

COMMENT

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DELAWARE COURTS' DELICATE RESPONSE TO THE CORPORATE GOVERNANCE SCANDALS OF 2001 AND 2002: HEIGHTENING JUDICIAL SCRUTINY ON DIRECTORS OF CORPORATIONS

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INTRODUCTION

Corporate law is a product of both federal and state law. Prior to 2001, the dichotomy between federal and state law in the area of corporate law seemed well established. The federal government played a limited role, primarily enacting disclosure-type laws—laws aimed at requiring corporations to make certain information about themselves available to the public.¹ For example, the federal government, through Congress and federal administrative agencies, implemented the Securities Act of 1933² (mandating what information must be made available prior to public offerings) and the Securities Exchange Act of 1934³ (governing securities trading). The bulk of corporate law, however, came from the states. State law historically governed the internal affairs of corporations,⁴ meaning it governed the legal relationships among the corporation, the corporate managers, and the shareholders.⁵

This structure, though, is not required. The division of corporate law authority, as described, is not a “crisp constitutional rule.”⁶ In fact, the United States Constitution empowers the federal government to make *all* corporate laws. Under the Commerce Clause, Congress has the enumerated power to “regulate commerce . . . among the several [s]tates,”⁷ and under the Supremacy Clause, any federal law trumps state law when the two conflict.⁸ Thus, the combination of those two clauses establishes that the federal government holds the ultimate authority on corporate law. If the federal government ever wants to dictate corporate law, it can. The states, particularly Delaware, are well aware of this fact.

1. See Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1438 (1992).

2. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2000) (governing disclosures regarding public offerings and requiring other disclosures about securities).

3. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78mm (2000) (requiring corporations to file certain reports—e.g., 10K annual report with financial statements; 10-Q quarterly report with earnings and other financial information; and 8K report for specified events, like mergers and requiring corporations to disclose certain conflicts of interest).

4. See Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 596-97 (2003) (discussing the internal affairs doctrine, which establishes that the law of the state where a corporation is incorporated will generally govern the internal affairs of the firm).

5. FRANKLIN A. GEVURTZ, CORPORATION LAW 36 (2000).

6. Roe, *supra* note 4, at 597.

7. U.S. CONST. art. I, § 8, cl. 3.

8. U.S. CONST. art. IV, § 3, cl. 2 (“The Congress shall have [p]ower to dispose of and make all needful [r]ules and [r]egulations respecting the [t]erritory or other [p]roperty belonging to the United States. . . .”).

Delaware is so cognizant of the federal government's dormant authority because it stands to lose the most if the federal government ever asserts its control over corporate law. Under what is called the "internal affairs doctrine," courts hold that only one state's law should govern the internal affairs of a corporation.⁹ The reasoning behind the one state rule is that corporations could face conflicting legal demands if multiple jurisdictions' laws applied to their entity.¹⁰ As for which state's law governs, courts hold that the law of the state of incorporation governs.¹¹ Consequently, corporations are inclined to incorporate in the state where the local corporate law is most favorable to their organization.¹² For the past century, Delaware has been the preferred state of incorporation due to its "corporate-friendly" laws.¹³ Prior to 2001, Delaware's position in corporate law seemed secure. The federal government seldom intervened in corporate law, and it had become "proper, traditional, and in need of deep respect" for states, like Delaware, to govern the internal affairs of corporations.¹⁴

The political and economic climate changed drastically in 2001 and 2002. The storied collapses of Enron, WorldCom, and other major public corporations exposed the pervasiveness of corruption in corporate America. The need for new corporate governance rules became glaringly apparent, and the federal government and/or state governments needed to respond. This Comment focuses on the Delaware courts' response in 2003 to the aforementioned corporate scandals. Part I describes the corporate scandals that triggered the public outcry for corporate law reform in 2001 and 2002. Part II examines the federal government's response to the corporate scandals, specifically the enactment of the Sarbanes-Oxley Act of 2002. Part III analyzes Delaware's response to those scandals by looking at three 2003 cases: *In re Walt Disney Co.*,¹⁵ *In re Oracle Corp.*,¹⁶ and *In re*

9. See *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982); see also RESTATEMENT (SECOND) OF CONFLICTS OF LAWS § 302 (1971).

10. *Id.*

11. GEVURTZ, *supra* note 5, at 36.

12. Compare William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974) (addressing concerns that states actually loosen regulations for corporations to attract their business/incorporation—the "Race to the Bottom" theory), with Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) (arguing that competition among states to attract business through their corporate laws actually benefits shareholders—the "Race to the Top" theory).

13. Marc Gunther, *Boards Beware!*, FORTUNE, Nov. 10, 2003, at 171, 176.

14. Roe, *supra* note 4, at 596.

15. 825 A.2d 275 (Del. Ch. 2003).

Abbott Laboratories.¹⁷ The courts in these cases, respectively, refused to defer to the business judgment of directors in a duty of care case, refused to follow the recommendation of a special litigation committee (SLC) to dismiss a shareholder derivative suit because it questioned the SLC's independence, and refused to defer to the business judgment of directors in a duty to supervise case. Part III also examines how these decisions are atypical, and how they evidence a heightening of judicial scrutiny on directors of corporations in the Delaware courts. Part IV looks into the motivations behind Delaware's judicial response. Part V concludes that Delaware courts will likely attempt to balance the competing interests of federal lawmakers and corporate America in the near future. The federal government may encroach further into corporate law if Delaware does not strengthen its corporate laws enough. Conversely, corporations may not be so inclined to incorporate in Delaware if the state strengthens its corporate laws too much. Thus, a delicate balancing act lies ahead for Delaware courts.

16. 824 A.2d 917 (Del. Ch. 2003).

17. 325 F.3d 795 (7th Cir. 2003) (interpreting Delaware law).