

PREEMPTION AND FEDERALISM IN CORPORATE GOVERNANCE: PROTECTING SHAREHOLDER RIGHTS TO VOTE, SELL, AND SUE

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I

INTRODUCTION

The legal rules of American corporate governance come primarily from state law.¹ The basic rights of shareholders relative to directors in the corporate entity have been determined in Delaware and the other states, not in Washington D.C.² Federal law supplements these state law rules principally through disclosure requirements that are designed to increase the protection of shareholders. But, traditionally, federal law has not supplanted the shareholder-director relationship as determined by the states. It is a prime example of “our federalism.”³

With the enactment of the Securities Litigation Uniform Standards Act of 1998⁴ and other recent changes, the traditional description no longer holds. There has been a noticeable expansion in the scope of federal regulation at the expense of the states, at least as it applies to the role of shareholders in the corporate form.⁵ Less noticeable is the shift, led by federal law, to a greater em-

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1. See, e.g., DOUGLAS M. BRANSON, *CORPORATE GOVERNANCE* (1993) (noting that “state law is the heart and soul of United States corporation law”).

2. As students of corporations quickly learn, Delaware is home to more than half of the country’s largest corporations and is the dominant state in corporate law.

3. See, e.g., Chief Justice William Rehnquist, Address at the American Law Institute Annual Meeting (May 11, 1998), in *LEGAL TIMES*, May 18, 1998, at 12 (“It is a principle enunciated by Abraham Lincoln in the 19th century and Dwight Eisenhower in the 20th century: Matters that can be adequately handled by states should be left to them; matters that cannot be so handled should be undertaken by the federal government.”).

4. See Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered subsections of 15 U.S.C. §§ 77-78).

5. Legal regulation of director conduct remains almost entirely a function of state law with some exceptions, such as the federal sentencing guidelines that relate to director conduct. See *In re Caremark Int’l Inc.*, 698 A.2d 959, 969 (Del. Ch. 1996) (“The Guidelines offer powerful incentives for corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered, and to take prompt, voluntary remedial ef-

phasis on the voting role of shareholders relative to other shareholder functions, such as selling or suing. With the preemption decreed by the 1998 Act, important parts of state law that address disclosure to shareholders can survive only if the state law is more restrictive toward shareholders than is the federal law, a reversal of the historical pattern that has characterized state and federal roles during the twentieth century.

This article examines the changed roles of the state and federal governments in this new era. Part II presents the traditional roles of the federal and state governments in regulating corporate behavior. Part III describes how that traditional pattern has changed, in part due to elements contained in the traditional system that have not been clearly visible, and in part due to express federal preemption of state law contained in recent congressional acts. Part IV focuses on where these changes have left us: with a greater dependence on federal law, a greater emphasis on the voting function of shareholders, and the likelihood of additional argument over traditional corporate issues such as the internal affairs rule and the distinction between direct and derivative suits.

II

THE TRADITIONAL FEDERAL AND STATE REALMS IN CORPORATE GOVERNANCE

A. The State Law Pattern

Under corporate law in all states, directors manage the business and affairs of the corporation.⁶ Shareholders have only a limited role: They can vote, sell, or sue.

1. *Vote.* The shareholder franchise is a key part of corporate law, but that does not mean that shareholders vote on very many things. Most business decisions are left entirely to the board of directors or those to whom they delegate such authority. Shareholders participate only infrequently in a limited set of decisions, including the election of directors, fundamental corporate changes, and ratification.

a. *Election of directors.* Directors are usually elected annually, but this pattern can be varied by the corporation's articles of incorporation or other private ordering.⁷ Shareholders also have the power to remove directors in

forts.”). Note, however, that the relative rights of shareholders and directors are often reciprocal so that expansions or contractions of the rights of shareholders by the federal government necessarily affect the rights of directors.

6. See MODEL BUS. CORP. ACT § 8.01 (1990); DEL. CODE ANN. tit. 8, § 141 (1991). Also, stock exchanges sometimes change the default rules provided by law (for example, by requiring a shareholder vote in instances beyond those where it is required by state law). These rules, as well as those rules provided by contractual arrangement among the parties, are not addressed in this article.

7. See, e.g., MODEL BUS. CORP. ACT § 8.05 (1990).

some circumstances.⁸

b. Fundamental corporate changes. Mergers and similar transactions require the approval of shareholders as well as directors and, thus, are an exception to the usual rule that leaves corporate decisions entirely in the hands of the directors.⁹ Of course, even here the directors act as gatekeepers: The shareholders can vote only on those transactions that are recommended to them by the directors.

c. Ratification. Shareholders occasionally vote on the ratification of self-dealing transactions by interested directors.¹⁰ The vote can cleanse the transaction of any taint or shift the burden of proof in a legal challenge.¹¹

2. *Sell.* The ability to sell one's shares is a core right for shareholders and one that corporate law has, for the most part, left to the market.¹² Appraisal—or dissenter's rights—is a rare exception where corporate law guarantees shareholders the right to sell their shares.¹³ Ordinarily, under corporate norms, a shareholder must obtain liquidity not from the corporation but from the market, if there is one. That is not to say that corporate law does not assume an important role for the ability to exit. Free transferability of shares and limited liability—both core characteristics of the corporate form—facilitate liquidity through the market.¹⁴ Many corporate rules take their specific shape because they exist in the shadow of a market for shares.¹⁵

3. *Sue.* In addition to voting and selling, a shareholder's ability to sue serves as a constraint on the actions of managers and is a regular part of the

8. See, e.g., *id.* §§ 8.08, 8.09. Under Delaware law, if the board is “classified”—elected to serve staggered terms—directors can be removed by shareholders only “for cause.” See DEL. CODE ANN. tit. 8, § 141(k) (1991).

9. See, e.g., MODEL BUS. CORP. ACT § 11.03 (1990).

10. See *id.* § 8.63; DEL. CODE ANN. tit. 8, § 144 (1991).

11. See *Lewis v. Vogelstein*, 699 A.2d 327, 335 (Del. Ch. 1997) (discussing four logical effects of shareholder ratification and noting that there are cases in Delaware that reflect three of those approaches).

12. See, e.g., CHARLES R. O'KELLEY, JR. & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 500 (2d ed. 1996) (“This exit right, in turn, makes a prospective minority shareholder contemplating acquisition of shares in a publicly-traded corporation less troubled by the majoritarian-directorial bias of the corporate law norm.”); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 833 (1981) (“All corporate statutes define the corporate skeleton in essentially identical terms For the publicly held corporation, the markets in which the corporation participates—product, managerial, and capital—are the central determinants of that structure and behavior.”).

13. See MODEL BUS. CORP. ACT §§ 13.01-.31 (1990).

14. See Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 262 (1967) (noting that publicly held corporations with many small shareholders could not exist without limited liability).

15. See Gilson, *supra* note 12, at 839 (“Where incentive mechanisms created by one part of the corporate structure—the various markets in which the corporation and its managers function—constrain managerial discretion to perform inefficiently, one would not expect a different part of the structure to provide redundant controls.”).

governance matrix.¹⁶ Litigation rights of shareholders include derivative suits, direct suits and class actions, and inspection and other ancillary rights.

a. Derivative suits. In particular circumstances, such as breaches of fiduciary duty by those in control of the corporation, all states permit a shareholder to bring a suit in the name of, and on behalf of, the corporate entity.¹⁷ This type of suit is an exception to the usual rule that directors act for the corporation. It occurs when directors are disabled by conflict or are otherwise unable to meet their fiduciary duty.¹⁸ In response to the fear that a self-appointed shareholder would bring a “strike suit” to harass the corporation or its directors, various procedural rules developed to balance the potential for abuse against the monitoring value of such lawsuits.¹⁹

b. Direct suits and class actions. Shareholders can also bring direct suits, which may be class actions if numerous shareholders are affected by common questions. In contrast to derivative suits, in which the loss to the shareholder is derivative of the harm to the collective enterprise, direct suits may be brought for an injury that the shareholder feels individually, such as deprivation of a right to vote or a contract right.²⁰ Such suits under state corporate law have increased in recent years.²¹ They may be based on fraud under state common law or on statutory remedies.

c. Inspection and other ancillary rights. Shareholders also have ancillary rights at state law, such as the right to inspect the books and records of the corporation, including the list of shareholders.²² Such inspection may be the first salvo in a litigation battle, an effort to sell shares, or a voting campaign.

B. The Federal Role

1. As to Corporate Governance. Federal legislation passed in the midst of the Great Depression reflected dissatisfaction with the state law corporate

16. See *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984) (“The machinery of corporate democracy and the derivative suit are potent tools to redress the conduct of a torpid or unfaithful management.”); see also Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 140 (1988) (suggesting two roles for shareholders visible in the legislative history of the Securities Exchange Act of 1934: as monitor of managerial performance and as an occasional decisionmaker exercising limited control over corporate affairs).

17. See *Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982).

18. See *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 (Del. 1981) (finding that a decision by interested directors would not be respected because it is wrongful).

19. See, e.g., MODEL BUS. CORP. ACT § 7.42 (1990) (requiring that shareholders make demand on directors).

20. See, e.g., *Lipton v. News Int'l*, 514 A.2d 1075 (Del. 1986).

21. See Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087 (1996) (describing recent Delaware cases that impose a fiduciary disclosure duty).

22. See, e.g., MODEL BUS. CORP. ACT § 16.02 (1990). See generally Randall S. Thomas, *Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information*, 38 ARIZ. L. REV. 331 (1996).

governance system.²³ In that same period, Adolf Berle and Gardiner Means wrote their well-known book, *The Modern Corporation and Private Property*,²⁴ which detailed the separation of ownership from control in modern corporations and called for additional legislation to constrain the discretion of managers. The congressional response, the Securities Exchange Act of 1934 (“the 1934 Act”), did not provide a federal law of corporations to replace the state system described above, but it did seek to enhance shareholder rights, primarily through disclosure.²⁵ The 1934 Act reflects what I have termed the “BASF model” of corporate governance, a term taken from the frequent television commercials for the international chemical firm that say, in effect, “We don’t make the cars you drive; we make them stronger. We don’t make the clothes you wear; we make them brighter.” The approach of the federal securities laws has not been to define or create the internal corporate relationship between directors and shareholders, but to make that relationship better for shareholders.²⁶ For federal securities laws, “better” usually has been defined through greater disclosure requirements. Louis Loss, the most noted securities commentator of the twentieth century, described the function of the federal law as “disclosure, again disclosure, and still more disclosure.”²⁷

Section 14 of the 1934 Act authorized the Securities and Exchange Commission (“SEC”) to regulate proxies, which managers used primarily to solicit shareholder votes in advance of a meeting.²⁸ The House report noted that the section stemmed from a congressional belief that fair “corporate suffrage is an important right that should attach to every equity security bought on a public

23. Federal incorporation, which had been discussed as far back as the late 19th century, was proposed again during the debate over the 1934 Act. See 1 LOUIS LOSS, *SECURITIES REGULATION* 109 (2d ed. 1961).

