups.¹²⁶ Delaware's citizens miss most of the impact of their corporate governance rules because most of the corporations conduct their business elsewhere.¹²⁷ Delaware citizens also have a strong personal incentive to support the state incorporation business because, were Delaware to lose its chartering business, those same citizens would be the party that would lose the most through the greatly increased state tax burden.

117. See ROMANO, *supra* note 7, at 9 (noting that “if Delaware is not the pioneer for a corporate law innovation, it is among the first to imitate”).

118. First State Judiciary—Court of Chancery Judges, http://courts.delaware.gov/Courts/Court_of_Chancery/?jud_off.htm (last visited Nov. 9, 2006).

119. ROMANO, *supra* note 7, at 39–40.

120. See *id.*

121. See *id.*

122. See Bratton, *supra* note 24, at 451–52.

123. ROMANO, *supra* note 7, at 41.

124. Bratton, *supra* note 24, at 467 (quoting Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1015 (1997)).

125. Roe, *supra* note 19, at 594.

126. See *id.*

127. See *id.*

B. What Delaware Stands to Lose

Delaware's success is also its Achilles' heel. In 2004, Delaware collected \$568,190,000 from corporate licenses.¹²⁸ This accounts for 24% of Delaware's revenue collection and allows the state to avoid imposing property or general sales taxes.¹²⁹ If Delaware wished to maintain its current revenue levels after the loss of its chartering business, the cost would run to \$684.57 per person.¹³⁰ This figure does not factor in the potential losses to the Delaware corporate legal community.

Delaware is in a unique position. While it must hold off attacks from other states, Delaware also must act cautiously or it will incite federal attention. Other states can afford to ignore the scrutiny of the SEC when they enact pro-management legislation because the benefit of additional corporate franchise revenue far outweighs the risk of federal preemption.¹³¹ Delaware, on the other hand, is in the spotlight; pro-management acts by Delaware would likely receive close federal scrutiny, especially after Sarbanes-Oxley.¹³² In fact, creeping federal intervention into the internal governance of corporations has already started one fire that could erupt into a raging inferno.

III. NEWCASTLE PARTNERS V. VESTA INSURANCE GROUP

The election of directors by shareholders at a corporation's annual meeting "is a cornerstone of Delaware corporate law."¹³³ Under Delaware law, a corporation must hold a shareholders' meeting every thirteen months.¹³⁴ After thirteen months, "the Court of Chancery may summarily order a meeting to be held upon the application of any stockholder or director."¹³⁵ There is no requirement that corporate managers disclose any information to shareholders as long as they provide the shareholders with a reasonable opportunity to vote.¹³⁶

While annual meetings may be the "cornerstone of Delaware corporate law," the SEC also heavily regulates them. Before any publicly-traded corporation may hold its annual meeting, it must provide shareholders with an annual report.¹³⁷ If a corporation

128. U.S. Census Bureau, State Government Tax Collections: 2004, <http://www.census.gov/govs/statetax/0408destax.html> (last visited Nov. 9, 2006) [hereinafter Census].

129. *See id.*

130. *Compare* Census, *supra* note 128 (listing tax collection amounts) *with* Facts, *supra* note 114 (listing population).

131. Bratton, *supra* note 24, at 458.

132. *See* Roe, *supra* note 19, at 601-02.

133. *Newcastle Partners v. Vesta Ins. Group*, 887 A.2d 975, 979 (Del. Ch.), *aff'd*, 906 A.2d 807 (Del. 2005) (unpublished table decision).

134. DEL. CODE ANN. tit. 8, § 211(c) (2001).

135. *Id.*

136. *See id.*

137. This is true whether or not a corporation is soliciting proxies. 17 C.F.R. § 240.14a-3(b) (2005) requires:

If the [proxy] solicitation is made on behalf of the registrant . . . and relates to an annual . . . meeting of security holders, or written consent in lieu of such meeting, at which directors are to be elected, each proxy statement furnished pursuant to paragraph (a) of this section shall be accompanied or preceded by an annual report to security holders . . .

is unable to distribute an annual report, then the corporation cannot hold its annual meeting.¹³⁸

