Leaving Delaware? The Essential Role of Specialized Corporate Courts

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Abstract

Following the Delaware Court of Chancery's invalidation of Elon Musk's $56 billion compensation package, Tesla moved its incorporation from Delaware—the long-preferred state for incorporation—to Texas. The ensuing legal battles did not end with calls to dethrone Delaware's Chancery through interstate competition. Musk, wielding his tentacular influence on the Executive, has also threatened to lobby for federal intervention over what he perceives as a runaway Chancery. Shortly thereafter, the Delaware legislature, to protect Delaware's incorporation position, passed the most sweeping corporate law changes in over fifty years. Both those siding with Musk and those siding with Delaware's judiciary have accused the other of prioritizing politics over substance. Yet neither side has addressed the heart of the matter: What is the proper role of a specialized judiciary entrusted with resolving corporate disputes? This Article presents a novel theory for the unique necessity of specialized corporate courts. Corporate disputes are distinct because they arise within ongoing relationships between shareholders and management, governed by an incomplete contract. To mitigate managerial disloyalty or incompetence, shareholders can replace managers or sue them for breaches of fiduciary duties. In this dynamic, the court becomes a third party to the incomplete contract, deciding which claims merit judicial intervention and which should be resolved by shareholders. Judicial review in corporate law thus culminates in claim dismissal specialization, exemplified by the business judgment rule. This Article reveals a new rationale for the business judgment rule as a tool for specialized courts to limit judicial intervention to cases of conflict of interest, while referring mismanagement cases to shareholders. Properly understanding the role of specialized corporate courts has far-reaching legal implications. It demonstrates that Delaware's Chancery Court has largely fulfilled its intended role while also highlighting its limits with respect to both shareholders and legislatures. With its home reincorporation, Texas can offer Tesla insulation from hostile takeovers and hedge-fund activism, prioritizing long term business strategies and the welfare of employees and the broader community. Finally, the Article provides the policy blueprint for the over twenty other states that have entered the specialized corporate courts arena.

Keywords: Delaware, Business judgement Rule, Self-dealing, sb21, specialized court, DExit, Corporate law, Entire fairness

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The Essential Role of Specialized Corporate Courts

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Following the Delaware Court of Chancery's invalidation of Elon Musk's $56 billion compensation package, Tesla moved its incorporation from Delaware—the long-preferred state for incorporation—to Texas. The ensuing legal battles did not end with calls to dethrone Delaware's Chancery through interstate competition. Musk, wielding his tentacular influence on the Executive, has also threatened to lobby for federal intervention over what he perceives as a runaway Chancery. Shortly thereafter, the Delaware legislature, to protect Delaware's incorporation position, passed the most sweeping corporate law changes in over fifty years.

Both those siding with Musk and those siding with Delaware's judiciary have accused the other of prioritizing politics over substance. Yet neither side has addressed the heart of the matter: What is the proper role of a specialized judiciary entrusted with resolving corporate disputes?

This Article presents a novel theory for the unique necessity of specialized corporate courts. Corporate disputes are distinct because they arise within ongoing relationships between shareholders and management, governed by an incomplete contract. To mitigate managerial disloyalty or incompetence, shareholders can replace managers or sue them for breaches of fiduciary duties. In this dynamic, the court becomes a third party to the incomplete contract, deciding which claims merit judicial intervention and which should be resolved by shareholders.

Judicial review in corporate law thus culminates in claim dismissal specialization, exemplified by the business judgment rule. This Article reveals a new rationale for the business judgment rule as a tool for specialized courts to limit judicial intervention to cases of conflict of interest, while referring mismanagement cases to shareholders.

Properly understanding the role of specialized corporate courts has far-reaching legal implications. It demonstrates that Delaware's Chancery Court has largely fulfilled its intended role while also highlighting its limits with respect to both shareholders and legislatures in correcting errors. With its home reincorporation,

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INTRODUCTION

To infinity . . . and Texas? Following an adverse decision in the Delaware Court of Chancery, Elon Musk announced his hope that Tesla would be leaving Delaware and reincorporating in the state of Texas.[1] In a tweet announcing a similar move for Space X, Musk warned others that if "your company is still incorporated in Delaware, I highly recommend moving to another state as soon as possible."[2] And, indeed, in its June 13th shareholder meeting, Tesla shareholders approved the move of the company to Texas.[3] The Delaware litigation sparking Tesla's move south centered around a compensation package that promised its prominent CEO 1% of the shares for every $50 billion increase in Tesla's value.[4] Musk accomplished all the milestones set for him and became entitled to shares valued at $56 billion.[5] An objecting shareholder brought suit in Delaware court, which subsequently blocked Tesla from paying Musk the promised shares.[6] Nevertheless, in the same June 13th shareholder meeting, Tesla shareholders also ratified the compensation package the Delaware court invalidated.[7] Musk's vindication, however, was only temporary: a later Delaware ruling doubled-down on its position and rendered the ratification invalid.[8] And even prior to this latest decision, Musk's compensation saga has already pushed him from state competition to federalism: "When there are egregiously wrong legal judgments in a single state that substantially harm American citizens in all other 49 states, the Federal government should take immediate corrective action."[9]