The Roper-Dickinson Report of early 1934, which is part of the legislative history of the Securities Exchange Act of 1934, recommended federal incorporation as the most effective way to deal with certain evils connected with market manipulation by directors and officers, the issuance of stock to insiders for inadequate consideration, incomplete publicity of corporate accounts and similar problems . . . [,] and others insisted that what are now §§ 12, 13, 14 and 16 of the 1934 Act—the securities registration, reporting, proxy and insider trading provisions—had no place in a stock exchange bill and that the proper solution was federal incorporation.

Id. See also Edward Ross Aranow & Herbert A. Einhorn, *Proxy Regulation: Suggested Improvements*, 28 GEO. WASH. L. REV. 306, 306 (1959) (“Notwithstanding the basic importance of the solicitation of proxies in determining the destiny of corporate management and affairs, and the temptations and abuses which almost inevitably accompany unrestricted power, the states did virtually nothing to cope with the problem.”).

24. ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1933).

25. See Ryan, *supra* note 16, at 135 (“Congress was aware that the proxy regulation section of its exchange bill extended to internal corporate affairs and that, at least to its proponents, this was necessary and proper.”).

26. See Arthur Fleischer, “Federal Corporation Law”: *An Assessment*, 78 HARV. L. REV. 1146, 1153 (1965) (“The federal securities laws affect a wide range of corporate activities, but generally they do not preempt complementary state laws; they are pervasive, but not exclusive.”).

27. LOSS, *supra* note 23, at 21; see also LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 29 (3d ed. 1989).

28. See 15 U.S.C. § 78n (1994).

exchange.”²⁹ As the Senate report noted, “[t]oo often proxies are solicited without explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought.”³⁰ Thus, federal legislation was intended to “control the conditions under which the proxies may be solicited with a view to preventing the recurrence of abuses which [had frustrated] the free exercise of the voting rights of shareholders.”³¹

The voting decision that disclosure supports is often the election of directors. Many of the proxy regulations address the format and substance of proxy solicitations relating to the annual election of directors.³² Much of the litigation, as well as the first Supreme Court cases addressing Section 14, concerned proxies to solicit approval of a merger.³³ These cases developed the core of federal law and enhanced shareholder voting rights otherwise available at state law.³⁴

When hostile tender offers provided a realistic alternative to proxy battles as a means to acquire control of a corporation, Congress extended the shareholder protection just discussed.³⁵ Again, shareholders were being asked to make a decision without sufficient information. Here, it was not a decision about voting, but rather whether to sell their shares in response to a bidder’s tender offer.

Federal law has developed more slowly to protect another shareholder decision arising out of a corporate change: a dissenting shareholder’s pursuit of appraisal rights after a merger or similar transaction. The Supreme Court left open that question in *Virginia Bankshares, Inc. v. Sandberg*,³⁶ but the four dissenting justices suggested that federal law protected that decision as well.³⁷ Subsequent federal appellate court decisions have held that “a minority share-

29. H.R. REP. NO. 73-1383, at 13 (1934).

30. S. REP. NO. 73-792, at 12 (1934).

31. H.R. REP. NO. 73-1383, at 14 (1934).

32. See, e.g., 17 C.F.R. § 240.14a-4(b)(2) (1998) (SEC Rule 14a-4(b)(2)) (form of proxy for election of directors); *id.* § 240.14a-11 (SEC Rule 14a-11) (provisions applicable to election contests); *id.* § 240.14a-101 (SEC Schedule 14A, Item 7) (required disclosure for election of directors).

33. See *TSC Indus. v. Northway, Inc.*, 426 U.S. 438 (1976) (defining the standard for “materiality” in lawsuits under Section 14a); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970) (finding that material misrepresentation in a merger requires only that proxy solicitation, and not a particular misleading statement, be an “essential link” in the accomplishment of the transaction); *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964) (recognizing for the first time a private right of action under the federal securities laws; suit involved shareholders complaining of a merger between their corporation and another).

34. For example, the shareholder proposal rule, 17 C.F.R. § 240.14a-8 (1998) (SEC Rule 14a-8), permits shareholder access to the company’s proxy solicitation statement. Ostensibly, state law could permit such access, but state law precedent often does not exist.

35. See *Williams Act of 1968*, Pub. L. No. 90-439, 82 Stat. 454. Analogy was also made to transfer of control through the offer of securities in the acquiring company, which would require disclosure under the provisions of the Securities Act of 1933 as an issuance of security.

36. 501 U.S. 1083, 1108 & n.14 (1991) (leaving open the appraisal issue because bank mergers, such as the one at issue in the case, were expressly excluded from Virginia’s appraisal statute).

37. See *id.* at 1121 (Kennedy, J., dissenting) (“The majority avoids the question of whether a plaintiff may prove causation by demonstrating that the misrepresentation or omission deprived her of a state law remedy. I do not think the question difficult, as the whole point of federal proxy rules is to support state law principles of corporate governance.”).

holder, who has lost his right to a state appraisal because of a materially deceptive proxy” may seek relief under federal law.³⁸

2. *As to Securities Transactions.* Apart from enhancing shareholder governance decisions, the first Congress of the New Deal also enacted federal legislation to regulate the purchase and sale of securities. The Securities Act of 1933 (“the 1933 Act”) sought to protect those who purchased securities, principally by requiring disclosure to those who bought stock in an initial public offering.³⁹ A year later, the 1934 Act, which regulated the proxy solicitations already discussed, expanded federal disclosure protection to include sellers and purchasers who traded in secondary markets.⁴⁰ Although originally overshadowed by the disclosure obligations of the 1933 Act, the provisions of the 1934 Act have grown considerably, and this regulation is now the centerpiece of federal securities regulation. In 1964, Congress expanded the disclosure coverage beyond companies traded on a national stock exchange to include all companies that met minimum thresholds of assets and number of shareholders.⁴¹ The mandatory disclosure required of those companies, now found in Regulation S-K, has expanded to include more than forty items and one hundred pages in the Code of Federal Regulations.⁴² Rule 10b-5,⁴³ an antifraud provision promulgated under the 1934 Act, has been interpreted to expand the disclosure obligations of companies so that it approaches an obligation to disclose any material fact.⁴⁴

This disclosure regime at first glance seems market-based (that is, triggered by the purchase or sale of securities) like the 1933 Act, rather than governance-based, as are the corporate rules discussed in the previous section. Such a market/governance distinction has been attractive to some who advocated federal preemption of the regulation of market transactions discussed later in this article. Yet, any clear division between corporate governance and regulation of market transactions has blurred to such an extent that the line seems difficult to

38. *Wilson v. Great Am. Indus.*, 979 F.2d 924, 931 (2d Cir. 1992); *see also* *Howing Co. v. Nationwide Corp.*, 972 F.2d 700, 707 (6th Cir. 1992); *cf.* *Scattergood v. Perelman*, 945 F.2d 618, 626 & n.4 (3d Cir. 1991).

39. *See* 15 U.S.C. §§ 77a-77i (1994).

40. *See id.* §§ 78m-n (requiring periodic disclosure by companies with securities registered under the 1934 Act and additional disclosure if proxies were solicited).

41. *See* Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (codified as amended in scattered sections of 15 U.S.C.). The 1964 amendments applied to companies with one million dollars in assets and 500 holders in a class of equity securities. *See id.* Under Rule 12g-1, the minimum threshold is now \$10 million. *See* 17 C.F.R. § 240.12g-1.

42. *See* 17 C.F.R. §§ 229.10-.911 (1998).

43. *See id.* § 240.10b-5 (1999).

44. Judicial interpretation has not gone as far as saying that there is a duty to disclose all material facts. *See, e.g., In re Time Warner, Inc.*, 9 F.3d 259, 267 (2d Cir. 1993) (noting that “a corporation is not required to disclose a fact merely because a reasonable investor would very much like to know that fact”). Rather, the disclosure obligation has a series of triggers—periodic disclosures, proxy solicitations, tender offers, initial distributions, insider trading, misrepresentations, and half-truths in voluntary disclosures—which, together with sometimes judicially imposed duties to update or correct, approach an obligation to disclose any material fact. *See id.* at 270.

preserve. The transactions regulated by the 1934 Act are different from those regulated by the 1933 Act because members of the protected class usually do not transact with the issuer—the alleged wrongdoer—but rather with another member of the public. Disclosure obligations are imposed on the issuer, a non-party to the transaction, to protect the parties' investment decisions. The duties owed in that setting are not unlike traditional corporate law duties—albeit usually imposed on the directors rather than the corporation—to protect other shareholder decisions. Damages, if any, usually are paid from the corporate treasury, in effect from the pockets of the larger body of shareholders for the benefit of a subgroup of shareholders.

Modern financial theory recognizes the direct link between market rules and governance rules, in which the existence of market constraints can reduce the need for legal rules of governance.⁴⁵ Political scientist Albert Hirschman noted the relationship between exit and voice: If investors are denied market remedies, voice via voting or other political access will become more important.⁴⁶

3. *Traditional Limits on the Federal Role Reflecting Respect for State Law.* For most of this century, there has been tension between the reach of state and federal regulation of shareholder-manager relations. Yet, at the federal level, there has been continuous recognition of the limited role of the federal government. Congress has repeatedly refused to enact a federal incorporations act, and federal courts often have restricted the reach of federal securities laws, citing a desire to preserve federalism and traditional state regulation of corporate matters.

a. *Rejecting a federal law of corporations.* The supportive, supplemental approach of the federal system to the rights created at state law is evidenced both in the laws passed by Congress and in other proposed legislation Congress chose not to enact. Both the 1933 and 1934 Acts contained savings clauses that preserved existing state law systems and remedies.⁴⁷ These clauses most often are discussed in the context of state securities laws but also are relevant to state corporate laws. Before World War I, there had been recurring proposals to enact a federal incorporations law, made first by President Theodore Roosevelt

45. See generally Lucian Ayre Bebchuck, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989); Gilson, *supra* note 12.