The new certification requirements of Sarbanes-Oxley¹³⁹ substantially increase the costs of putting out an annual report. What happens if a Delaware corporation is unable to distribute an annual report within thirteen months after its previous annual meeting? If it holds its meeting without distributing the annual report, then it is subject to fines by the SEC. If, on the other hand, it does not have its meeting, then the Delaware Court of Chancery may order it to hold the meeting and, thus, violate the SEC regulation. Just such a case arose in *Newcastle Partners v. Vesta Insurance Group*.¹⁴⁰

A. The Case

In *Newcastle Partners*, the Delaware Court of Chancery confronted a clear conflict between state law and SEC regulation. Through suspect application of the internal affairs doctrine, the chancery court concluded that the laws of Delaware controlled, even if following those laws may subject the corporation to SEC fines.¹⁴¹

Vesta Insurance Company is an independent insurance agent specializing in homeowners insurance, automobile insurance, and fire insurance.¹⁴² By the time the case was ultimately decided on November 15, 2005, Vesta Insurance Group, Inc. (“Vesta”) had not held an annual shareholders’ meeting to elect directors since June 2004.¹⁴³ In July 2005, Newcastle Partners, a large shareholder, sued Vesta in the Court of Chancery, seeking an order that Vesta hold its shareholders’ meeting. Since Vesta had not held a shareholders’ meeting in over thirteen months, the court ordered Vesta to hold its meeting within ninety days.¹⁴⁴

Vesta moved for relief from this order and argued that the Delaware annual meeting requirement was in direct conflict with SEC regulations requiring information disclosures before a shareholders’ meeting could be held.¹⁴⁵ Vesta claimed that it could not publish its annual report or certified financial statements for 2004 before December

Id. In addition, 17 C.F.R. § 240.14c-2(a) (2005) requires:

In connection with every annual . . . meeting of [shareholders] . . . the registrant shall transmit a written information statement containing the information specified in Schedule 14C . . . and containing the information specified in . . . such form, to every [shareholder] . . . entitled to vote . . . in regard to any matter to be acted upon and from whom proxy authorization or consent is *not* solicited on behalf of the registrant pursuant to Section 14(a) of the Act.

Id. (emphasis added). See also 17 C.F.R. § 240.14c-3 (2005) (“If the information statement relates to an annual . . . meeting . . . of . . . [shareholders] at which directors . . . are to be elected, it shall be accompanied or preceded by an annual report to security holders . . .”).

138. 17 C.F.R. § 240.14c-2(b) (2005).

139. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 & 29 U.S.C. (Supp. II 2002)).

140. 887 A.2d 975 (Del. Ch.), *aff’d*, 906 A.2d 807 (Del. 2005) (unpublished table decision).

141. *Id.* at 977.

142. About the Shelby and Vesta Insurance Companies, <http://www.vesta.com/about.htm> (last visited Apr. 9, 2006).

143. *Newcastle Partners*, 887 A.2d at 977.

144. *Id.* The court rendered its initial ruling orally.

145. *Id.*

31, 2005.¹⁴⁶ Therefore, under SEC Rule Numbers 14a-2,¹⁴⁷ 14c-2,¹⁴⁸ and 14c-3,¹⁴⁹ Vesta would be subject to SEC fines if it held its annual meeting before that date.¹⁵⁰ The court denied Vesta's motion and ordered Vesta to hold its annual meeting on November 17, 2005.¹⁵¹

The Delaware court reached the right result under the wrong analytical framework. The Court of Chancery applied the internal affairs doctrine—a rule of conflicts of laws between states—to analyze a conflict between a state law and a federal regulation. As a result, the Delaware courts appear to be biting their thumbs at the SEC—suggesting that Delaware has equal corporate lawmaking power as the federal government.

*B. The Internal Affairs Doctrine is an Inappropriate
Vehicle for Discussion of a Federal/State Conflict*

The *Newcastle Partners* court based its opinion on the policy considerations underlying the internal affairs doctrine of conflicts of law.¹⁵² Under the internal affairs doctrine, only the laws of the state of incorporation govern a corporation's internal affairs.¹⁵³ This doctrine developed as an outgrowth of the Fourteenth Amendment's "implicit guarantee of the stockholder's right to 'know by what standards of accountability they may hold those managing the corporation's business and affairs.'"¹⁵⁴

This argument is flawed because it fails to recognize the supremacy of federal law and treats the federal government as if it were just another competing state. Instead, the *Newcastle Partners* court attempts to use the internal affairs doctrine to draw a line in the sand to protect Delaware's dominion over internal corporate governance rules.

