

How We Make Law in Delaware, and What to Expect from Us in the Future

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How We Make Law in Delaware, and What to Expect from Us in the Future

MY PAPER HAS NO THEORETICAL CONTENT WHATSOEVER. In fact, it is one of these odd papers that is not normative, not theoretical, and barely even predictive. My paper is almost purely narrative. It is titled, as you see, "The Policy Foundations of Delaware Corporate Law,"¹ which is a very high-sounding title, but one with a very small point. My paper is a product of having lived in Delaware for thirty years. I spent eighteen of those years in practice, and taught the subsequent twelve years. I have also sat on the Council of the Delaware State Bar Association's Corporation Law Section, which is the principal source of legislative drafting in the corporate law field.²

During my career, I have listened to people in practice and in academia talking about Delaware. Unlike most of these commentators, I have been in Delaware, watching what goes on. From time to time I have thought, "Gee, you know, what you are saying is very interesting. I had not thought of that, but that is not quite what happens." So I want to offer a real-world view of how law is made in Delaware.

Before I touch on the substance of the paper, let me offer a brief outline. First, I will introduce the major policymaking people in Delaware corporate law. Then, I will take a very brief look at the major scholarly pieces that address Delaware's motivations, results, and theoretical impact. Lastly, I will try to fatten the discussion by suggesting some things about what actually happens in Delaware.

The best-known of the principal policymakers in Delaware are the members of the judiciary. One of those major actors, Justice Jacobs, is participating in this conference.³ Academics tend to study the Delaware judiciary a lot because the Delaware judges get out a lot, as evidenced by Justice Jacobs' participation. These Delaware judges are particularly interesting because of their appointive, nonpolitical, nonpartisan character. They are also interesting because unlike us academics, they tend to

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1. Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749 (2006).

2. Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 900-01 (1990).

3. Jack B. Jacobs, *The Fiduciary Duty of Disclosure After Dabit*, 2 J. BUS. & TECH. L. 391 (2007).

HOW WE MAKE LAW IN DELAWARE

thoughtfully focus on specific cases, as opposed to broad topics.⁴ These judges are reared in the common law tradition where they generally try not to say much more than what a case requires them to say.

This has led the Delaware courts into the “indeterminacy rap,” which is the idea that the world would be a better place if judges could spend a little more time thinking more theoretically and trying to draw brighter lines, instead of looser standards.⁵ Most of those judges, as do I, tend to say that this is not a fair way to describe the world, nor a fair way to describe what they can realistically accomplish, but that is the rap, in any event.⁶

The other major player in the Delaware corporate lawmaking system is the legislature. I do not mean to exaggerate the role of the legislature in formulating corporate law. While a lot of legislators understand corporate law, most of the corporate law drafting is done by the Council of the Corporation Law Section of the Delaware State Bar Association (Council).⁷ As one would expect, the Council is composed mostly of lawyers who meet monthly and talk about corporate law issues.⁸ The lawyers in the Council are the principal players.

Now, a lot of commentators talk about these players’ behavior and motivations.⁹ For example, Professor Cary has described Delaware as participating in a “race to the bottom.”¹⁰ Professor Cary describes Delaware as a “pygmy among the 50 states [that] prescribes, interprets and indeed denigrates national corporate policy as an incentive to encourage incorporation” within the state.¹¹ For the most part, Professor Cary is correct. Delaware certainly does “prescribe” and “interpret” national corporate policy, and has done so for quite a long time. I guess, two out of three is not too bad.

4. See *id.* (discussing the impact of *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006)).

5. See William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 727 (1998) (“Delaware increases litigation costs through the adoption of open legal standards (rather than bright-line property rules.”); Jack B. Jacobs, *The Uneasy Truce Between Law and Equity in Modern Business Enterprise Jurisprudence*, 8 DEL. L. REV. 1, 15 (2005) (suggesting the need for “bright line rule[s] . . . [to] make the application of equity more predictable”); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1919 (1998) (arguing that “legal indeterminacy” in Delaware corporate law creates a suboptimal balance of legal standards).