46. See ALBERT O. HIRSCHMAN, *EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS AND STATES* (1970); see also Richard M. Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CAL. L. REV. 1671 (1985) (discussing the framework of exit, voice, and loyalty in corporations and suggesting that the reduction of shareholder participation reflects judicial and administrative decisions on governance).

47. See 15 U.S.C. § 77p (1994) (“The right and remedies provided by this subchapter shall be in addition to any and all other rights and remedies that may exist at law or in equity.”); *id.* § 78bb(a) (“The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity.”).

and then by Presidents Taft and Wilson.⁴⁸ Mention has already been made of the debate over federal incorporation at the time of the enactment of the 1934 Act.⁴⁹ In the early 1940s, there was another effort to enact a federal incorporation law, which evolved later in the decade into the Model Business Corporation Act, a basis for subsequent state statutes.⁵⁰ In the 1960s and 1970s, concern about the laxity of state regulation—highlighted by Professor William Cary’s 1974 article on the race to the bottom among the states—led to increased calls for federal regulation.⁵¹ Even the American Law Institute’s *Principles of Corporate Governance*—later to be vigorously criticized as making overregulatory suggestions for state corporate law—began as an effort to minimize the need for federal corporate law.⁵² None of these federal incorporation efforts succeeded.

b. Limiting broad judicial interpretation of federal disclosure laws. Federalism concerns have also been prominent in judicial decisions. In *Santa Fe Industries, Inc. v. Green*,⁵³ the Supreme Court refused to include alleged director misconduct within the fraud prohibited by the 1934 Act and Rule 10b-5 when there had been full disclosure. The majority opinion emphasized judicial reluctance to interfere with state corporate law principles.⁵⁴ The Court, however, did not address how to resolve federalism concerns in the much more common situation where corporate directors do not fully disclose possible wrongdoing in the misuse of their position.⁵⁵ A series of federal appellate cases after *Santa Fe* held Rule 10b-5’s prohibition of fraud to include nondisclosure or omissions that shielded alleged misuse of corporate position as defined by state law.⁵⁶ Placed within the structure suggested by this article, these decisions

48. See LOSS, *supra* note 23, at 108.

49. See *id.*

50. See ABA Comm. on Corporation Law, Section on Corporation, Banking, and Mercantile Law, Preliminary Draft of a Federal Corporation Act (Aug. 1943) (on file with author).

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

52. See generally Roswell B. Perkins, *The Genesis and Goals of the ALI Corporate Governance Project*, 8 CARDOZO L. REV. 661 (1987).

53. 430 U.S. 462 (1977).

54. See *id.* at 478-79 (“The result would be to bring within the Rule a wide variety of corporate conduct traditionally left to state regulation Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.”).

55. See *id.* at 475 (distinguishing a prior appellate case that “included some element of deception” and noting that the *Santa Fe* facts contained full disclosure).

56. See *Goldberg v. Meridor*, 567 F.2d 209, 217 (2d Cir. 1977) (“Schoenbaum, then, can rest solidly on the now widely recognized ground that there is deception of the corporation (in effect, of its minority shareholders) when the corporation is influenced by its controlling shareholder to engage in a transaction adverse to the corporation’s interests (in effect, the minority shareholder’s interests) and there is nondisclosure or misleading disclosures as to the material facts of the transaction.”); see also *Kas v. Financial Gen. Bankshares, Inc.*, 796 F.2d 508, 512 (D.C. Cir. 1986); *Healey v. Catalyst Recovery*, 616 F.2d 641, 645-47 (3d Cir. 1980); *Alabama Farm Bureau Mut. Cas. Co. v. American Fidelity Life Ins. Co.*, 606 F.2d 602, 613-14 (5th Cir. 1979); *Kidwell ex rel. Penfold v. Meikle*, 597 F.2d 1273, 1291-92 (9th Cir. 1979); *Wright v. Heizer Corp.*, 560 F.2d 236, 249-51 (7th Cir. 1977).

interpreted federal law to protect not just voting decisions but also shareholders' decisions to sell their shares or to sue to enforce their rights. The Supreme Court denied *certiorari* in several of these cases and has yet to resolve this issue. Commentators have discussed the coverage of such "shame facts" or "sue facts,"⁵⁷ but cases based on this theory seem to be brought less frequently today than in earlier decades.⁵⁸ To the extent federal action intruded into state law, it was consistent with other examples of federal intrusion that enhanced the shareholder position.

Federal deference to state corporate governance law can also be seen in cases such as *Business Roundtable v. SEC*,⁵⁹ where the D.C. Circuit invalidated SEC Rule 19c-4, which sought to deter companies listed on stock exchanges from changing their corporate structure to include dual-class voting. By giving extra voting rights to one class of stock—likely held by management—the changes had the potential to disenfranchise majority shareholders permanently.⁶⁰ Although such changes usually required a shareholder vote, the SEC was concerned about possible collective action problems. The SEC was also concerned that existing safeguards would be insufficient if companies influenced shareholders' votes to change to a dual-class voting structure by offering "sweeteners," such as higher dividends on the limited voting rights shares.⁶¹ The federal appellate court struck down the SEC's effort to protect fair corporate suffrage because it exceeded what had been authorized in the 1934 Act and impinged on the tradition of state regulation of corporate law.⁶² The court focused on congressional regulation of disclosure and limited its disclosure discussion to one context: shareholders making decisions at a shareholders' meeting.⁶³

Another area of restrictive judicial interpretation occurred in the 1980s and related to the reach of the Williams Act, a 1968 amendment to the 1934 Act, that regulated hostile tender offers.⁶⁴ The Williams Act imposed disclosure requirements designed to protect shareholders when they were deciding how to respond to a tender offer for their shares. When state legislatures imposed ad-

57. See Harvey Gelb, *Rule 10b-5 and Santa Fe—Herein of Sue Facts, Shame Facts and Other Matters*, 87 W. VA. L. REV. 189 (1985) (defining a "sue fact" as one material to a litigation decision and a "shame fact" as one that would have shamed management into abandoning a proposed transaction).

58. See, e.g., *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1100 n.9 (1991) (declining to use sue facts or shame facts as a basis for meeting the "essential link" of *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970)); *LHLC Corp. v. Cluett, Peabody & Co., Inc.*, 842 F.2d 928, 932 (7th Cir. 1988) (noting that "[w]e have held repeatedly in recent years that the securities laws do not ensure that people will receive information sufficient to make correct decisions about filing or pursuing lawsuits").

59. 905 F.2d 406 (D.C. Cir. 1990).

60. See Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347 (1991).

61. See Exchange Act Release No. 24,623, [1987 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 84,143, at ¶ 88,773-74 (June 22, 1987).

62. See *Business Roundtable v. SEC*, 905 F.2d. 406 (D.C. Cir. 1990).

63. See *id.* at 410 ("The goal of federal proxy regulation was to improve those communications [with potential absentee voters] and thereby to enable proxy voters to control the corporation as effectively as they might have by attending a shareholder meeting.").

64. See 15 U.S.C. §§ 78m(d)-(f), 78n(d)-(f) (1994).

ditional, often onerous, requirements on bidders, the Supreme Court struck down such state laws as violative of the Commerce Clause.⁶⁵ The Court's decision did not reduce the states' desire to protect target companies from hostile takeovers, and the legislatures returned to the drawing board and crafted second-generation statutes that equaled or exceeded their first-generation counterparts in their dampening effect on hostile takeovers. The newer statutes were framed as permissive authorizations of what corporate managers could do in contrast to the earlier statutes' restrictive limitations on what bidders could do.

Several federal courts interpreted the Williams Act to protect a shareholder's ability to sell shares by defining the space within which takeovers would be permitted to function unimpeded by state law. A Seventh Circuit decision emphasized that Congress, through the Williams Act, sought to preserve a shareholder's ability to receive tender offers through the market so that any state law that blocked the use of the market should be preempted.⁶⁶ The Supreme Court reversed that decision and interpreted the Williams Act as having a limited purpose that focused on the conduct of the bidder vis-à-vis the shareholders who were to receive the offer and not on the shareholder's ability to receive an offer unimpeded by management defensive tactics.⁶⁷ The effect was to leave to state law the determination of what rights shareholders would have to use the market as a means to constrain management prerogatives.

III

CHANGES IN THE FEDERAL/STATE MATRIX

A. The Expansion of Federal Remedies Even Within a System Acknowledged Only to Supplement or Enhance State Law Rights

The creation of federal rights—even if only disclosure to make more effective the state law allocation of rights between shareholders and directors—carried the seed of broader federal intrusion into corporate governance. At least three alternatives seemed possible to describe the relationship between state and federal law: federal disclosure obligations, but no private federal remedy; a federal remedy to replace a lost state remedy; and a separate federal remedy for failure to comply with federal disclosure rules.

1. *Federal Disclosure Obligations, But No Private Federal Remedy.* It would be possible to have federal disclosure requirements but no federal remedy, or at least no private remedy for damages. Such a regime seems to have been contemplated by courts before the Supreme Court's 1964 decision in *J.I. Case Co. v. Borak*.⁶⁸ The required disclosure would make visible misuse of

65. See *Edgar v. MITE Corp.*, 457 U.S. 624, 631-34 (1982).

66. See *Dynamics Corp. v. CTS Corp.*, 794 F.2d 250 (7th Cir, 1986), *rev'd*, 481 U.S. 69 (1987).

67. See *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69 (1987).

68. 377 U.S. 426, *aff'g*, *Borak v. J.I. Case Co.*, 317 F.2d 838 (7th Cir. 1963) (overruling the district

director power that otherwise might have been invisible.⁶⁹ We might expect shareholders to use this disclosure in their decisions to vote, exit, or sue. Practically, there would seem to be no way to limit their use of this disclosure only to voting decisions. Indeed, it seems realistic to recognize that this added disclosure would aid shareholders in selling or suing.