The court inappropriately relies on *VantagePoint Venture Partners 1996 v. Examen, Inc.* as support for its application of the internal affairs doctrine. *VantagePoint* involved an attempt by California to regulate the voting rights of shareholders in corporations that have contact with California, but are incorporated in other states.¹⁵⁵ The California statute in question required that, in connection with a proposed merger, holders of preferred stock were entitled to vote as a separate class.¹⁵⁶ *Examen, Inc.*, a Delaware corporation, sought a declaration that the voting rights of

146. Vesta's 2004 annual report was eventually filed on May 25, 2006. Vesta Ins. Group, Inc., Annual Report (Form 10-K) (May 25, 2006). As of December 4, 2006, Vesta had yet to post its annual report for 2004 on its webpage. See Annual Reports, http://www.vesta.com/vta/annual_reports.htm (last visited Dec. 4, 2006).

147. 17 C.F.R. § 240.14a-2 (2006).

148. 17 C.F.R. § 240.14c-2 (2006).

149. 17 C.F.R. § 240.14c-3 (2006).

150. See *supra* text accompanying notes 134–38.

151. *Newcastle Partners v. Vesta Ins. Group*, 887 A.2d 975, 977 (Del. Ch.), *aff'd*, 906 A.2d 807 (Del. 2005) (unpublished table decision).

152. *Id.* at 981.

153. *Id.* at 981–82 (citing *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1113 (Del. 2005)); see also *supra* notes 3–5.

154. *Id.* at 982 (quoting *VantagePoint Venture Partners 1996*, 871 A.2d at 1113).

155. *VantagePoint Venture Partners 1996*, 871 A.2d at 1109–10 n.1 (citing CAL. CORP. CODE § 2115 (West 2006)).

156. *Id.* at 1110 (citing CAL. CORP. CODE § 1201(a) (West 2006)).

VantagePoint Venture Partners 1996, a holder of Series A Preferred Stock, were controlled by Delaware law rather than California law.¹⁵⁷ The Delaware Supreme Court agreed.

The *VantagePoint* court concluded that the internal affairs doctrine mandated the application of Delaware law to the internal affairs of a Delaware corporation.¹⁵⁸ The *VantagePoint* court also argued that the Fourteenth Amendment mandates the internal affairs doctrine; in the context of a conflict between two opposing *states*, this makes sense. However, the internal affairs doctrine is a rule of conflicts of law between different states—coequal sovereigns. Therefore, it is inappropriate to use this doctrine in the context of a conflict between federal and state law—a situation involving not coequal sovereigns but rather a supreme sovereign (the federal government) and a lesser sovereign (the state).¹⁵⁹

The internal affairs doctrine developed as an outgrowth of the Full Faith and Credit Clause, a clause based on the concept of states as coequal sovereigns. The Full Faith and Credit Clause of the Constitution states: “Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every *other State*.”¹⁶⁰ An early example of the Full Faith and Credit Clause’s application in the corporate governance context is the case of *Broderick v. Rosner*.¹⁶¹

Broderick involved a conflict between the superintendent of Banks of the State of New York, and 557 residents of New Jersey who were shareholders of the Bank of the United States, incorporated in New York.¹⁶² Under New York law, shareholders of New York banks were responsible “for all contracts, debts and engagements of the bank, to the extent of the amount of their stock therein, at the par value thereof, in addition to the amount invested in such shares.”¹⁶³ The superintendent sued in New Jersey, but the case was dismissed for lack of jurisdiction.¹⁶⁴ New Jersey law denied its courts jurisdiction to hear any action seeking to impose personal liability on shareholders of corporations, regardless of where the corporation was incorporated.¹⁶⁵ On appeal to the United States Supreme Court, the New Jersey statute was held unconstitutional under the Full Faith and Credit Clause.¹⁶⁶

The Court reasoned that the contractual nature of incorporation brought the nature of the case within the scope of the Full Faith and Credit Clause.¹⁶⁷ The “incident of

157. *Id.* at 1110–11.

158. *Id.* at 1113.

159. The Restatement (Second) of Conflicts of Law § 302 provides:

The local law of the state of incorporation will be applied to determine . . . [issues involving the rights and liabilities of a corporation], except in the unusual case where, with respect to the particular issue, some *other state* has a more significant relationship to the occurrence and the parties, in which event the local law of the *other state* will be applied.

Id. (alterations added) (emphasis added).