While Musk's ire over his withheld bonus payment may be understandable, the benefits of reincorporating in Texas are not as obvious. Nor is it clear whether Delaware's Chancery Court has truly taken a wrong turn away from its position as a trustworthy corporate law court. Then again,

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1. *See* Tornetta v. Musk, 310 A.3d 430, 446 (Del. Ch. 2024) (invalidating Elon Musk's $56 billion compensation package); Elon Musk (@elonmusk), X (Feb. 1, 2024, 12:09 AM), https://x.com/elonmusk/status/1752922071229722990 (announcing immediate move to vote on Texas reincorporation).
2. Elon Musk (@elonmusk), X (Feb. 14, 2024, 7:27 AM), https://x.com/elonmusk/status/1757924482885583112.
3. Tesla, Inc., Form 8-K (June 13, 2024), https://www.sec.gov/ix?doc=/Archives/edgar/data/0001318605/000110465924071439/tm2413800d31_8k.htm ("Votes cast in favor of approving Proposal 3 [Texas reincorporation] constituted approximately 63%.").
4. *Tornetta*, 310 A.3d at 445.
5. *Id.*
6. *Id.*
7. Tesla, Inc., Form 8-K (June 13, 2024), https://www.sec.gov/ix?doc=/Archives/edgar/data/0001318605/000110465924071439/tm2413800d31_8k.htm ("Votes cast in favor of approving Proposal 4 [Elon Musk's compensation] constituted approximately 76%.").
8. Tornetta v. Musk, 2018-0408-KSJM, 2024 WL 4930635, at *1 (Del. Ch. Dec. 2, 2024).
9. Elon Musk (@elonmusk), X (Nov. 7, 2024, 11:50 AM), https://x.com/elonmusk/status/1854567200113533325.

Tesla was not alone in its desire to reincorporate out of Delaware. For instance, TripAdvisor attempted to reincorporate in Nevada but was stopped by a striking decision by Delaware's Chancery, which was later reversed by Delaware's Supreme Court.[10] Despite being one of the smallest states in the union, Delaware has long been the preferred state for incorporation, even though most companies do not maintain a headquarter or significant facilities there.[11] Scholars have offered many reasons why Delaware has maintained a position atop the incorporation hierarchy, but all have centered around either the existence of judicial expertise or the uniqueness of Delaware corporate law.[12]

These analyses are undoubtedly important, but they have also left a gaping hole in our understanding of corporate courts and corporate law: What is so special about corporate law that we couch it in judicial expertise and specialized courts? While other legal areas like tax,[13] patents,[14] and bankruptcy[15] have specialized courts, other complex fields like medical malpractice do not. This discrepancy indicates that complexity alone is insufficient to warrant specialization. Each specialized area has unique reasons justifying its need for specialized courts.[16] Therefore, understanding the specific rationale for corporate law's specialization, beyond just its complexity, is critical. This Article answers these questions by offering a novel theory of the connection between corporate law and specialized courts.

Unlike most state courts in the United States, the Delaware Chancery Court has jurisdiction solely over equity cases, which has evolved into a specialty for corporate disputes.[17] For decades, it has been the gold-standard

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[10] Maffei v. Palkon, 125, 2024, 2025 WL 384054, at *1 (Del. Feb. 4, 2025) (reversing the Chancery Court and holding that the business judgment rule applies to corporate reincorporations).

[11] *See, e.g.*, ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 6 (1993) (providing a seminal exploration of Delaware's dominance).

[12] *See, e.g.*, *id.* at 148-51 (explaining Delaware's dominance as due to judicial specialization and laws developed to protect shareholders); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 705 (1974) (explaining Delaware's dominance as due to laws developed to enable managerial abuse of shareholders); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1923-27 (1998) (arguing that Delaware's advantage comes from the concentration of firms, judicial specialization, and Delaware's strong commitment to corporate value).

[13] *See, e.g.,* Leandra Lederman, *(Un)Appealing Deference to the Tax Court*, 63 DUKE L.J. 1835 (2013) (describing the Tax Court role).

[14] *See, e.g.,* Rochelle C. Dreyfuss*, The Federal Circuit: A Case Study in Specialized Courts,* 64 N.Y.U. L. REV. 1 (1989) (exploring the rationale for patent courts specialization).

[15] *See, e.g.,* Jonathan M. Seymour, *Against Bankruptcy Exceptionalism*, 89 U. CHI. L. REV. 1925 (2022) (exploring the rationale for bankruptcy courts specialization).

[16] For instance, family courts and probate courts handle sensitive matters like custody, divorce, and estate disputes, illustrating a social rationale.