2. *Federal Remedy to Replace a Lost State Remedy.* If disclosure that failed to meet federal standards led to a shareholder's failure to take advantage of a state-provided remedy, a limited federal remedy might simply replace the lost remedy. One example is inadequate disclosure that led a shareholder not to exercise appraisal rights within the time allotted by state law.⁷⁰ Of course, state law itself could provide a remedy if fraudulent conduct induced shareholders not to pursue these rights,⁷¹ but such state law has never developed very far, perhaps because of the hostility to appraisal rights found in modern American jurisprudence before the explosion of cash-out mergers in the last decade.⁷² Even this apparently limited federal right would present complications for other shareholder decisions where the collective nature or other factors present questions about the connection of particular shareholder action to the alleged wrongful conduct.⁷³

3. *Separate Federal Remedy for Failure to Comply with Federal Disclosure Rules.* The federal courts opted for neither of the more limited choices described above but, instead, settled on a full, federal remedy when federal standards were violated. In part, this choice reflected an express rejection of

court decision that a claim under Section 14(a) of the Securities Exchange Act for damages and relief other than declaratory judgment was a suit arising under state law); see also *Dann v. Studebaker-Packard Corp.*, 288 F.2d 201 (6th Cir. 1961), *aff'd*, 377 U.S. 426 (1964) (finding that federal jurisdiction must end with the holding of a contested proxy action).

69. See *Hamermesh*, *supra* note 21, at 1149-50.

70. See, e.g., *Pavlidis v. New England Patriots Football Club, Inc.*, 737 F.2d 1227 (1st Cir. 1984) (ruling against plaintiffs' claim that they were induced to accept a merger by misleading proxy statements that contained various misrepresentations).

71. See *Smith v. Shell Petroleum, Inc.*, No. CIV.A.8395, 1990 WL 186446 (Del. Ch. Nov. 26, 1990), *aff'd*, *Shell Petroleum v. Smith* 606 A.2d 112 (Del. 1992) (finding a disclosure violation when shareholders challenged the adequacy of disclosure before their decision on appraisal and refusing to base the remedy on the assumption that all class members would have sought an appraisal if the company had properly disclosed all material information).

72. As originally conceived and until very recently, appraisal statutes served to provide liquidity to minority shareholders who chose not to join the majority in a merged or reorganized business. Appraisal valuation and procedural rules erred on the side of making it difficult for these shareholders to withdraw their capital from the corporation. See Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 *YALE L.J.* 223 (1962). With judicial willingness to permit majority shareholders to implement mergers as a way of forcing minority shareholders out of the enterprise, appraisal has taken on a different role as a check on majority opportunism. See Robert B. Thompson, *Exit, Liquidity and Majority Rule: Appraisal's Role in Corporate Law*, 84 *GEO. L.J.* 1 (1995).

73. See, e.g., *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970). The court of appeals ruled that if the respondent could show that the merger had merit and was fair to the minority shareholders, the trial court would be justified in concluding that a sufficient number of shareholders would have approved the merger had there been no deficiencies in disclosure. See *id.* at 379-80. The Supreme Court objected because that standard would "insulate from private redress an entire category of proxy violations—those relating to matters other than the terms of the merger." *Id.* at 382.

federalism concerns described by the Supreme Court in *Borak*: “And if the law of the [s]tate happened to attach no responsibility to the use of misleading proxy statements, the whole purpose of the section might be frustrated.”⁷⁴ These federal remedies existed for each of the shareholder functions described in this article: to vote (*Borak and Mills*),⁷⁵ to sell (*Basic*),⁷⁶ and to sue (*Goldberg* line of cases following *Santa Fe*).⁷⁷

These federal remedies existed alongside state remedies. Often, the federal remedy had to resolve an issue that would have been present in a state law adjudication.⁷⁸ Not surprisingly, given the historical purpose of federal law to enhance shareholder rights at state law, the federal remedy often was more attractive to plaintiffs than the remedy available under state law. For example, Louis Loss observed that federal law effectively resolved the split of opinion on insider trading and made the minority view on director duty the law of the land.⁷⁹

Sometimes the federal remedy filled a gap where there was no state relief: for example, the disclosure obligation established under Section 13 of the 1934 Act and expanded by judicial interpretations of Rule 10b-5.⁸⁰ There are notable examples where plaintiffs simultaneously pursued both state and federal remedies in suits related to voting,⁸¹ selling,⁸² or suing.⁸³ Given the supplemental approach of federal law to state law, these federal cases had no need to dif-

74. 377 U.S. 426, 434-35 (1964).

75. See *supra* notes 68 and 73 and accompanying text.

76. *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

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

78. See, e.g., *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970) (discussing the causation issue that would arise under common law fraud).

79. Traditional common law has often been described as having a majority view under which directors have duties only to the corporation, a minority view under which insiders are held to fiduciary standards and must make full disclosure of all material facts when they transact with shareholders, and the special facts doctrine, an in-between position. See LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 823 (1983) (“It does not seem too much to say today that the minority or trusteeship view at common law has become, thanks to Rule 10b-5, the law of the land.”).

80. See, e.g., *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

81. In *Borak v. J.I. Case Co.*, count one of the complaint claimed a breach of fiduciary duty to the stockholders under Wisconsin law, and count two alleged a violation of Section 14(a) of the 1934 Act. See 317 F.2d 838 (7th Cir. 1963), *aff'd*, 377 U.S. 426 (1964). The Court of Appeals described the allegation of count one as follows:

Case directors breached their fiduciary duty by approving and issuing a letter and proxy statement of October 15, 1956, prior to the meeting at which the merger was approved, which contained numerous material omissions and false and misleading statements relied on by Case shareholders in approving the merger and without which the merger would not have been approved.

Id. at 843-44.

82. Compare *Pavlidis v. New England Patriots Football Club, Inc.*, 737 F.2d 1227 (1st Cir. 1984) (involving plaintiffs who claimed they were induced to accept corporation’s cash-out offer by a misleading proxy statement containing various misrepresentations) with *Coggins v. New England Patriots Football Club, Inc.*, 492 N.E.2d 1112 (Mass. 1986) (involving plaintiffs who challenged the same transaction as a breach of fiduciary duty).

83. Compare *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955) (applying Indiana law and finding a breach of fiduciary duty when a controlling shareholder sold shares for a premium that was not shared with the minority shareholders) with *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952) (rejecting a Rule 10b-5 claim that arose from the same transaction).

ferentiate state-provided voting rights from exit or litigation rights.

B. The Growth of State Law of Disclosure

Even as the federal law of disclosure has expanded, there has been a parallel growth in state law related to disclosure, particularly in establishing a shareholder's right to cast an informed vote.⁸⁴ The disclosure obligations of directors have been applied much more frequently in recent years, particularly in Delaware.⁸⁵ Thus, courts have defined a duty of disclosure—although they have not always found a violation of that duty⁸⁶—where shareholders are asked to vote on a merger,⁸⁷ sale of assets,⁸⁸ amendment to the articles of incorporation for purposes of a corporate reorganization,⁸⁹ election of directors,⁹⁰ and ratification of a conflict-of-interest transaction.⁹¹

Disclosure obligations under state law have not been limited to contexts in which shareholders are asked to vote. Some Delaware decisions suggest a lim-

84. See *In re Tri-Star Pictures, Inc.*, 634 A.2d 319, 331-32 (Del. 1993) (“By alleged breaches of duty of disclosure, Coca-Cola materially and adversely affected the minority’s right to cast an informed vote. . . . It is a unique, special harm.”); *Avacus Partners v. Brian*, No. CIV.A.11001, 1990 WL 161909 (Del. Ch. Oct. 24, 1990) (noting that shareholders have the right to elect a board without unfair manipulation); *Spillyards v. Abboud*, 662 N.E.2d 1358 (Ill. App. Ct. 1996) (noting that the right of a shareholder to elect a board without unfair manipulation is an individual contract right).

85. See *Hamermesh*, *supra* note 21, at 1090 (“Of growing importance, however, is a state law duty that courts have created and imposed upon directors based on their fiduciary relation to the corporation and its stockholders. In the last twenty years, this branch of fiduciary doctrine has blossomed prolifically, particularly in Delaware state courts.”).

86. The Delaware statute that allows exculpation of directors, DEL. CODE ANN. tit. 8, § 102(b)(7) (1991), has been interpreted as permitting exculpation of directors for breaches of the duty of disclosure, thus narrowing the impact of the duty. See *Arnold v. Society for Sav. Bancorp, Inc.*, 650 A.2d 1270 (1994).

87. See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983) (noting that “one possessing superior knowledge may not mislead any stockholder by use of corporate information to which the latter is not privy”); *Smith v. Shell Petroleum, Inc.*, No. CIV.A.8395, 1990 WL 186446 (Del. Ch. Nov. 26, 1990), *aff’d*, 606 A.2d 112 (Del. 1992).

88. See *Schreiber v. Butte Copper & Zinc Co.*, 98 F. Supp. 106 (S.D. N.Y. 1951) (holding that a challenge to a lease accomplished without consent of shareholders is primary and personal).

89. See *Thorpe v. CERBCO, Inc.*, No. CIV.A.11713, 1993 WL 35967 (Del. Ch. Jan. 26, 1993). Plaintiffs complained that proxy solicitation prior to shareholder vote on a dual-class proposal was misleading because it did not disclose that insiders felt no fiduciary duty not to use control for personal benefit. See *id.* at *1. The court found that the plaintiffs lacked standing because they were not shareholders at the time of the challenged proxy solicitation. See *id.* at *3; see also *Margolies v. Pope & Talbot, Inc.*, 1986 WL 15145 (Del. Ch. Dec. 23, 1986). Plaintiffs challenged 18 deficiencies in a proxy statement prior to a reorganization. The court found that the proxy statement provided enough information for stockholders to make their own decisions.

90. See *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 141 (Del. 1997) (noting that “[t]here may be circumstances under which a proxy statement soliciting votes for the election of directors is actionable under Delaware law for material misstatements or omissions,” but concluding that this was not such a case); *Brody v. Zaucha*, 697 A.2d 749 (Del. 1997) (finding no disclosure violation in plaintiff’s solicitation of written consents for election of directors).