160. U.S. CONST. art. IV, § 1 (emphasis added).

161. 294 U.S. 629 (1935).

162. *Id.* at 638.

163. *Id.* at 637.

164. *Id.* at 638–39.

165. *Id.* at 638.

166. *See id.* at 643.

167. *Id.*

incorporation” brought the matter “within the regulatory power of New York.”¹⁶⁸ Since a shareholder voluntarily decides to enter into a relationship with the corporation, the shareholder implicitly agrees to accept the public policy decisions of the incorporating state. Therefore, full faith and credit must be given to the relative rights and obligations created by the incorporating state.¹⁶⁹

Applying Delaware law to override the federal regulation at issue in *Newcastle Partners* cannot, therefore, be said to support “the important policies underlying the internal affairs doctrine.”¹⁷⁰ While Delaware does have important public policy concerns that would prevent a court from applying the law of a different *state*, the Delaware Supreme Court applies the wrong conceptual framework and, therefore, emphasizes policies that are inappropriate in a discussion of federal/state conflicts.

Applying the internal affairs doctrine to a conflict between state and federal law suggests that Delaware’s lawmaking power is equal to that of the federal government. The Delaware legal community may very well wish that were true, but it is not. As we saw earlier, the federal government has the power to preempt state internal governance laws.¹⁷¹ The answer to the court’s concern that corporations will not know which law to apply is simple. Corporations must apply state corporate law *and* federal securities law, and where those laws must be harmonized, federal law is supreme. By ignoring this, the Court of Chancery appears to be biting its thumb at the SEC and picking a fight where none is required.

C. Analysis Under the Supremacy Clause

Instead of a doctrine derived from the Full Faith and Credit Clause, the Court of Chancery should have applied the Supreme Court’s Supremacy Clause¹⁷² jurisprudence. While no state’s law is inherently superior to that of any other state,¹⁷³ federal law is superior to any state’s law.¹⁷⁴ The Supremacy Clause states: “the Laws of the United States . . . shall be the supreme Law of the Land.”¹⁷⁵ The Supreme Court has established two tests for Supremacy Clause conflicts. First, a state regulation is invalid “where compliance with both federal and state regulations is a physical impossibility.”¹⁷⁶ Second, where compliance with both laws is not impossible, a state

168. *Id.*

169. *Id.* at 643–44 (“[T]he act of becoming a member [of a corporation] is something more than a contract, it is entering into a complex and abiding relation, and as marriage looks to domicil, membership looks to and must be governed by the law of the State granting incorporation.”) (alterations added) (quoting *Modern Woodmen of America v. Mixer*, 267 U.S. 544 (1925)).

170. *Newcastle Partners v. Vesta Ins. Group*, 887 A.2d 975, 981 (Del. Ch.), *aff’d*, 906 A.2d 807 (Del. 2005) (unpublished table decision).

171. *See supra* note 56 and accompanying text.

172. U.S. CONST. art. VI, § 2.

173. *See* U.S. CONST. art. IV, § 1.

174. U.S. CONST. art. VI, § 2.

175. *Id.*

176. *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69, 79 (1987) (plurality opinion) (quoting *Fla. Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142–43 (1963)).

law is invalid when “the state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.”¹⁷⁷

1. Physical Impossibility

In *Florida Lime & Avocado Growers, Inc. v. Paul*, the Supreme Court provided an example of two laws that would be impossible to satisfy simultaneously.¹⁷⁸ “[C]ompliance with both federal and state regulations [would be] a physical impossibility . . . if, for example, the federal orders forbade the picking and marketing of any avocado testing more than 7% oil, which the California test excluded from the State any avocado measuring less than 8% oil content.”¹⁷⁹ However, the court also points out that, if there is anything that a party could do that would be permissible under both laws, then the state law is not preempted.¹⁸⁰ This test examines the two potentially conflicting statutes on their face. The test is completely objective. If there is any way that a party can satisfy the requirements of both laws, then the federal law does not preempt the state law on the grounds of physical impossibility.¹⁸¹

In *Newcastle Partners*, compliance with both laws was not a physical impossibility because Vesta could have completed its disclosures in sufficient time to hold its annual meeting under the Delaware law. If it had distributed an annual report and information statement, Vesta would not have violated any of the SEC regulations. While it was physically impossible for Vesta to complete its disclosures in the two days before the court-ordered meeting date, this does not amount to a physical impossibility under the *Florida Lime* test.