[17] *See* William T. Quillen & Michael Hanrahan, *A Short History of the Delaware Court of Chancery—1792-1992*, 18 DEL. J. CORP. L. 819, 831 (1993) (explaining this historical

for resolution of complex business and corporate governance disputes.[18] As of 2020, twenty five states have come to appreciate the benefits that specialized business courts can bring and created their own specialized courts.[19]

Texas joined this trend in 2023, endorsing the creation of the Texas Business Court.[20] Similarly to Delaware's Court of Chancery, this court exclusively hears business and corporate governance disputes.[21] Strikingly, Tesla and Space X decided to reincorporate in Texas shortly thereafter, despite the fact that the court was only to begin its operations in September 2024.[22] Even to this day, the court remains in its infancy.[23] This raises the question, what benefits does reincorporating in Texas bring?

As the Texas court is still developing, its doctrinal form is uncertain. While practical and political considerations may help mold the court over time, relying on a newly created court to settle high-stakes business suits comes with a certain amount of unpredictability and risk.[24] The lack of established precedents also means corporate managers face uncertainty about potential liability for their desired plan of action.

In other words, the Texas Business Court represents a blank canvas–an opportunity to offer its own vision for handling corporate law and governance suits. But can this vision be structured to be as successful as Delaware's established system? Can Nevada, who has similarly proposed to establish a business court in February 2025,[25] do the same? To answer these questions, we need to examine why specialized business courts are necessary to resolve corporate governance disputes.

Assessments of corporate courts exist within corporate law's broader political economy. In this economy, states compete with one another in

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development).

[18] *See* About the Division of Corporations, DEL. DIV. OF CORPS., https://corp.delaware.gov/aboutagency/ ("More than 66% of the Fortune 500 have chosen Delaware as their legal home . . . the Delaware Court of Chancery is a unique 225 year old business court that has written most of the modern U.S. corporation case law.").

[19] Lee Applebaum, Mitchell Bach, Eric Milby & Richard L. Renck, *Through the Decades: The Development of Business Courts in the United States of America*, 75 BUS. LAW. 2053, 2057 (2020)

[20] Sidley Austin LLP, *Welcome to Texas: Texas Governor Signs Law Creating Specialized Business Courts*, SIDLEY (Mar. 6, 2024, 5:29 PM), https://www.sidley.com/en/insights/newsupdates/2023/06/welcome-to-texas_texas-governor-signs-law-creaing-specialized-business-courts.

[21] *Id.*

[22] *Id.*

[23] *Id.*

[24] *Id.* ("there are likely to be some growing pains and a number of unexpected effects").

[25] *See* Kyle Chouinard, *Establishing A Nevada Business Court Could Attract Billions in Revenue, Lawmaker Says*, LAS VEGAS SUN (FEB. 9, 2025 2:00 AM), HTTPS://LASVEGASSUN.COM/NEWS/2025/FEB/09/ESTABLISHING-A-NEVADA-BUSINESS-COURT-COULD-ATTRACT/ (noting the proposal).

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order to attract incorporations to their state—a significant source of franchise taxes and other benefits.[26] And as Musk is clearly acutely aware of, this competition is not just interstate: states like Delaware must also weigh the threat that the federal government will intervene and take over the laws they develop, as it has in the past, particularly in the context of laws regarding shareholder votes.[27]

Within this regulatory context, traditional justifications for creating specialized courts can be described as either "public-facing" or "business-facing." Public-facing arguments claim that specialized courts will attract businesses, creating economic benefits such as jobs, revenue, and enhanced incorporation tax income for public services.[28] Business-facing justifications highlight the advantages specialized courts bring to incorporated businesses:[29] judges overseeing only business disputes develop expertise, leading to quicker resolution and more predictable, higher-quality decisions over time.[30]

While valid, these justifications don't fully explain why specialized courts are necessary to resolve complex corporate governance disputes. The main issue is that the cited benefits lack a clear connection to the specific subject matter of these courts. In other words, these justifications could apply to specialization in any legal area.

Consider, for example, lawsuits arising from brain surgery complications. Such cases can be extremely complex, requiring judges to understand advanced medical concepts.[31] One could argue for specialized courts in this area too, citing efficiency and predictability. Yet, there hasn't been a significant push for such courts. The American judicial system is seemingly content to allow courts of general jurisdiction to handle these cases, despite judges' lack of expertise in the subject matter. Therefore,

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[26] *See, e.g.*, Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1443-46 (1992) (describing the states' incentives and competition).

[27] *See generally* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003) (describing the impact of federal law and threat of further federalization on corporate law).

[28] *See, e.g.*, New York Commercial Division Advisory Council, *The Benefits of the Commercial Division to the State of New York*, https://www.nycourts.gov/LegacyPDFS/courts/comdiv/PDFs/TheBenefitsoftheCommercialDivisiontotheStateofNewYork.pdf.

[29] *See, e.g.*, ROMANO, *supra* note 11, at 44 ("The more firms there are in Delaware, the more legal precedents will be produced, further providing a sounder basis for business planning.").

[30] *See, e.g.*, Ad Hoc Committee on Business Courts, *Business courts: Towards A More Efficient Judiciary*, 52 THE BUS. LAW. 947, 951-53 (1997) (explaining benefits of scope in judicial specialization).