91. See *Lewis v. Vogelstein*, 699 A.2d 327, 334 (Del. Ch. 1997) (“To be effective, of course, the agent must fully disclose all relevant circumstances with respect to the transaction to the principal prior to ratification.”). See, e.g., *Reifsnnyder v. Pittsburgh Outdoor Adver. Co.*, 173 A.2d 319 (Pa. 1961) (involving minority shareholder challenges to the validity of a shareholder meeting resolution that authorized the corporation to purchase stock held by the majority shareholder).

ited disclosure duty regardless of any requests for specific action.⁹² In addition, disclosure is sometimes used to support the effective exercise of the directors' role in corporate governance. For example, disclosure to a corporation's board of directors can change the legal test for finding that a director improperly took a corporate opportunity in violation of a fiduciary duty.⁹³ The Delaware Supreme Court modified the Chancery Court's statement that such disclosure was necessary to satisfy a fiduciary duty and, instead, made disclosure available as a safe harbor that would defeat liability.⁹⁴ Other courts⁹⁵ and the American Law Institute⁹⁶ have made disclosure a separate part of fiduciary duty.

The expansion of state law of disclosure increased the interface with the federal law of disclosure. Given the long-standing tolerance of federal law for parallel state law and the federal law's basic purpose to enhance state law, this emerging law provoked no extended federalism discussions. Action by Congress in 1996 and 1998 to preempt some state law changed that discussion dramatically.

C. Preemption

Congressional views of the benefits of federalism in corporate and securities law changed dramatically in the late 1990s, when Congress enacted three new securities laws within less than three years, a flurry of federal legislation in this area not seen since the early days of the New Deal. The National Securities Markets Improvement Act of 1996⁹⁷ changed the roles of federal and state governments in the registration of securities. It reversed six decades of legislative policy when it amended Section 18 of the 1933 Act, which, until then, provided that nothing in the 1933 Act affected the jurisdiction of a state agency over any

92. See *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998) ("Whenever directors communicate publicly or directly with shareholders about the corporation's affairs, with or without a request for shareholder action, directors have a fiduciary duty to shareholders."). However, this state common law cause of action does not extend to suits for fraud on the market, which are regulated by federal law, and may be subject to restrictions if brought as a class action. See *id.* at 13-14; see also *Marhart, Inc. v. Calmat Co.*, CIV.A. No. 11,280, 1992 WL 82365 (Del. Ch. Apr. 22, 1992) (finding a sufficient cause of action where a press release was alleged to be misleading); *In re Rexene Corp. Shareholders*, No. CIV.A.10,897, 1991 WL 77529 (Del. Ch. May 8, 1991).

93. See *Cellular Info. Sys., Inc. v. Broz*, 663 A.2d 1180, 1186 (Del. Ch. 1995) (noting that a director who seeks to exploit a corporate opportunity has an obligation to disclose it to the board for their action; after-the-fact testimony that the board did not desire the opportunity "is a very thin substitute for an informed board decision made at a meeting in 'real time'").

94. See *Broz v. Cellular Info. Sys., Inc.*, 673 A.2d 148 (Del. 1996) (finding that a presentation to the board "creates a kind of 'safe harbor' for the director, which removes the specter of a post hoc determination that the director or officer has improperly usurped a corporate opportunity It is not the law in Delaware that presentation to the board is a necessary prerequisite to finding that a corporate opportunity has not been usurped.").

95. See, e.g., *State ex. rel. Hayes Oyster Co. v. Keypoint Oyster Co.*, 391 P.2d 979, 984 (Wash. 1964) ("Such a contract [between a corporation and an interested director] cannot be voided if the director or officer can show that the transaction was fair to the corporation. However, nondisclosure by an interested director or officer is, in itself, unfair.").

96. See AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.05(a)(1)-(2) (1994).

97. Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

security or person.⁹⁸ Until 1996, both federal and state regulatory systems existed side by side in the registration of securities, regulation of antifraud provisions, and regulation of broker-dealers and others in the securities business. Efforts to coordinate these two systems expanded over the years,⁹⁹ but issuers objected to having to submit not just to federal regulation but also to various state regulatory systems wherever the securities were sold. The issuers found a receptive audience in Congress, particularly when coupled with arguments about the growing internationalization of securities issuance and the disadvantage to American companies in having to comply with regulations of multiple American jurisdictions.¹⁰⁰

In 1998, Congress took a second and larger preemption step by blocking state law, antifraud class actions involving the largest American corporations.¹⁰¹ This step followed 1995 legislation that imposed limitations on class actions brought under Rule 10b-5.¹⁰² When plaintiffs' lawyers filed disclosure suits under state law in response to the 1995 restrictions, members of Congress lost little time in proposing new legislation to prevent such an end-run.¹⁰³ As enacted, the ban is broad:

No covered class action based on the statutory or common law of any [s]tate . . . may

98. Before 1996, section 18 read: "Nothing in this subchapter shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State of Territory of the United States, or the District of Columbia, over any security or any person." 15 U.S.C. § 77r (1994) (amended 1996). After the amendment, the section now reads:

Except as otherwise provided in this section, no law, rule, regulation, or order, or other administrative action of any State or any political subdivision thereof . . . requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to . . . a covered security.

15 U.S.C.A. § 77r (West Supp. 1999).

99. See generally Mark A. Sargent & Hugh H. Makens, *ULOE: New Hope, New Challenges*, 45 BUS. LAW. 1319 (1990).

100. See S. REP. NO. 105-182, at 3 (1998) (quoting *Private Securities Litigation Reform Act of 1995: Oversight Hearings Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 105th Cong., 1 (1998) (statement of Steven M.H. Wallman):

Disparate, and shifting, state litigation procedures may expose issuers to the potential for significant liability that cannot easily be evaluated in advance, or assessed when a statement is made. At a time when we are increasingly experiencing and encouraging national and international securities offerings and listings, and expending great efforts to rationalize and streamline our securities markets, this fragmentation of investor remedies potentially imposes costs that outweigh the benefits. Rather than permit or foster fragmentation of our national system of securities litigation, we should give due consideration to the benefits flowing to investors from a uniform national approach.

101. See Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered subsections of 15 U.S.C. §§ 77-78).

102. See Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.). The 1995 Act made several important changes that made securities fraud litigation more difficult: It included a safe harbor to preclude private actions based on allegedly misleading forward-looking statements, heightened pleading standards to require specific facts to support a fraud allegation, and added a stay of discovery while the court hears a defendant's motion to dismiss. See 15 U.S.C. §§ 78u-5, 78u-4(b) (1994 & Supp. III 1997).

103. See Michael A. Perino, *Fraud and Federalism: Preempting State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273 (1998). But see Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1 (1998) (questioning the data that purported to show an increase in state-court filings).

be maintained in any [s]tate or [f]ederal court by any private party alleging: (1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or (2) that the defendant used any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.¹⁰⁴

The ban tracks the language of Rule 10b-5, or at least as Rule 10b-5 is interpreted.¹⁰⁵ The use of “covered securities” limits the preemption to those companies with shares traded on a national stock exchange or comparable national market.¹⁰⁶

During the congressional debate over the bill, a “carve-out” was added to preserve certain state law actions.¹⁰⁷ Crafted by a group of experienced Delaware lawyers, securities practitioners, academics, and SEC staff,¹⁰⁸ the carve-out limits the reach of federal preemption in two ways. The definition of class action explicitly excludes state law actions brought exclusively as derivative suits. In addition, a separate section preserves state law actions in two kinds of cases: (1) a purchase or sale transaction where one side is the issuer or an affiliate, and the other side is exclusively holders of the issuer’s equity securities, and (2) recommendations or other communications “with respect to the sale of securities of the issuer”¹⁰⁹ made to equity holders by or on behalf of the issuer or an affiliate concerning (a) voting, (b) acting in response to a tender or exchange offer, or (c) exercising dissenters’ or appraisal rights.

The carve-out combines, in an unusual way, shareholder voting and exit functions. State actions alleging disclosure violations where shareholder voting pertains to elections or perhaps ratification are not affected by the preemption if they are not in connection with a purchase or sale of security. Disclosure challenges for other shareholder voting that are in connection with the purchase and sale of security, such as voting or appraisal, are included within the definition of preempted actions but are then preserved by the carve out. State disclosure actions relating to shareholder selling are similarly preserved if the action relates to a tender offer, but if shareholders are affected by a similar disclosure problem in deciding to sell outside a tender offer, state action is pre-

104. Securities Litigation Uniform Standards Act of 1998, 15 U.S.C. § 77p (West Supp. 1999).

105. The language of Rule 10b-5 is more limited as to omission, specifically prohibiting only half-truths “to omit to state a material fact necessary in order to make the statement made, in light of the circumstances under which they were made, not misleading.” 17 C.F.R. § 240.10b-5 (1999). Silence when no prior statement has been made is not explicitly covered by the rule. The new statute uses “omission” without the qualifying language. Under judicial interpretation of Rule 10b-5, omissions are fraud only if there is a duty to speak. See, e.g., *Chiarella v. United States*, 445 U.S. 222 (1980). This language bans state law class actions based on omissions whether or not they are covered by Rule 10b-5.

106. See Securities Litigation Uniform Standards Act of 1998, 15 U.S.C. § 77p(f)(3) (West Supp. 1999).

107. See 15 U.S.C. § 77p(d)(1) (West Supp. 1999). Class actions brought by states or state pension plans were also preserved by this section. See 15 U.S.C. § 77p(d)(2) (West Supp. 1999).

108. See David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California’s Blue Sky Laws*, 54 BUS. LAW. 1, 24 (1998) (“In order to preserve these advantages of state law, a provision was drafted by an ad-hoc committee led by then-SEC General Counsel Richard H. Walker and consisting of certain members of the American Bar Association’s Task Force on Securities Reform and the Delaware bar, as well as academics and SEC staff.”).

109. 15 U.S.C. § 77p(d)(1)(B) (West Supp. 1999).

empted. State class actions based on nondisclosure or omissions are preserved where shareholder voting leads to a sale of stock (for example, a merger or for similar transaction) but not where shareholder voting leads to election of directors or ratification of self-dealing transactions.¹¹⁰ State actions are preserved where shareholders sell to a third party in a tender offer but not where shareholders sell to a third party outside of a tender offer.