2. Policy Compatibility

In the *Newcastle Partners* opinion, the Court of Chancery does provide a cursory analysis of the interests at play: “there are, of course, some circumstances in which a state’s governance of internal corporate affairs is preempted by federal law, but those instances are rare, and occur only when the law of the state of incorporation is ‘inconsistent with a national policy on foreign or interstate commerce.’”¹⁸² However, the court takes this test from the wrong doctrine.

The language above originated in the Delaware case of *McDermott Inc. v. Lewis*.¹⁸³ The *McDermott Inc.* case concerned the application of the internal affairs doctrine to a dispute that involved a Delaware subsidiary of a Panamanian corporation.¹⁸⁴ The issue

177. *Id.* (plurality opinion) (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)).

178. *Fla. Lime*, 373 U.S. at 143.

179. *Id.* at 142–43 (alterations added).

180. *Id.* at 143.

181. *See id.* Since the Supreme Court will only find compliance physically impossible in the rarest of cases, the question has not been frequently litigated. *Florida Lime* still stands as the definitive case on the issue of physical impossibility.

182. *Newcastle Partners v. Vesta Ins. Group*, 887 A.2d 975, 982 (Del. Ch.), *aff’d*, 906 A.2d 807 (Del. 2005) (unpublished table decision) (quoting *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1113 (Del. 2005)) (alteration added).

183. 531 A.2d 206, 217 (Del. 1987).

184. *See id.* at 216–19.

was whether the Delaware subsidiary could vote its shares in its Panamanian parent, a practice allowed by Panamanian law.¹⁸⁵ While a subsidiary would have been unable to exercise its shares under Delaware law, the Delaware Supreme Court felt compelled by the internal affairs doctrine to defer to the laws of Panama.

The major policy concern behind the internal affairs doctrine, as the *Newcastle Partners* court acknowledges, is the need to avoid conflicting standards of corporate governance between coequal powers—the states—by declaring a blackletter winner: the state of incorporation.¹⁸⁶ The policy concerns under the Supremacy Clause are substantially different. Instead of a coequal sovereign, a federal/state conflict involves one party—the federal government—that has the constitutional authority to preempt any state law in any area of federal competence.¹⁸⁷

In those areas where Congress has not completely displaced state regulation, federal law preempts state law if the state law stands as an obstacle to the accomplishments and execution of the full purposes and objectives of Congress.¹⁸⁸ The Supreme Court applied this doctrine in *CTS Corp. v. Dynamics Corp.*¹⁸⁹ *CTS Corp.* involved an anti-takeover statute. Under the statute, any shareholder who purchased an ownership interest in excess of three floors—20%, 33⅓%, or 50% of the corporation—was denied voting rights in the acquired corporation until a majority of the disinterested shareholders of the target company granted voting power by resolution.¹⁹⁰ Dynamics Corporation of America (“Dynamics”) sought to acquire 27.5% of CTS Corporation (“CTS”). CTS adopted the protection of the Indiana statutes, and Dynamics sued on the grounds that the Williams Act preempted the Indiana statute.¹⁹¹ The Williams Act¹⁹² regulates takeover offers in two ways. First, it imposes substantial filing requirements before an acquiring company can tender an offer.¹⁹³ Second, it establishes procedural rules for the tender offer.¹⁹⁴

Dynamics argued that the Indiana statute reflected the public policy that hostile takeovers are bad.¹⁹⁵ The Indiana Act gives disinterested shareholders—potentially a group consisting entirely of the current managers of the corporation—a veto over a hostile takeover offer. If an acquiring company does not know whether it will receive any voting power in exchange for its purchased stock, the acquirer loses all incentive to make the tender offer in the first place. Dynamics argued that the offeror’s disadvantages under the Indiana Act upset the delicate balance between shareholders

185. *Id.* at 208–09.

186. *See Newcastle Partners*, 887 A.2d at 981.

187. U.S. CONST. art. VI, § 2.

188. *Crosby v. Nat’l Foreign Trade Council*, 530 U.S. 363, 372 (2000); *Cal. Fed. Sav. & Loan Ass’n v. Guerra*, 479 U.S. 272, 281 (1987); *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69, 79 (1987); *Pac. Gas & Elec. Co. v. State Energy Res. Conservation & Dev. Comm’n*, 461 U.S. 190, 226 (1983); *Fla. Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142–43 (1963); *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941).