[31] Deciding whether a doctor failed to exhibit the same level of care that other reasonable brain surgeons would have exercised requires a certain level of understanding of the underlying science, an area of medicine that requires years of study and which the judge is most likely unfamiliar with.

citing generic benefits of specialization is insufficient to reveal the distinct rationale for corporate disputes specialization. We must identify the unique characteristics of corporate law and governance disputes that set them apart from other legal matters.

Corporate disputes are not isolated conflicts but rather take place in the context of an ongoing relationship between shareholders and management, among shareholders themselves, and between shareholders and other corporate stakeholders.[32] The cardinal relationship, between shareholders and management, can be thought of as an *incomplete contract* between a principal and an agent.[33] The principal (the shareholders) invests in the firm, and the agent (the board) manages the firm to create future value.[34] Beyond the general instruction to "maximize firm value," there are few (if any) enforceable precepts as to how to manage the firm.[35] Instead, the parties agree to a general allocation of *control rights* (which govern the distribution of decision-making power over the firm) and *cash-flow rights* (which govern the distribution of firm-generated value).[36] In this incomplete contract, conflicts may arise as to the allocation and use of these two types of rights.[37]

To begin, the allocation of control rights to agents leads to *agent costs* that include both *competence costs*, such as the costs imposed by a loyal but incompetent manager, and *conflict costs*, capturing the costs imposed by disloyal managers motivated to benefit themselves at the expense of the firm and its shareholders.[38] Both types of costs reduce firm value. To cope with potential manager-agent costs, the principal-shareholders keep two rights: *discretionary control rights* such as shareholder voting allowing them

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[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] For the seminal case, *see* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders.").

[36] *See* Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 785 (2017) (describing the nature of control and cash-flow rights) [hereinafter *Goshen & Squire*].

[37] Corporate control rights conflicts are most visible in contests for control over the entire corporation, such as a hostile takeover. Challenging the right of the target corporation's board to adopt "takeover defenses" without shareholder consent is a dispute over the allocation of control rights between the board and shareholders. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (analyzing the interests of shareholders and managers in the takeover context). Disputes over the allocation of cash-flow rights, on the other hand, arise when a conflict has the potential to influence the division of cash flows or assets. For example, minority shareholders in a public corporation may dispute whether the price offered for the minority shares by the controlling owner in a merger was fair. *See, e.g.*, Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785 (2003) (theorizing the role of law in disputes between controlling and minority shareholders).

[38] Goshen & Squire, *supra* note 36, at 788 and 793 (theorizing agent competence and conflict costs).

to dismiss the manager, and *duty-enforcement rights* such as the right to sue the agent for breach of directors' fiduciary duties.[39]

When shareholders choose to use discretionary control rights, they may be imposing *principal costs* that include both *competence costs* (e.g., mistakenly firing a loyal and competent manager) and *conflict costs* (e.g., shareholders demanding short-term profits at the expense of long-term value).[40] Both types of costs harm firm value. Importantly, the use of discretionary control rights is tantamount to a self-help remedy, as shareholders need not explain why, for instance, they replaced the manager. However, when the principals enlist the help of courts by using duty-enforcement rights, they may be imposing *adjudication costs* that include both *competence costs* (e.g., honest mistakes made by inexperienced judges while determining whether an agent breached fiduciary duties) and *conflict costs* (e.g., plaintiff lawyers filing meritless suits). Both types of costs reduce firm value.

To maximize firm value, the parties need to minimize the *total control costs*: agent costs, principal costs, and adjudication costs. One important consideration to minimize control costs is whether to hold an agent accountable through discretionary control rights (and bear the principal costs) or through duty enforcement rights (and bear the adjudication costs). Obviously, that decision should depend on the relative size of principal costs compared with adjudication costs. Theoretically, the shareholders will decide to sue the manager only when adjudication costs are lower than principal costs.

However, shareholders do not decide whether to sue the managers, it is plaintiff lawyers that make this decision.[41] The plaintiff lawyers' incentives to litigate are not always aligned with the interest of the shareholders.[42] Regardless of the relative size of principal costs and adjudication costs, the plaintiff lawyer interest is to file a suit whenever there is a positive probability for rewards either through a court's ruling or a settlement. This reality transfers to the court the role of deciding which issues to accept for litigation and which issues to send back to the shareholders to solve on their own, through discretionary control rights. The court's role of sorting cases transforms the court into a third party to the incomplete contract that governs the ongoing relationship between shareholders and management.

In this triangular arrangement, the agents, principals, and courts are not only concerned with resolving the dispute in front of them, but they are also concerned with how the choice of dispute resolution mechanism (be it discretionary control right or duty-enforcement right) impacts the efficient

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39 *Id.* at 779 (explaining both mechanisms).

40 *Id.* at 786 and 791 (theorizing principal competence and conflict costs).