The preemption section is a substantive statement that shareholders should not be able to sue directors through class actions under state law for disclosure deficiencies related to how directors have run the corporation. The carve-out then preserves such claims for disclosure deficiencies if they relate to certain voting and selling decisions, but not other shareholder decisions. The justification for such preemption is that issuers face the possibility of suit in numerous jurisdictions, creating unnecessary costs to American issuers and too much power for an individual state.¹¹¹ The argument is that a shareholder's right to sue derives from the place of the transaction. A corporation is unable to control the place of transaction—remember it is not even a party to many transactions—therefore, a corporation could find itself subject to suits in multiple jurisdictions.¹¹²

Although proponents of preemption raise the specter of suits in numerous states, the legislation seemed motivated more by the possibility of a conflicting rule in one state: California, where Silicon Valley companies feared not having the full protection of recent federal restrictions.¹¹³ It was unclear at the time of the federal legislation whether California would actually have a contrary rule, but there was little sentiment in Congress to postpone the use of the preemption club.¹¹⁴ The new federal law was more concerned with defining the limits on shareholder rights vis-à-vis directors than adhering to a coherent federalism policy.

110. These results occur because the clause “with respect to the sale” precedes and, therefore, modifies all three forms of shareholder action specified. Because an election of directors or ratification is not related to a sale, it would not fall within the carve-out and would be preempted. For example, one part of the claim in *Smith v. Van Gorkom*, 488 A.2d 858, 890-93 (Del. 1985) was based on inadequate disclosure as to shareholder ratification. That claim would be preempted.

111. See *Securities Litigation Uniform Standard Act of 1997: Hearings on S.160 Before the Subcomm. on Sec. of the Senate Comm. on Banking, Housing, and Urban Affairs*, 105th Cong., 15 (1998) (statement of Sen. Dodd) (“Without a national standard for liability, the potential threat is always there that one [s]tate will change its laws in such a way as to become the haven for litigation. This almost happened in California last year with Proposition 211. The potential remains it could successfully happen elsewhere in the future.”).

112. See *id.* (testimony of Daniel Cooperman, Senior Vice President, Oracle Corp.) (“As nationally traded companies in a global marketplace it simply makes no sense for there to be fifty different state laws applying to the buying and selling of securities.”).

113. See Painter, *supra* note 103, at 36 & n.183 (noting that 78% of the suits are in California).

114. See *id.* at 89 (noting that Congress interfered in an internal fight among Californians); see also Levine & Pritchard, *supra* note 108 (suggesting that if Congress had just waited, issue may have receded).

IV

OBSERVATIONS ON THE CURRENT SYSTEM

Corporate governance has now become a shared function between federal and state governments in a way that places the current structure outside the traditional legal pattern. Delaware and other states still retain the primary role of determining the authority and power of directors, and they retain a significant role in specifying procedures for shareholder action, but the federal government has become the principal law-giver in determining what shareholders do and in defining the range within which shareholders act. The result is somewhat jarring: Some shareholder functions are protected both under federal and state law; some receive protection from only one government; and a third group of decisions receives little protection from either government.

The patchwork nature of current laws increases the likelihood of unintended consequences. The result suggests the aptness of the comments of SEC Chairman Arthur Levitt, originally directed toward the dual system of state and federal regulation of securities registration: “[It] is not the system that Congress or the Commission would create today if we were designing a new system.”¹¹⁵ Or it may be the predictable result when two governments share power, and interested parties can lobby one government or the other to shape a result more to their liking. A similar process occurred elsewhere in the law of business associations where interested parties lobbied state legislatures to create new business organizations—the limited liability company and, later, the limited liability partnership—to achieve limited liability and pass-through tax treatment from the federal government for those who would not otherwise qualify for that recognition. In turn, federal tax rules determined the contours of state law governance rules for these new alternatives to corporations.

Some of the confusion surrounding the current regime of corporate governance can be attributed to the historic way in which we have approached policy decisions related to disclosure. Milton Cohen’s observation of the 1933 and 1934 Acts has been much quoted:

[T]he combined disclosure requirements of these statutes would have been quite different if the 1933 and 1934 Acts . . . had been enacted in opposite order, or had been enacted as a single, integrated statute—that is, if the starting point had been a statutory scheme of continuous disclosures covering issuers of actively traded securities and the question of special disclosures in connection with public offerings had then been faced in this setting.¹¹⁶

Something similar could be said for the current topic: The structure of shareholder disclosure would be quite different if we had started from the perspective of corporate governance rather than market transactions, with shareholder decisions to sell—compared to decisions to vote or sue—as a particular

115. S. REP. NO. 105-182, at 5 (1998) (*Hearings on S.1815 Before the Subcomm. on Sec. of the Senate Comm. on Banking, Housing, and Urban Affairs*, 105th Cong., 32 (1997) (statement of Arthur Levitt)).

116. Milton H. Cohen, “*Truth in Securities*” Revisited, 79 HARV. L. REV. 1340, 1341-42 (1966).

example of governance rights. Federal preemption of state laws regarding disclosure to shareholders can be more easily justified if viewed as part of a unified federal system that is designed to provide information to investors who are making investment decisions on markets. Individual states might lack sufficient incentives to produce disclosure requirements in that context.¹¹⁷ On the other hand, regulation by state law is more defensible if viewed as part of corporate governance. Indeed, as an alternative to preemption, there have been recent proposals to let the state of incorporation determine anti-fraud disclosure regimes. This alternative would respond to the market-based concerns about multiplicity of suits, but in a manner more consistent with federalism principles than the preemption of the 1998 legislation.¹¹⁸ This part of the article describes the current federal role and evaluates that role against the governance matrix described in Part III.

A. The Emerging Dominance of Federal Law

Federal law has a broader scope than might be expected even given the changes discussed above. Federal law has gone further to define the space for shareholder participation in setting the agenda of the corporation than a supplemental role would suggest. The emerging state law of disclosure defers to federal law in broad areas, and recent preemption legislation has a broader effect than the presence of a Delaware carve-out would suggest.

1. *Federal Law Defining the Space for Shareholder Voting.* Even for shareholder voting, where claims for state control are the most well-established, federal law has made significant inroads in determining the substance of the shareholder role in corporate governance. State law provides only minimal requirements for an annual shareholder meeting and shareholder approval of fundamental corporate changes, such as mergers, after they have been proposed by the directors.¹¹⁹ Under such a system, shareholders are necessarily passive and reactive. They are given no authority to initiate corporate action or set the agenda.

Although most corporation statutes permit corporations to limit or restrict the power of the board of directors and to thereby place power in the hands of the shareholders, those changes to the statutory norms usually must be made by provisions in the articles of incorporation.¹²⁰ The board itself acts as a gatekeeper for any amendments to the articles; shareholders have no authority to initiate such changes.¹²¹ Shareholders in many states can directly change the

117. See John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984).

118. See Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998); see also Perino, *supra* note 103.

119. See MODEL BUS. CORP. ACT §§ 7.01, 11.03 (1990).

120. See, e.g., DEL. CODE ANN. tit. 8, § 141 (1991) (except as otherwise provided in the certificate of incorporation); MODEL BUS. CORP. ACT § 8.01 (1990) (subject to any limitation set forth in the articles of incorporation or in an agreement authorized under § 7.32).

121. See DEL. CODE ANN. tit 8 § 242 (1991); MODEL BUS. CORP. ACT § 10.03 (1990).

bylaws without going through the board as a gatekeeper,¹²² but there is a significant question about whether bylaws can be used to interfere with a director's power—based on corporate law—to manage the business and affairs of the corporation unless an alternative regime is set out in the articles.¹²³

Against such a limited regime for shareholder action, federal law has greatly expanded shareholder participation in setting the agenda for issues to be voted on by shareholders. Every year, hundreds of shareholder proposals find their way onto the agendas for shareholders' meetings and onto management's proxy ballots because of federal Rule 14a-8.¹²⁴ The rule ostensibly permits issuers to refuse to include individual shareholder proposals for any of thirteen reasons; the first reason states, "[T]he proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization."¹²⁵ Given the limited role of shareholders under state law, this provision could exclude many, if not most, shareholder proposals. The SEC has passed quickly over any constraints that could arise from this limit in a note to the rule pointing out the difference between mandatory and precatory shareholder action: While proposals that mandate corporate action may be beyond the powers of shareholders, a proposal that recommends or requests such action of the board may be proper under such state law.¹²⁶ There is little state law to that effect.¹²⁷ Indeed, state law permits directors to prevent shareholders from deciding on a tender offer, which likely will more dramatically affect shareholders than will most shareholder resolutions. Nor is there an easy way to raise in court the issue of possible federal expansion of the law regarding the

122. See MODEL BUS. CORP. ACT § 10.20(b) (1990).

123. See John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests*, 51 U. MIAMI L. REV. 605, 608 (1997) ("It would seemingly elevate form over substance to permit shareholders to do by way of bylaw amendment what they could not do by way of a shareholder resolution—use bylaw amendments to dictate 'ordinary' business practices of the corporation."); see also Jeffrey N. Gordon, "Just Say Never?" *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511 (1997); Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409 (1998); Jonathan R. Macey, *The Legality and Utility of the Shareholder Rights Bylaw*, 26 HOFSTRA L. REV. 835 (1998).

124. 17 C.F.R. § 240.14a-8 (1998).

125. *Id.* § 240.14a-8(i)(1).