189. 481 U.S. 69.

190. *Id.* at 73–74.

191. *Id.* at 75.

192. 15 U.S.C. §§ 78m(d)–(e) & 78n(d)–(f) (2000) (amended 2003).

193. *CTS Corp.*, 481 U.S. at 79.

194. *Id.* at 79–80.

195. *See id.* at 76–77.

and managers under the Williams Act.¹⁹⁶ The Supreme Court, painting purpose with a broad brush, held that the federal law did not preempt because both statutes supported the same basic purpose: “plac[ing] investors on an equal footing with the takeover bidder.”¹⁹⁷

It is not necessary to fudge the purposes behind the proxy regulations and the annual meeting requirement to conclude that they are in harmony. The important policy behind the SEC’s proxy regulations was considered by the Supreme Court in *Mills v. Electric Auto-Lite Co.*:¹⁹⁸ “[t]he provision was intended to promote ‘the free exercise of the voting rights of stockholders’ by ensuring that proxies would be solicited with ‘explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought.’”¹⁹⁹ This public policy does not conflict with Delaware’s stated public policy of protecting a shareholder’s franchise.²⁰⁰

That does not mean that there is no tension between the two laws. The opinion stressed the importance of an actual and informed vote.²⁰¹ Therefore, even though Delaware and the federal government both have a policy of supporting the shareholder’s franchise, the federal government has chosen to emphasize full disclosure. Since Delaware’s law may frustrate this purpose, the preemption rubric might suggest that Delaware’s law should give way. The question ultimately requires a court to determine how much deference a state statute should receive. On this issue, however, the Supreme Court has issued conflicting standards.

The Supreme Court has issued conflicting statements on when there is a presumption against preemption. There is a presumption against finding preemption of state law in areas traditionally regulated by the states.²⁰² However, no presumption arises when the state regulates in an area where there has been a history of significant federal presence.²⁰³ This raises the question of whether or not there is a presumption against preemption in an area where states have traditionally regulated *and* where the federal government has had a history of significant presence. This “Schrödinger’s cat” of presumptions was not discussed by the Delaware Court of Chancery.

196. *See id.* at 82 n.7.

197. *Id.* at 82 (alterations in original) (quoting *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 30 (1977)).

198. 396 U.S. 375 (1970).

199. *Id.* at 381 (citing H.R. REP. NO. 73-1383, at 14 (1934)).

200. *Newcastle Partners v. Vesta Ins. Group*, 887 A.2d 975, 981 (Del. Ch.), *aff’d*, 906 A.2d 807 (Del. 2005) (unpublished table decision).

201. *Mills*, 396 U.S. at 381.

202. *See California v. ARC Am. Corp.*, 490 U.S. 93, 100 (1989).

203. *United States v. Locke*, 529 U.S. 89, 109 (2000).

The court's actions do not lead to the wrong result.²⁰⁴ Shareholders should be allowed to exercise their franchise over a corporation on a periodic basis. *Annual* meetings accomplish just that: they allow shareholders to maintain some level—however low—of consistent control over managers and directors of the corporation. However, the court reached its conclusion using a flawed analytical framework. Had the court balanced the public policies under the correct conceptual framework, it would have a strong argument for the result ordered. However, through application of the internal affairs doctrine, Delaware insists on asserting its ultimate authority as corporate lawgiver.

D. The Result

For the parties involved, the result was that Vesta held its shareholders' meeting without filing its annual report. For Delaware, the case now stands for the principle that the internal affairs doctrine requires Delaware law to prevail over federal rules that regulate the internal affairs of a corporation. This hostile attitude is inconsistent with Delaware's history of avoiding conflict with the federal government.²⁰⁵ With the increase in federal regulation of internal corporate governance, it is easy to see why Delaware might be worried that it will lose its state business. Many commentators have recently suggested that the end of state control of corporate law is at hand.²⁰⁶ However, the political momentum for federal regulation has slowed slightly.²⁰⁷ *Newcastle Partners* involved a clear instance where state law could legitimately control, at a time when political turmoil in Washington had slowed the corporate governance reform movement; therefore, the case offered an excellent opportunity for Delaware to take a swipe at the federal government and reassert its authority as corporate lawgiver.