41 *See* Ronald J. Gilson & Robert H. Mnookin, *Disputing Through Agents: Cooperation and Conflict Between Lawyers in Litigation*, 94 COLUM. L. REV. 509 (1994) (describing conditions under which lawyers dominate principal-agent conflicts).

42 *Id.*

performance of the firm. Understanding this dynamic is key to understanding the role of specialized corporate courts.

The crucial point is that the total control costs of managing a firm exist before, during, and after any business harm occurs. This is distinct from other types of legal disputes.[43] Consider our brain surgery example from before. The plaintiff and doctor had virtually no relationship before the injury. There is no balancing of rights between them or negotiation over responsibilities and entitlements. Once harm occurs, the plaintiff's sole recourse is judicial intervention. She lacks other mechanisms to address the damage or influence the doctor's behavior. After the suit concludes, their interaction likely ends.

Corporate disputes differ from isolated conflicts, as they involve ongoing relationships between shareholders, management, and the court.[44] While in the brain surgery case judicial recourse is the plaintiff's only option, corporate disputes offer alternative mechanisms to address agent costs. Furthermore, courts know that any decision they impose on the corporation will change the corporate arrangement going forward.

This unique characteristic of corporate disputes necessitates specialized courts with knowledge and expertise in corporate law. Knowledgeable courts are aware of their own competence and conflict costs, understanding that legal remedies aren't always necessary to resolve a corporate dispute. Shareholders and managers can use other mechanisms to handle matters on their own. Accordingly, expert courts limit their intervention to cases where shareholders exercising legal rights would be more efficient than shareholders addressing the problems themselves. The ability to distinguish these scenarios is rare, uniquely required in corporate law, and drives the need for specialized corporate courts. It is this tripartite allocation of competence and conflict costs across courts, shareholders, and managers that makes specialized corporate courts necessary and important.

Viewed in this context, the business judgement rule ("BJR")[45] should be seen as a representation of specialized corporate courts' proper role in the ongoing relationship among management, shareholders, and the courts. The BJR embodies the core reason for specialized courts: limiting judicial intervention to certain types of agent costs. For some types of agent costs, such as those resulting from non-conflicted decisions that did not pan out,

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[43] For discussion on the interplay between corporate law and other types of legal disputes, such as tort litigation, *see* Robert J. Rhee, *The Tort Foundation of Duty of Care and Business Judgement*, 88 NOTRE DAME L. REV. 1139, 1143 (2013) ("Tort theory provides not just the lexicon of liability, but the foundational principles of the duty and liability of corporate boards").

[44] *See infra* Section I.A.

[45] *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006) ("[In] business judgment rule review . . . Our law presumes that 'in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.'") (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del.1984)).

the business judgement rule would prevent judicial intervention.[46] This is not because specialized courts are unable to adjudicate these matters but rather because the court recognizes that it would be more efficient for shareholders to address this type of mismanagement instead. In essence, being a specialized court requires knowing when to apply the business judgement rule and when not to. And beyond the business judgment rule, specialized courts understand that even when their involvement is necessary, their enforcement role is not absolute, and they must retain sensitivity to the impact on principals and agents going forward.

Specialized corporate courts function similarly to constitutional courts.[47] When deciding constitutional matters, a constitutional court recognizes that it is also adjudicating the scope and allocation of its own powers relative to the Executive and the Legislative branches.[48] They understand that not every problem requires judicial intervention, as other recourses exist.[49] Some disputes might better be resolved by turning to the Executive or the Legislature, and indirectly leaving it for the voters.[50] Similarly, specialized corporate courts recognize that, when adjudicating corporate disputes, they are also regulating their own powers relative to the shareholders and managers.

In other words, specialized corporate courts are needed not only because of *how* they resolve corporate disputes but because they know *when* to do so and, most importantly, *when not* to do so. Rather than presuming they must resolve all corporate governance disputes, these courts consider what is the most efficient resolution of each dispute. Sometimes direct court intervention is best; other times creating rules that will allow shareholders to resolve the issue themselves is more appropriate. The utility of a specialized corporate court stems from the fact that it views itself not as an adjudicator overseeing a dispute between two distant parties. Rather, specialized corporate courts recognize that they themselves are ongoing participants in a triangular relationship.

Given the necessary specialization, Tesla's move to Texas is strategic, even though Texas' specialized corporate law courts are still in their infancy.

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[46] *See* discussion and sources in *infra* Section IV.A.

[47] For discussion on the proper role of constitutional courts, see Stephen Gardbaum, *What Makes for More or Less Powerful Constitutional Courts?*, 29 DUKE J. COM. & INT. L. 1 (2018) (exploring various constitutional courts to explain the sources and scope of constitutional court's judicial power).

[48] *See, e.g.*, Nuno Garoupa, *Building Reputation in Constitutional Courts: Political and Judicial Audiences*, 28 ARIZONA J. INT. & COMP. L. 539, 544 (2011) (explaining the interaction between constitutional courts and the political branches when addressing constitutional issues).