126. See *id.* § 240.14a-8(i)(1) note.

127. See, e.g., *Carter v. Portland Gen. Elec. Co.*, 362 P.2d 766, 770 (Ore. 1961) (refusing to compel management to include in a proxy solicitation a shareholder's statement opposing management's plan to construct a dam after the shareholder's attempt to present a resolution opposing the dam was ruled out of order by the chairman at the annual meeting of shareholders: "We do not think that the proposal in this case was one that was necessarily proper for stockholders to give an advisory opinion about."). But see Melvin A. Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489, 1523-24 (1970) ("[T]hose who would deny shareholder access to the corporate proxy materials for the purpose of including a proposal which is within the shareholder competence to initiate and act upon, should be required to furnish a court with more than the *Carter* opinion if their position is to carry the day."); see also *Conservative Caucus v. Chevron Corp.*, 525 A.2d 569 (Del. Ch. 1987) (observing that, in the context of determining a proper purpose for obtaining a shareholder list, a resolution is not improper merely because it requests the board to take certain action); *Auer v. Dressel*, 118 N.E.2d 590 (N.Y. 1954) (ruling that shareholders may call a meeting to support an ousted president even though they have no power to force his reappointment).

role of shareholders.¹²⁸ The result has been a significant expansion of the role of shareholders; every year, because of those rules, shareholders vote on hundreds of issues, from seeking annual election of all directors to not force-feeding geese.¹²⁹

2. *State Law Deferring to Federal Disclosure Rules, Even for Voting Rules.* Even though Delaware has in recent years embraced a shareholder's right to an informed vote as an essential corporate right, its courts often have been satisfied to let federal law determine the content of such a right. Thus, when a shareholder sought to obtain relief for incomplete and misleading disclosure in a proxy that sought approval of a stock option plan, Delaware's chancellor noted that provision of a state law remedy for breach of a duty of candor "does not mean that fiduciary duty of corporate directors is the appropriate instrument to determine and implement sound public policy with respect to this technical issue."¹³⁰ Sometimes this deference to federal law is practical given the existing federal regulation: "We see no legitimate basis to create a new cause of action which would replicate, by state decisional law, the provisions of Section 14 of the 1934 Act."¹³¹ Sometimes it seems more like an abdication: "Neither the Delaware corporation code nor the common law suggests that Delaware can or should pick up the perceived regulatory slack when federal scrutiny may not include review of every actionable theory divivable by a dogged plaintiff."¹³²

3. *Federal Law Constraining State Efforts to Change the Matrix.* The 1998 federal legislation takes state deference a step further. Even if the states want to provide shareholders more effective disclosure rights, they cannot, at least not via a class action. One Delaware decision refused to find a state cause of action because it would replicate Section 14 of the 1934 Act and concluded that "[s]uch a result would represent a significant change to the existing matrix of duties which governs the relationship among shareholders, directors and corporations. If such a change is to be, it is best left to the General Assembly."¹³³ Congress has now taken some of that choice from the General Assembly. States are limited to providing disclosure for certain voting actions,

128. See Susan W. Liebler, *A Proposal to Rescind the Shareholder Proposal Rule*, 18 GA. L. REV. 425, 459 (1984) ("Even though strong legal arguments can be made that the Commission has exceeded its authority in promulgating the shareholder proposal rule, it is unlikely that any issuer would find it cost effective to test this issue directly. The direct costs of shareholder proposals are almost certainly less than the litigation costs and costs associated with incurring the wrath of the Commission staff which certainly would be visited upon such a deviant issuer.").

129. See, e.g., *Lovenheim v. Iroquois Brands, Ltd.*, 618 F. Supp. 554 (D.D.C. 1985) (involving a shareholder resolution that condemned the practice of force-feeding geese to produce pâté).

130. *Lewis v. Vogelstein*, 699 A.2d 327, 332-33 (Del. Ch. 1997) ("An administrative agency—the Securities and Exchange Commission—has a technical staff, is able to hold public hearings, and can, thus, receive wide and expert input, and can specify forms of disclosure, if appropriate.").

131. *Arnold v. Society for Sav. Bancorp, Inc.*, 678 A.2d 533, 539 (Del. 1996).

132. *Malone v. Brincat*, No. CIV.A.15510, 1997 WL 697940, at *2 (Del. Ch. Oct. 30, 1997), *aff'd in part and rev'd in part*, 722 A.2d 5 (Del. 1998).

133. *Arnold*, 678 A.2d at 539.

principally those for which the directors have been given a gatekeeper function. If a state were to decide that additional disclosures were necessary for shareholders to exercise their right of exit or litigation effectively, federal law now prevents any such adjustment to the matrix of regulations, at least as such rights would be enforced by class actions.

B. The Hierarchy of Shareholder Governance Rights

The various shareholder governance rights identified at the beginning of this article—to vote, sell, and sue—do not receive equal attention in our current legal regime. Both state and federal law protect a shareholder's right to cast an informed vote. Indeed, it seems to be the centerpiece for both systems. The federal carve-out in the 1998 legislation preserves most, but not all, state law authority to regulate voting. A shareholder's right to be informed in making a sale or purchase decision receives extensive federal protection, although noticeably less after the 1995 Act, but the federal government now bans states from providing additional protection through class actions that the federal government does not provide. The third basic shareholder function—bringing litigation that will constrain management—is also excluded from state class action enforcement of disclosure under the recent preemption legislation, but it receives little express federal protection.

This hierarchy may simply reflect a view held by both sovereigns that the shareholder voting function is more important to corporate governance than are the exit or litigation functions.¹³⁴ More realistically, it may be a recognition that law has a relative advantage in the area of voting and that markets can be relied on to perform any needed monitoring of market transactions. It may be that voting's preferred place in the regulatory hierarchy reflects a practicality: A vote is a focused act more capable of being supported by disclosure obligations. Yet we have a well-developed law on disclosure that supports shareholders making investment decisions to buy or sell so that the relative advantage of law in the area of voting is not overpowering.

This preference, which is visible in both federal and state law, seems to exist apart from any federalism concerns. Delaware case law regarding anti-takeover actions has given corporate directors wide discretion in making decisions about poison pills or other takeover defenses that prevent shareholders from making an exit decision when responding to a tender offer.¹³⁵ Delaware decisions suggest that directors have considerably less room in defensive tactics that block shareholder voting decisions.¹³⁶ Corporate raiders unsuccessfully sought to in-

134. See *Hoschett v. TSI Int'l Software, Ltd.*, 683 A.2d 43, 44 (Del. Ch. 1996) (“The critical importance of shareholder voting both to the theory and to the reality of corporate governance, may be thought to justify the mandatory nature of the obligation to call and hold an annual meeting.” (citations omitted)).

135. See *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1990).

136. See *Blasius Indus. Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988) (holding that matters involving the integrity of the shareholder-voting process involve considerations that are not present in other contexts in which the directors exercise delegated power); see also *In re Santa Fe Pacific Corp.*,

voke federal tender offer legislation to block takeover defenses that were portrayed as restricting a shareholder's right to sell their shares to a tender offerer. These narrow interpretations of federal tender offer law may be viewed as resting on federalism grounds, demonstrating federal deference to state corporation regulation.¹³⁷ More likely, it is a shared reluctance, found in state as well as federal law, that law has a limited role in regulating shareholder decisions to sell.¹³⁸

C. Preemption Viewed in the Context of Shareholder Governance Functions

1. *The 1998 Legislation as Part of Regulation of the Market Transactions.* Our current system of disclosure related to investment decisions arose from a system centered on the regulation of market transactions. The preemption and carve-out contained in the 1998 legislation consider disclosure rules that affect shareholder trading decisions as a subset of other disclosure rules that affect transactions that occur across markets. This view supports a broad reach for federal preemption, using the market-based reasons previously advanced to support the 1996 legislation: An issuer who is subject to liability for market transactions cannot choose the jurisdictions in which securities will be traded and is thus open to suit in multiple jurisdictions or at least any jurisdiction with less restrictive standards than the federal rule.¹³⁹

The preemption rule in the 1998 legislation presumes a bright line between such market-based regulation and the traditional state regulation of corporate governance. Part II of this article sets out the contrary reality. This part of the article addresses more practical issues that can be expected to arise given the market-based orientation of the new preemption statute.

a. *Direct versus derivative suits.* Derivative suits are brought by a shareholder in the name of and on behalf of the corporation. Although recognized as a bulwark against manager self-dealing, the possibility of a strike suit by a self-appointed shareholder litigator has produced various procedural limitations on these suits.¹⁴⁰ A claim that directors have breached their

669 A.2d 59, 68 (Del. 1995) (advocating enhanced judicial scrutiny to assure a shareholder vote). See generally Robert B. Thompson, *Shareholders as Grown-ups: Voting, Selling, and Limits on the Board's Power to "Just Say No,"* 77 U. CIN. L. REV. 999 (arguing that directors' ability to constrain shareholder selling decisions should parallel their ability to constrain voting decisions).

137. See *supra* notes 34-37 and accompanying text.

138. For an example of judicial reluctance to enhance shareholder selling decisions under state law, see *Colonial Securities Corp. v. Allen*, No. CIV.A.6778, 1983 WL 19788 (Del. Ch. Apr. 18, 1983), where the court rejected the plaintiff's claim that characterized a severance benefit package as an effort to emasculate the shareholder right to vote or to coerce shareholders to vote only for board-approved nominees. The court concluded that it would be unreasonable to view the complaint as anything more than an attack on the compensation agreement, which must be brought derivatively. See *id.*; see also *Moran v. Household Int'l, Inc.*, 490 A.2d 1059 (Del. Ch.1985) (finding no contractual right to receive takeovers where no shareholder presently engaged in proxy contest), *aff'd*, 500 A.2d 1346 (Del. 1985).

139. See, e.g., *Coffee*, *supra* note 117.

140. For example, plaintiffs must make a demand on directors before proceeding with the litigation. See MODEL BUS. CORP. ACT § 7.42 (1990).

fiduciary duty in the management of the corporation usually must be brought as a derivative action. Some claims, however, give rise to a direct action, such as a claim that a shareholder suffered a particular harm from breach of a contract right or loss of a right to vote.

Judges and commentators have struggled to set out a consistent theory that separates direct from derivative suits, using the nature of the claim or the nature of the harm, but always leaving ample room for judicial discretion and argument.¹⁴¹ Because the standard is vague, some cases have a decidedly opportunistic flavor as a party seeks to gain or avoid the results of one label or the other in a particular circumstance.¹⁴²

The disclosure cases often raise difficult questions of placement in the direct versus derivative discussion. Incomplete or omitted disclosure usually relates to a voting or selling decision that affects all shareholders similarly, in much the same way as the harm in most derivative suits. But, because the disclosure violation relates to a shareholder decision to vote or exit rather than a collective corporate decision, disclosure suits are often direct suits. Usually this determination is like a traffic cop directing a claim to either of two state law causes of action. With the enactment of the 1998 Act, the difference between direct and derivative now has a federalism aspect. Defendants will now have reason to argue that shareholder claims are direct claims and are thus preempted by the new federal act.¹⁴³

b. Fiduciary duty and fraud. Another distinction that will receive renewed emphasis because of the new act is that between fiduciary duty and fraud. Director actions that breach fiduciary duties owed to the corporation and shareholders often seem to overlap with fraud, particularly if fraud is defined to include the more open-ended concept of constructive fraud. Insider trading has long straddled this division, sometimes viewed as a breach of fiduciary duty and sometimes viewed as fraud.¹⁴⁴ The corporate governance provisions of the 1934 Act raise similar overlapping concerns. It was this

141. See, e.g., John W. Welch, *Shareholder Individual and Derivative Actions: Underlying Rationales and the Closely Held Corporation*, 9 J. CORP. L. 147 (1984).

