The Fall and Rise of Federal Corporation Law

FOREWORD

It is quite remarkable that corporation law remains the province of the states. The proper role of federal law in corporate governance has been debated since at least the 1930s. Although one could begin the story earlier, the first major incursion of federal law into the area came with Congress' passage of the Securities Act of 1933\(^1\) and the Securities Exchange Act of 1934.\(^2\)

Securities regulation is one thing. But corporation law is quite another. In 1940, the American Bar Association (ABA) Section of Business Law undertook to develop the Model Business Corporation Act\(^3\) (MBCA) because the ABA wanted to be in a position to offer an appropriate statute to Congress when a call for federal corporation law arose. The call never came, but the MBCA was nonetheless born and was eventually followed by approximately thirty-five states.\(^4\)

In the mid-1960s, federal securities law began to offer protection for stockholders that had not been available under state law—at least not under Delaware law, which governs most publicly traded companies.\(^5\) In 1964, the Supreme Court recognized a private right of action under federal proxy rules.\(^6\) In 1968, the Second Circuit held that Rule 10b-5 governed press releases by publicly held companies and insider trading by their employees.\(^7\) And in the same year, Congress passed the Williams Act, establishing federal rules for the conduct of tender offers.\(^8\) No doubt these developments encouraged Professor William Cary of the Columbia University School of Law to write his landmark 1974 Yale Law Journal article, stating that

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4. See, e.g., George C. Seward & William W. Nauss, Basic Corporate Practice § 2.01, at 32 n.10 (2d ed. 1977).
THE FALL AND RISE OF FEDERAL CORPORATION LAW

Delaware was leading a race to the bottom in standards of corporate conduct, and calling for federal standards of corporate responsibility.9

The race to the bottom theory would later be questioned and arguably disproved by legal scholars.10 But in the mid-1970s, it appeared that federal securities law might well supplant a large part of state corporation law. For a plaintiff, federal court was the place to be. Then, in 1977 the Supreme Court decided Santa Fe Industries, Inc. v. Green.11 Although Santa Fe was not the first Supreme Court decision to confine the reach of Rule 10b-5,12 it was the first to emphasize and preserve the traditional role of state corporation law.13 In essence, Santa Fe held that federal securities law applied only if there was a failure of disclosure.14 The Court explained that Rule 10b-5 did not require the parent corporation in a cash-out merger to disclose to minority stockholders that there was no business purpose for the merger because there was no state law requirement that there be a business purpose for the merger.15

At first that might seem like a victory for state law. But the decision also increased the threat level for a federal takeover. After all, Congress might be inclined to enact new legislation to govern the internal affairs of corporations if existing federal securities law had reached the limits of its applicability, as Santa Fe seemed to indicate.

It was six months later (to the day) when the Supreme Court of Delaware handed down its decision in Singer v. Magnavox Co.,16 holding that indeed there was a business purpose requirement for mergers.17 The irony is that with Singer on the books, Santa Fe would have been decided the other way. But the die was cast for the course of federal law. Following Santa Fe, the federal courts looked to state law to determine the contours of fiduciary duty not only for mergers, but also for insider trading, takeover defenses, and virtually every other issue that came before them under federal securities law.

9. See William L. Cary, Federalism and Corporate Law: Reflections upon Delaware, 83 Yale L.J. 663, 705 (1974) (describing the phenomena as a "race for the bottom, with Delaware in the lead"). It is no coincidence that Cary also served as SEC Chairman from 1961 to 1964, or that the most expansive ruling by the Supreme Court in connection with Rule 10b-5 was authored in 1970 by William O. Douglas, who served as SEC Chairman from 1937 to 1939.


14. Id. at 470.
15. Id. at 478–79.
17. Id. at 975–76.

162 JOURNAL OF BUSINESS & TECHNOLOGY LAW
Richard A. Booth

Singer was a mixed blessing for Delaware. Although it may have avoided a federal takeover of state corporation law, Singer also meant that in Delaware a plaintiff could challenge a merger by incanting the mantra of no business purpose. Every merger was thus reviewable by the courts. Moreover, if a merger was found wanting, the remedy was quite generous. Rescissory damages gave the plaintiffs the value of what they would have had if the merger never occurred, encouraging even more litigation. Singer did not last long. It was overruled in 1983 by Weinberger v. UOP, Inc., which did away with the business purpose requirement. But Weinberger also installed more effective protections for stockholders, requiring arms length negotiations in parent-subsidiary mergers. Since that time, Delaware has been quite vigilant about stockholder rights.

There was not much talk about the federalization of corporation law during the 1980s and 1990s. During that period, Congress passed two acts addressing insider trading, and two acts addressing private securities litigation, the second of which sought to eliminate state court jurisdiction over failure to disclose actions. But these statutes were more about problems with federal law than they were about jurisdictional competition. There was little if any objection when Congress administered the coup de grace with the National Securities Markets Improvement Act of 1996 (NSMIA), preempting most state corporation law. Few legal scholars seem to view the essential demise of state securities laws—blue sky laws—with much regret. That may be because they recall their first years in big firm practice doing blue sky work.

Then came the demise of Enron, WorldCom, and the other corporations. Although these scandals that began in late 2001 were mostly about accounting prac-


19. 457 A.2d 701.

20. Id. at 704.

21. Id. at 715 (citing Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 109–10 (Del. 1952)).


tices, they also implicated corporate governance and executive compensation. So it is not surprising that the legislation that followed—the Sarbanes-Oxley Act of 2002 (SOX)—includes several provisions that intrude into areas that have traditionally been left to state law. And that is not to mention a raft of new SEC regulations based in some cases on a questionably broad reading of statutory authority. Moreover, and perhaps more importantly, the Department of Justice has chosen to prosecute pretty much whenever it can, thus turning many offenses that once might have been seen as mere breaches of fiduciary duty into federal crimes.

The question is whether this is the beginning of a new movement to federalize corporation law or merely a border skirmish. On the one hand, SOX establishes rules about director independence, committee composition, executive compensation, and conflict of interest transactions that have never been part of federal law. To the extent that SOX addresses these matters, they would seem now to be off limits for the states to say or do otherwise. On the other hand, the changes wrought by SOX are relatively specific. The papers produced by this conference address this question from a variety of angles.

Finally, for those who are fans of British television comedies, the title of this conference was inspired by my all time favorite—The Fall and Rise of Reginald Perrin. Aside from the obvious parallel—that federalization seemed to have been staved off only to raise its ugly head again in 2002—Reggie was all about corporate governance. Reginald Iolanthe Perrin (RIP) faked his own death to escape his life as a middle manager of Sunshine Desserts (PLC) only to return as an entrepreneur purveyor of useless goods and then to found a cult of disaffected businesspeople. Think of Atlas Shrugged with a laugh track. It could happen here. Who needs the grief that goes with being a public company when there is all that private equity about?

27. Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC, 467 F.3d 73, 77 (2d Cir. 2006).
28. Incidentally, there is a certain ambiguity inherent in the idea of federalization. While the first meaning that comes to mind is that the federal government has assumed control, federalism also refers to the division of authority between state and federal government.