[49] *See e.g.*, Lawrence G. Sager, *Fair Measure: The Legal Status of Underenforced Constitutional Norms*, 91 HARV. L. REV. 1212 (1978) (describing doctrinal underenforcement as invitation by the Supreme Court of participation by other branches of government).

[50] *Id.*

While a successful specialized court in Texas, following this Article's blueprint, would offer benefits similar to those in Delaware, the unique advantage lies in Texas being Tesla's home state. Texas can provide insulation from hostile takeovers and hedge-fund activism, prioritizing not only shareholder profits but also the welfare of employees and other residents.[51] This environment enables Tesla to pursue long-term innovative projects that benefit employees and, eventually, shareholders as well.[52]

This Article offers a novel justification for specialized corporate courts by examining their unique role in regulating corporate affairs. Part I analyzes the participation of the courts in the incomplete contract between shareholders and management, identifies the prototypes of corporate value loss, and explains how the parties would like to address them. Part II discusses "mismanagement" losses, explaining why judicial intervention is inefficient in these cases. Part III contrasts "mismanagement" with "managerial takings," where shareholders can't adequately address losses independently, thus warranting judicial intervention. Part IV argues for specialized courts over general courts in refraining from mismanagement cases and addressing takings cases effectively. This Part presents a new rationale for the business judgment rule and related review doctrines, considering specialized corporate courts' proper role in managing the ongoing management-shareholder relationship, and their relationship with legislative bodies. Using this novel framework, Part V resolves the issues underlying the Tesla jurisdictional dispute and draws out the profound policy implications for the future development of state corporate law. A brief Conclusion follows.

I. AGENCY COSTS AND THEIR MOST EFFECTIVE DETERRENT

This Part begins in Section I.A by detailing the nature of the incomplete contract between shareholders (the principals) and management (the agent). Section I.B then proceeds to detail seven possible explanations for an agent's motivations and conduct whenever there is a loss in corporate value, and explores in which of these cases the parties would like to impose sanctions on the agent.

A. Defining the Incomplete Contract

When shareholders hire managers, such as corporate directors and officers, to work on their behalf, they create a separation between ownership and control.[53] While the shareholders own the corporation, it is the directors and officers who control the operations and business decisions of the

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[51] *See infra* Part V.

[52] *Id.*

[53] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (providing a pioneering examination of the separation of ownership and control) [hereinafter Jensen & Meckling].

corporation.[54] Shareholders are willing to relinquish control of their corporations, and directors and officers are willing to assume such control, because separating ownership and control provides benefits that cannot otherwise be achieved.[55] Shareholders, for their part, can invest in businesses that they would not have the time or expertise to manage, and directors and officers, in consideration, are able to be compensated for their skills in managing a business without having to personally incur the costs and risks of owning a business.[56] But the benefits of separating ownership and control also carry a unique set of costs that is a defining feature of the corporate contract: contractual incompleteness.[57]

When shareholders and managers agree that the latter shall act on behalf of the former, they enter into what can best be described as a principal-agent contractual arrangement.[58] Shareholders, acting as the principal, invest in the firm, while management, acting as the agent, are charged with managing the firm in an effort to maximize the firm's value.[59] But beyond the general call for value maximization, there isn't much if any description as to *how* the firm should be managed and what would be considered appropriate performance.[60] This principal-agent contract, however beneficial, is inherently incomplete: neither party's rights and responsibilities can be fully articulated when the relationship between the two is formed.[61] This incompleteness is inevitable because the agent's efforts, ideas, and motivation are non-observable and thus non-contractible.

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[54] For a seminal examination of this phenomena *see* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[55] Stephen G. Marks, The Separation of Ownership and Control, in 3 ENCYCLOPEDIA OF LAW AND ECONOMICS: THE REGULATION OF CONTRACTS 694-95 (Boudewijn Bouckaert & Gerrit de Geest eds., 2000) (explaining the benefits from the separation of ownership and control).

[56] *Id.*

[57] For further background on the "incomplete contract," *see generally* Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Lateral and Vertical Integration*, 94 J. POL. ECON. 691 (1986); Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755 (1988); Jonathan R. Macey, *Corporate Law and Corporate Governance A Contractual Perspective*, 18 J. CORP. L. 185, 190 (1993); Frank H. Easterbrook, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989).

[58] We refer to "principals" and "agents" in the broader economic sense, not the technical legal sense, which requires the right to provide interim instruction to the agent. *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

[59] *See* McRitchie v. Zuckerberg, 315 A.3d 518, 562 (Del. Ch. 2024) ("The proper orientation of the directors' fiduciary duties is toward maximizing the value of the firm."); Philippe Aghion & Richard Holden, *Incomplete Contracts and the Theory of the Firm: What Have We Learned over the Past 25 Years?*, 25 J. ECON. PERSP. 181 (2011) (summarizing the literature on the incompleteness of the corporate contract.).

[60] *Id.*

[61] For a general analysis of transaction costs and incomplete contracts see Robert E. Scott & George G. Triantis*, Incomplete Contracts and the Theory of Contact Design*, 56 CASE W. RES. L. REV. 187, 190 (2005).