Newcastle Partners has misapplied the internal affairs doctrine—a doctrine only applicable to a conflict between two coequal sovereigns—to a conflict between the state and the federal government. Now that Delaware has unleashed the beast, the state and the federal governments are set on a collision course. As we have already seen with Sarbanes-Oxley, the federal government has recently flirted with substantive regulations of internal corporate affairs.²⁰⁸ What if the federal government decides to

204. The same day that Vesta held their annual meeting, they reached a settlement agreement with Newcastle Partners in which Vesta agreed to expand the size of the board by one member. In exchange, Newcastle Partners agreed to withdraw its three director nominations and accept Vesta's slate of directors. Vesta Ins. Group, Inc., Entry Into a Material Definitive Agreement (Form 8-K) (Nov. 22, 2005). Vesta has also fired the accounting firm responsible for the delay in the distribution of its annual report for 2004. Vesta Ins. Group, Inc., Changes in Registrant's Certifying Accountant (Form 8-K) (Dec. 9, 2005). Due to Vesta's inability to fulfill its disclosure requirements, its stock has been delisted by the New York Stock Exchange. Vesta Ins. Group, Inc., Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing (Form 8-K) (Jan. 3, 2006).

205. See *supra* Part I.D.

206. See, e.g., Loewenstein, *supra* note 21, at 353.

207. Cf. Renee M. Jones, *Dynamic Federalism: Competition, Cooperation, and Securities Enforcement*, 11 CONN. INS. L.J. 107, 117 (2004) (discussing the SEC's recent unwillingness to adequately enforce its own regulations).

208. See *supra* notes 106–11 and accompanying text.

go further and adopt minimum fiduciary standards of care for corporate directors and officers—a rule that Professor Cary suggested in his article on the “race to the bottom”? Delaware has declared that the internal affairs rule requires the state to prevail over conflicting internal governance standards. Would Delaware be so bold as to extend this doctrine in a case where the policy considerations are not so clearly aligned?

The SEC can avoid many of these problems if it simply asserts its authority. First, the SEC should fine Vesta because Vesta clearly violated SEC Rules 14c-2 and 14c-3²⁰⁹ when it held an annual meeting without first distributing an annual report.²¹⁰ If Vesta is not fined, then companies will look to state courts to order shareholders’ meetings to avoid the federal disclosure requirements.

Second, the SEC should issue a statement that the proxy disclosure requirements do not preempt state laws on meeting frequency. Practitioners have complained that the SEC’s silence on the issue has created confusion.²¹¹ If the SEC acknowledges that state meeting frequency laws must be respected, the practitioners will accept the state law as a deadline for meeting proxy disclosure requirements.

Finally, the SEC could respond by setting time limits in the proxy regulations for disclosure requirements. While this case may have come out with the right result from a public policy perspective, it would have been far better if the SEC had set time limits and avoided the controversy in the first place. Time limits would provide clear guidance to corporations, as a corporation would no longer be required to look in two places—state law and federal law—to determine annual meeting requirements.

CONCLUSION

Delaware has dominated the corporate chartering scene since the presidency of Woodrow Wilson. In that time, Delaware has fought competing states and the federal government to maintain its market position. Delaware has shown great resilience at every turn. After Sarbanes-Oxley, the landscape has changed dramatically. *Newcastle Partners* is but the first fight in what could be a lengthy battle for national corporate supremacy.

Delaware would be much better served if it were to acknowledge the federal government’s supremacy. The internal/external distinction between state and federal regulation is eroding.²¹² Many scholars already acknowledge that the SEC overwhelmingly dominates the regulation of the annual election of directors.²¹³ It might be time for Delaware to take a step back, contract the scope of its operations, and find new ways in which it can continue to add value for its incorporating “clients.”

209. 17 C.F.R. §§ 240.14c-2 to -3 (2005).

210. 17 C.F.R. § 240.14c-3 (2005). Vesta held its annual meeting on November 17, 2005. Vesta Ins. Group, Inc., Entry Into a Material Definitive Agreement (Form 8-K) (Nov. 22, 2005).

211. Morris, Nichols, Arsht & Tunnell LLP, *Delaware Court of Chancery Suggests That Federal Securities Regulations Do Not Trump State Annual Meeting Law*, Dec. 15, 2005, <http://www.mnat.com/assets/attachments/27.pdf>.

212. See *supra* Part I.E.

213. See, e.g., Roe, *supra* note 19, at 612.