6. See, e.g., Leo E. Strine, Jr., *The Delaware Way: How We do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 683 (2005) (noting that “indeterminacy” permits Delaware judges to pull back in future cases in the event that prior decisions were unwise).

7. Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1599–1600 (2005); see Alva, *supra* note 2, at 900–01.

8. Alva, *supra* note 2, at 900; Hamermesh, *supra* note 1, at 1756.

9. See, e.g., Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 561–63 (2002) (discussing whether the alleged competition among states for corporate charters is an incentive for states to adopt favorable corporate law); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

10. Cary, *supra* note 9, at 705.

11. *Id.* at 701.

Professor Cary is also correct in describing Delaware's corporation law as an enabling statute.¹² This can either be a nice adjective or a nasty adjective, depending on how you want to think about it. Professor Cary also correctly states that Delaware's motivation when creating corporate law is to generate revenue.¹³ It has been enormously important. The revenue from corporate franchise taxes has averaged well over 20 percent of the state's budget.¹⁴

Professor Cary has also been personally responsible for much of the evolution of Delaware case law. Soon after his paper came out, there were a bunch of fairly restrictive cases dealing with freezeouts,¹⁵ such as *Singer v. Magnavox*.¹⁶ Even later, *In re Caremark International Inc., Derivative Litigation*,¹⁷ the Court of Chancery articulated a notion of director responsibility for oversight that Professor Cary urged in his paper.¹⁸

Even though we in Delaware are said to think of Professor Cary as a big, bad guy, I can agree with a lot of what he said. But, the real question is whether Professor Cary was right in terms of his views about "race to the bottom?" Some people say that Delaware has won the race, and there is no longer a race at all.¹⁹ But, in Delaware we still care about the race, and we look over our shoulder at other states, including Maryland, all the time.

The more important point about Professor Cary's paper is that the race, if there ever was one or still is one, is really not a downhill race. For example, section 203 of the Delaware Takeover Statute²⁰ is probably the most irrelevant and least deterrent of all the state takeover statutes in this country. Historically, if it deters anything, it has been deterrent in more friendly deals than hostile deals.²¹

12. *See id.*

13. *Id.* at 664.

14. *See id.* at 669.

15. *Singer v. Magnavox*, 367 A.2d 1349, 1354 (Del. Ch. 1976), *aff'd in part, rev'd in part*, 380 A.2d 969 (Del. 1977), *overruled by* *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983); *see* *Tanzer v. Int'l Gen. Indus., Inc.*, 379 A.2d 1121, 1124 (Del. 1977), *overruled by* *Weinberger*, 457 A.2d 701; *Young v. Valhi, Inc.*, 382 A.2d 1372, 1378-79 (Del. Ch. 1978); *Kemp v. Angel*, 381 A.2d 241, 244 (Del. Ch. 1977).

16. *Singer*, 367 A.2d at 1354-57.

17. *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996).

18. Cary, *supra* note 9, at 702.

19. *See* *Bebchuk & Hamdani, supra* note 9, at 586 ("Delaware faces a very weak threat of a challenge by another state."); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 590 (2003) ("States . . . are said to use their corporate law to compete for corporate tax revenue . . . Delaware has 'won' that race . . .").

20. DEL. CODE ANN. tit. 8, § 203 (2001).

21. *See* *Roe, supra* note 19, at 625 (describing Delaware's takeover statute as "mild").

HOW WE MAKE LAW IN DELAWARE

On the other end of the spectrum, the “race to the top” folks love Delaware. Among these race to the top folks are Ralph Winter,²² Dan Fischel,²³ and Roberta Romano.²⁴ As they see it, Delaware is the epitome of how the federalist system ought to work and the way markets ought to work.²⁵ We in Delaware like this sort of comment: as Adlai Stevenson once said, “[we] don’t mind a little praise—as long as it’s fulsome.”²⁶ The race to the top folks, however, are certainly capable of giving Delaware a lot of praise in areas where it may not be as deserved as they say.