Moreover, it is impossible to predict all possible future contingencies that may occur during the life of the firm. For illustration, imagine that an investor decides to enter into the emerging autonomous vehicle market and hires an engineer who specializes in this field to manage product development and commercialization strategies. This principal-agent arrangement is beneficial because the investor, acting as the principal, is able to invest in a business that they do not have the time or expertise to pursue, and the manager, the engineer acting as the agent, is able to be compensated for their unique set of engineering skills and time investment. But such an agreement will also necessarily be incomplete and bring forth contractual uncertainties: If the manager must decide whether to use existing object-detection platforms or to experiment with using a newly found artificial intelligence decision automation technology, who gets to decide? Can we contractually account for all possible technologies that exist now or may exist in the future? If the steel and aluminum raw materials markets experience an unexpected supply-chain issue, how should the business pivot, and what is the decision-making process for doing so? If the manager makes their best decision under the circumstances, and the investor is unhappy with that decision, would that be a breach?

While this incompleteness problem is inevitable, and too costly to fully address by smart contracting, parties to a principal-agent arrangement, such as shareholders and directors, develop general strategies to mitigate its costs. Parties to this arrangement address incompleteness by seeking to adequately restrain and incentivize each other's behavior by balancing *cash-flow* rights and *control rights*.[62] Cash-flow rights entitle the holder to value generated by the firm, whereas control rights grant the holder decision-making authority over the firm.[63] In a nutshell, principals and agents attempt to distribute the costs of contractual incompleteness by distributing rights to firm-generated cash and firm control in a way that balances the incentives of the shareholders and managers.

Since the principals, or shareholders, are investors whose incentive is to reap financial gains from projects they could not have pursued without the hired managers, it follows that the shareholders are generally best served by receiving most of the cash-flow rights. In the same vein, it also follows that agents, or directors and officers, are best served by receiving control rights that allow them to demonstrate the skills and expertise they want to be compensated for. Such general distribution of cash-flow and control rights is certainly a helpful measure for solving the problem of contractual incompleteness, but it also brings forth yet another troubling misalignment

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62 *See* Goshen & Squire, *supra* note 36, at 798-801 (modeling the economic analysis of this balancing act).

63 *See, e.g.*, Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 584-87 (2016) (theorizing the role of control and cash-flow rights) [hereinafter Goshen & Hamdani].

in incentives: while control rights determine the party's *ability* to manage the firm, it is the cash-flow rights that determine the party's *incentive* to properly manage a company. Consequently, while management's control rights (i.e., its freedom to make decisions) provides them with the requisite power to maximize company value, the fact that shareholders hold most of the cash flow rights (i.e., they will reap most of the fruits of the managers' labor) dulls managers' incentive for exercising their control rights in the best possible way.[64] For instance, if our engineer-manager will receive the same salary regardless of whether the business makes a million or ten million dollars in revenue, can we trust him to invest the necessary energy in developing business strategies that would lead to the higher revenue result?

Agent-imposed costs, to which we generally refer to as "agent costs," manifest both in the form of agent *conflict costs* and in the form of agent *competence costs*.[65] Agent conflict costs arise from managers' disloyal or self-seeking conduct, and the costs incurred by shareholders to prevent such conduct in the first place.[66] While managers may have decision-making authority over the firm, a lack of adequate cash-flow rights deprives them of the incentive to maximize the firm's value. Managers face greater incentives to shirk their duties and divert firm value to themselves, at the expense of shareholders.[67] Agent competence costs can be defined as costs resulting from honest mistakes and human error, as well as the costly efforts undertaken to reduce or mitigate such mistakes.[68] While shareholders have incentives to find the most competent individuals to join their management, sometimes they can get it wrong. Incompetent managers can make ill-advised decisions that hurt the firm's revenue.[69] Furthermore, even if managers are incredibly bright and sufficiently competent, they can still make honest mistakes.[70] Even if significant steps are taken to reduce both the misguided decisions of disloyal managers and the honest mistakes of loyal managers, those efforts would still constitute a cost that shareholders must bear.[71] The principal and agent therefore seek to allocate cash-flow and

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[64] *See, e.g.*, Goshen & Squire, *supra* note 36, at 794 (providing examples of agent conflicted incentives).

[65] *See* Zohar Goshen & Sharon Hannes, *The Death of Corporate Law*, 94 N.Y.U. L. REV. 263, 295 (2019) (describing agent costs as including both *competence* and *conflict* costs) [hereinafter *Goshen & Hannes*].

[66] *See* Goshen & Squire, *supra* note 36, at 779 (detailing agent conflict costs).

[67] Jensen & Meckling, *supra* note 53, at 308 (explaining agent conflict of interests).

[68] *See* Goshen & Squire, *supra* note 36, at 788 (theorizing agent competence costs)

[69] *Id.*

[70] *See* Goshen & Hannes, *supra* note 65, at 293 ("Competence costs arise when the party exercising control makes an honest mistake that reduces firm value.").