142. See *Lipton v. News Int'l, Plc.*, 514 A.2d 1075, 1082 (Del. 1986) (Moore, J., concurring) ("Through artful drafting, News' complaint . . . appears to speak derivatively on behalf of the corporate enterprise, while subtly mixing in certain language upon which it now relies to stake out 'individual' claims."). Shareholders in a close corporation would usually prefer to have the claim characterized as direct and thereby avoid the procedural complexity of a derivative suit, but plaintiffs or judges sometimes adopt a derivative position, in part because it provides a vehicle for requiring the corporation to pay the plaintiff's attorney's fees. See F. HODGE O'NEAL & ROBERT B. THOMPSON, *O'NEAL'S CLOSE CORPORATIONS: LAW AND PRACTICE* § 8.16 (3d ed. 1994).

143. Some cases, such as the classic control premium case, *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955), permit direct recovery in a derivative case. Where both direct and derivative recovery are available under state law, there is not an immediate need to define the line between the two remedies. After the 1998 Act, there will be times when direct suits will be preempted but derivative suits will not, and we can expect much additional argument on issues like direct recovery in derivative suits.

144. Compare *Chiarella v. United States*, 445 U.S. 222 (1980) (discussing insider trading within the context of fraud and using traditional fiduciary duty to define when silence is fraud) with *Goodwin v. Agassiz*, 186 N.E. 659 (Mass. 1933) (discussing insider trading as a breach of fiduciary duty).

overlap that provided the context for Justice William O. Douglas's observation that director misconduct and fraud are all part of a "single seamless web."¹⁴⁵ The Supreme Court's subsequent decision in *Santa Fe* was an effort to define fraud narrowly under federal law so that it did not absorb what were also fiduciary duty claims under state law.¹⁴⁶ Corporate defendants will now seek to reverse that argument and will broadly define fraud to include disclosure claims so that their claims can be preempted by the federal legislation.

The disclosure cases, particularly those related to shareholder exit decisions, raise a difficult question of categorization. From a practical standpoint, disclosure can be seen as market regulation, supporting and improving the decisions of market participants, or it can be viewed as part of corporate governance, part of the duty owed to shareholders. In recent years, the judicial role in this overlap area has been considerably more active under federal law based on fraud than under state law based on fiduciary duty.¹⁴⁷ In part, the preference for fraud is driven by who the defendant is.¹⁴⁸ In a fraud suit, the corporation is often the defendant; in a fiduciary duty suit, the claim is against the directors. It may be easier to recover from the corporate treasury than to pursue individual defendants. Also, the directors might be protected by exculpation provisions, which are permitted in most states. These exculpation provisions have been held to cover disclosure claims, so that no recovery will be available under state law against directors.¹⁴⁹ But, on the same nondisclosure, a fraud cause of action will permit a recovery against the corporation.¹⁵⁰

145. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11-12 (1971) (noting that Congress made it clear that "disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web' along with manipulation, investor's ignorance, and the like" (quoting H.R. Rep. No. 73-1383, at 6 (1934))).

146. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1977) ("To the extent that the Court of Appeals would rely on the use of the term 'fraud' in Rule 10b-5 to bring within the ambit of the Rule all breaches of fiduciary duty in connection with a securities transaction, its interpretation would, like the interpretation rejected by the Court in *Ernst & Ernst*, 'add a gloss to the operative language of the statute quite different from its commonly accepted meaning.'").

147. *See* LEWIS D. SOLOMON ET AL., *CORPORATIONS LAW & POLICY* 884 (4th ed. 1998).

148. The identity of the defendant also determines the exclusivity of the appraisal remedy in corporate law. Suits based on breach of fiduciary duty have long been a basis for claims of misuse of majority power in the context of a merger or other fundamental corporate change. Some state courts have held that the appraisal remedy can provide all the protection needed for minority shareholders. *See Stringer v. Car Data Systems, Inc.*, 841 P.2d 1183 (Or. 1992) ("Cases such as these are the very kind addressed by the statutory scheme."). Delaware continues to permit alternative actions, in part because appraisal is a limited suit against the corporation, and the corporation's valuation necessarily cannot include damages from directors' breaches of fiduciary duty. *See Ceder Co. v. Technicolor, Inc.*, 542 A.2d 1182, 1189-90 (Del. 1998) ("A determination of fair value does not involve an inquiry into claims of wrongdoing on the merger."). California and other states assert that appraisal can do that. *See Steinberg v. Amplica, Inc.*, 729 P.2d 683, 690 (Ca. 1987) ("We see nothing in the appraisal statutes to prevent vindication of a shareholder's claim of misconduct in an appraisal proceeding.").

149. *See Arnold v. Society for Sav. Bancorp, Inc.*, 650 A.2d 1270 (Del. 1994) (ruling that the exculpation provision in the corporate charter covered a claim that was based on a director's alleged breach of duty to disclose all facts relating to a merger).

150. A Delaware court has suggested another way of drawing the line: Suits against directors are brought under fiduciary duty; state law suits against the corporation based upon breach of fiduciary duty must be predicated on legal or equitable fraud. *See In re Dataproducts Corp.*, No. CIV.A.11164, 1991 WL 165301, at *6 (Del. Ch. Aug. 22, 1991) (reasoning that this is "not to say that a corporation

2. *Disclosure as Part of Corporate Governance.* There is an alternative to the market-based preemption described above that does not include its vague overlaps and greater federal presence. Disclosure regulation of exit transactions is one of several shareholder functions that are part of corporate governance. State corporate law could regulate this function as it does other functions of the state corporate governance process. Indeed, recent proposals recognize that this type of regulation of market transactions can be placed within the traditional governance structure.¹⁵¹ Such a proposal offers a ready solution to the problem of multiple states asserting jurisdiction and the negative impact on companies that compete in international markets. As is true in corporate governance generally, a suit could be brought only under the law of the state of incorporation. At that point, the market-based justification for preemption loses its power. One side effect, albeit probably positive, is the further withering away of the “pseudo-foreign” corporation doctrine, by which a state other than the state of incorporation asserts jurisdiction based on the shareholders’ citizenship and residence within the state.¹⁵² This doctrine is subject to arguments similar to the market-oriented preemption argument that was made to support the 1998 Act because it opens up the possibility of suits in multiple jurisdictions and it can be a way to avoid a substantive rule of the state of incorporation. The 1998 Act lands a telling, although largely unnoticed, blow against pseudo-foreign corporations by permitting direct suits arising only under the state of organization.¹⁵³

Viewing disclosure for shareholder trading decisions as within the umbrella of the overall regulation of corporate governance is more likely to foster a conscious weighing of the relative merits of the various shareholder functions. It is also likely to encourage a more comprehensive development of the discussion of direct versus derivative suits and the overlap between fraud and fiduciary duty.¹⁵⁴

owes no duty or can never be liable under Delaware law if it promulgates false and misleading disclosures to its shareholders. Rather, it means that under Delaware law any disclosure duty owed by the corporation to its shareholders must be predicated upon a theory of legal or equitable fraud.”). Whatever the validity of the distinction, such a suit, if direct, would seem to be preempted by the 1998 legislation. See Hamermesh, *supra* note 21, at 1174 (noting that directors have no recognized function to manage information to permit intelligent stock-related decisions by one segment of market—existing shareholders—and distinguishing state law from what is historically federal law).

151. See Romano, *supra* note 118 (urging disclosure choice for public issuers in both primary and secondary markets and one sovereign with jurisdictions over all transactions in the securities of a corporation); see also Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1 (arguing that issuers should be able to choose the nature and level of ex ante disclosure to investors with mandatory Rule 10b-5 liability, but secondary market requirements and liability should be different because of reduced incentives and constraints for management disciplining).

152. See CALIF. CORP. CODE § 2115 (West Supp. 1999).

153. See S. REP. NO. 105-182, at 6 (1998) (“[T]he Committee expressly does not intend for suits excepted under this provision to be brought in venues other than in the issuer’s state of incorporation, in the case of a corporation, or state of organization, in the case of another entity.”).

154. See Painter, *supra* note 103, at 52 (noting that state law filing avoids having to make a sharp distinction between fiduciary duty and fraud).

V

CONCLUSION

The relationship between shareholders and directors within a corporation, long thought to be within the domain of state law, now has a dominant federal aspect. Federal law, whose original role was limited to making shareholder voting more effective through disclosure, now defines a broad range of shareholder rights vis-à-vis directors. Federal law permits shareholders to determine the corporate agenda beyond any rights contemplated by state law. State law now defers to federal law even on core disclosure questions about voting. Federal law now preempts any competing state law via class actions regarding disclosure that shareholders may need to exercise their core governance functions of exit and litigation.

We have lost any sort of firebreak to preserve federalism in corporate regulation.¹⁵⁵ The division between federal and state regulation now seems to turn on the substantive result that Congress desires rather than on any determination of which corporate functions are better performed by state governments in our federal system. If there is any real concern about federalism, it is possible to address the multijurisdictional problems that seem to have motivated the 1998 Act while still preserving state regulation of corporate governance by simply extending the internal affairs doctrine to include all shareholder functions. This approach has the added advantage of being less likely to spur growth in extraneous issues, such as whether a suit must be direct or derivative, or possible differences between fiduciary duty and fraud. This alternative solution prefers federalism, and it does not require the federal government to determine the substantive rules. In adopting a contrary approach, it seems that the real focus of the 1998 Act was to prevent any alternative state rule more favorable to shareholders.¹⁵⁶ That goal, while certainly within the range of substantive rules that might be adopted, suggests that we have taken another large step toward a federal corporations law.

155. *See Business Roundtable v. SEC*, 905 F.2d 406, 413 (D.C. Cir. 1990) (“If the Commission’s one share/one vote rule is to survive, then some kind of firebreak is needed to separate it from corporate governance as a whole.”).

156. The removal provision in the 1998 Act—which allows federal courts to interpret the scope of preemption and to use the stay of discovery of the Reform Act—seems to suggest a distrust of state courts and a focus on ensuring that the substance of the rule was changed, with little concern for federalism.