There are three problems with the race to the top theory. First, the market for corporate chartering posited by them is not as efficient as one might think.²⁷ Second, their theory does not really lead to the market-driven results that they posit.²⁸ Third, from my standpoint, nobody told us in Delaware that we have been leading a race to the top. Moreover, nobody ever told us how exactly we were supposed to carry out this race to the top. How do we do it? Are we that smart? And the answer is “No, we are not.”

Along comes a recent paper by Mark Roe called “Delaware’s Competition.”²⁹ In my view, this paper advanced the ball enormously. As Roe says, it is really the fear of federal incursion that keeps us in Delaware from racing to the bottom.³⁰ Because of the federal folks down in Washington, we can never know how a purely interstate race for corporate chartering would come out.³¹ The federal government keeps us honest, or at least keeps us in Delaware from going too far in one direction or the other.³²

Even though I think that Roe’s theory is much better than the pure “race to the top” or pure “race to the bottom” theories, I still have some problems with it. One problem is that Roe fails to explain the daily happenings in Delaware corporate

22. See Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254–62 (1977) (explaining that competition has been critical in allowing corporations to compete freely).

23. See Daniel R. Fischel, *The “Race to the Bottom” Revisited: Reflections on Recent Developments in Delaware’s Corporation Law*, 76 NW. U. L. REV. 913 (1982) (stating that no empirical evidence supports the view that Delaware’s corporate law has failed to provide adequate protection to shareholders).

24. See Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 709 (1987) (arguing that shareholders benefit from state competition, but competition occasionally produces laws that shareholders would have created within their firms anyway).

25. See *id.* at 720–25; Winter, *supra* note 22, at 292; see also E. Norman Veasey with Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1412 (2005) (comparing advantages of Delaware corporate law with other states’ corporate law and claiming that the “genius” of Delaware’s corporate law is its flexibility).

26. The Quotations Page, <http://www.quotationspage.com/quote/22321.html> (last visited Sept. 17, 2007).

27. See Bebchuk & Hamdani, *supra* note 9, at 608–10 (arguing that Delaware state law rules are not as efficient as “race-to-the-top” advocates suggest).

28. *Id.* at 609.

29. Roe, *supra* note 19.

30. See *id.* at 601–02.

31. *Id.* at 600.

32. See *id.* at 601 (noting “the federal government replaces those state rules that it finds despicable, and it modifies those that it dislikes strongly”).

lawmaking. In Roe's view of the world, there is a lot of room for movement within the broad orbital sphere that federal authority allows Delaware.³³ For example, Roe believes that Delaware simply tries to head off federal incursion when making corporate law.³⁴ Roe's theory, however, does not explain why Delaware has not been more proactive in heading-off threats of federal involvement. For example, Delaware's statutory response to Sarbanes-Oxley was very, very small.³⁵ There was not even a huge movement in the case law. The whole ongoing controversy about proxy access and majority voting has not even elicited any enormous changes in the Delaware statute.

I like Kahan and Rock's symbiotic federalism theory.³⁶ Their key notion is that the federal government can step in and help in areas beyond Delaware's competence.³⁷ In other words, the federal government's involvement in corporate lawmaking allows us in Delaware to continue to do what we do well and to cede the other areas of law to the federal government. The areas that the federal government handles much better than we do at the state level include market-oriented disclosure regulation, audit and accounting regulation, and insider trading enforcement.³⁸ There is no way that the State of Delaware could ever systematically monitor and enforce an insider trading regime.³⁹ Delaware, on the other hand, has a system primarily based on private enforcement, meaning that it is much better able to deal with insider conflict transactions, and merger and acquisition transactions.⁴⁰

Now, I can get to the point of this paper: what principles govern what we in Delaware actually do when it comes to corporate lawmaking?

First, the key principle is the idea to "do no harm."⁴¹ This idea explains why the responses to Sarbanes-Oxley were so mild.⁴² Also, this idea explains things like the peculiar phenomenon of why Delaware has not just resolved the whole controversy about what bylaws can do.⁴³ To be frank, this unwillingness is a question of not wanting to screw up, and not knowing the best solution. The "do no harm" idea

33. See *id.* at 601 (arguing that in corporate rule making, Delaware "gets to make, or keep, only the rules that the federal authorities do not make themselves").

34. *Id.* at 601-02.

35. Kahan & Rock, *supra* note 7, at 1617-19.

36. *Id.*

37. *Id.* at 1578.

38. *Id.* at 1620.

39. *Id.*

40. See *id.* at 1605-09 (noting that "Delaware has taken great care in developing a first-rate system for private enforcement" and describing the scope of Delaware law within this system).

41. E. Norman Veasey & Michael P. Dooley, *The Role of Corporate Litigation in the Twenty-First Century*, 25 DEL. J. CORP. L. 131, 136 (2000); see also Kahan & Rock, *supra* note 7, at 1601-02 (noting that most of Delaware's corporate law amendments address minor or technical issues).

42. Kahan & Rock, *supra* note 7, at 1617.

43. See, e.g., Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 428-29 (1998); Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987, 1025 (1994) ("[T]here is so little Delaware law on stockholder adopted bylaws that one cannot draw anything more than the most tentative conclusions . . .").

HOW WE MAKE LAW IN DELAWARE

also explains the relatively muted response to the whole controversy over majority voting.⁴⁴

In Delaware, we also are cautious because the statute⁴⁵ is full of live ammunition. The statute applies to many people all over the world, and we have a concern that if you tinker with it, you are going to upset somebody's expectations.⁴⁶ Specifically, this concern is manifested in our refusal to mess around with a statute in a way that affects a matter currently in litigation. In fact, this is an explicit rule when we draft statutes.⁴⁷ We do not legislate on matters currently in litigation because we view the courts as the first line of defense, the first responders in dealing with complex situations. When drafting legislation, we abstain from addressing complicated matters that are hard to figure out, allowing them to develop through the common law. We resist the use of "bright-line" rules. Instead, we prefer flexibility.⁴⁸ Ultimately, we are dependent on the courts to curb the opportunistic misuse of the flexibility that the enabling statute provides.⁴⁹

Where is this going to take us? Well, it is very simple. Do not expect detailed regulatory prescriptions from future Delaware lawmaking. Do not expect to see anything involving criminal or regulatory enforcement. Do not look for active attempts by the state legislature to head-off further federal activity. Federal activity is going to come or it is not going to come, according to political factors that we in Delaware are not going to have much to say about. Nevertheless, you should expect us in Delaware to make every effort to maintain the stability and continuity of the existing balance of authority among managers and shareholders.

44. See generally INST. S'HOLDER SERVS. INSTITUTE FOR CORP. GOVERNANCE, MAJORITY VOTING IN DIR. ELECTIONS: FROM THE SYMBOLIC TO THE DEMOCRATIC 2 (2005), available at <http://www.issproxy.com/pdf/MVwhitepaper.pdf> (discussing majority voting in director elections).

45. DEL. CODE ANN. tit. 8, § 216(3) (2001).

46. See David C. McBride, *Delaware Considers Majority Voting for Directors: Proposed Amendments to the Delaware General Corporation Law*, in WHAT ALL BUSINESS LAWYERS & LITIGATORS MUST KNOW ABOUT DELAWARE LAW DEVELOPMENTS 2006, 289, 308 (2006) (noting that caution should be taken "before 'majority voting' [is] imposed upon all Delaware corporations as a default rule . . .").

47. See Kahan & Rock, *supra* note 7, at 1610–11 (describing Delaware law as expressing a preference towards common law development and incremental legislation).

48. Hamermesh, *supra* note 1, at 1783–86.

49. *Id.* at 1749.