[71] Prevention efforts are especially costly given the informational asymmetries between agents and principals. *See* Goshen & Hamdani, *supra* note 63, at 565.

control rights in a manner that minimizes agent's conflict and competence costs, in an effort to increase overall corporate value.[72]

Shareholders aim to minimize agent costs by keeping two types of control rights for themselves: *discretionary control* rights and *duty-enforcement* rights.[73] Discretionary control rights are rights that principals may exercise without first having to prove that the agent violated an established restriction.[74] Paradigmatic examples include the rights of corporate shareholders to elect and replace directors and to vote on proposed mergers.[75] One can think of discretionary control rights as ways shareholders can resolve problems themselves, without the need for intervention by third parties, such as courts. Duty-enforcement rights enable a principal to invoke judicial review and sue an agent for breach of a restriction on the agent's exercise of control.[76] Instances of these rights include, for example, the right to sue for breach of directors' fiduciary duties.[77] Importantly, fiduciary duties are also part of the incomplete contract, as they are open ended and not clearly defined, leaving the discretion to the court to decide ex post whether a given agent's behavior breached their duties.[78]

Taken together, discretionary control rights and duty-enforcement rights provide shareholders with two different tools to cope with agent costs.[79] In deciding which mechanisms should apply to which agent costs, the principal and the agent must decide whether the agent costs can best be resolved by shareholders directly (i.e., when discretionary control rights are the optimal solution) or with the aid of a court (i.e., when duty-enforcement rights might be necessary).

Importantly, the principal's exercise of their discretionary control rights is itself subject to *principal costs*.[80] Indeed, agents are not alone in bringing competence and conflict costs into the firm.[81] Recall why management was hired in the first place: the principal-shareholder lacks the time or expertise to manage the business, and the manager-agent is called to fill these gaps. If

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[72] Goshen & Squire, *supra* note 36, at 788, 793 (describing the need to reduce agent competence and conflict costs, respectively).

[73] *Id.* at 799-801 (comparing discretionary control and duty-enforcement rights).

[74] *Id.* at 799.

[75] *Id.* at 800.

[76] *Id.* at 798.

[77] *Id.* at 799. *See also* William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 454–55 (2002) (explaining the difficulty of enforcing the duty of care).

[78] *See* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993) (theorizing fiduciary duties as tool for judicial gap filling).

[79] *See* Goshen & Squire, *supra* note 36, at 799-801 (theorizing the tradeoffs between the two options).

[80] *See* Goshen & Squire, *supra* note 36, at 786, 791 (explaining principal competence and conflict costs, respectively).

[81] *Id.*

principals interfere with the agent's managerial decisions, they may interfere with the agent's proper exercise of her expertise. For instance, imagine that the investor funding the autonomous vehicle business decides to strong-arm the engineer-manager, with the threat of being fired, into pursuing a technological path that may bring the product to market quicker, but that the engineer has correctly deemed impractical from a technical standpoint in the long-run. Imagine further that the investor did so both because they are incentivized to make money sooner rather than later and because they are not as knowledgeable as the engineer. This will harm the firm's value. In other words, principals too bring about principal costs, both competence and conflict, and these costs must be weighed in any attempt to address agent costs.[82]

Similarly, using duty enforcement rights is not free of costs. Enforcing fiduciary duties in courts will create *adjudication costs*, that also include conflict and competence costs. Normally, the case will be filed in court by the plaintiff bar, which might have interests that diverge from the interests of the shareholders, thereby generating conflict costs in the form of strike suits or improper settlements.[83] Once the case is brought to court, the judges will generate competence costs, in the form of potentially mistaken decisions. The higher the quality of the judges the lower the competence costs.

Notably, in this framework the court becomes another "party" to the incomplete contract between the principal and the agent and their on-going relationship. Once the court is called to act, when the enforcement of fiduciary duties is used, it needs to first decide whether the court or the shareholders are the appropriate forum to resolve the issue.[84] Second, when appropriate, the court needs to decide how to fill the gaps in the incomplete contract by enforcing and concretizing fiduciary duties.

Together, the costs imposed by the principal, by the agent, and by the courts, amount to the *total control costs* of the firm.[85] The goal of the parties is to minimize the total control costs in order to increase the value of the firm. For that purpose, it is important to decide when it is more efficient to reduce agent costs using discretionary control rights (and bearing the principal costs that comes with it), or duty enforcement rights (and bearing the adjudication costs that comes with it). In the next Section, we begin exploring this question.

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[82] *Id.*

[83] Goshen & Hannes, *supra* note 65, at 295 ("Because the possibility of plaintiff's counsel's conflict is only introduced when parties engage the court to resolve this type of dispute, the resulting conflict costs are effectively species of adjudicatory conflict costs.").

[84] Indeed, under certain conditions, the court might delegate this task to disinterested directors through the demand requirement. *See, e.g.,* United Food & Commercial Workers Union v. Zuckerberg, 262 A.3d 1034 (Del. Sup. 2021).

[85] *Id.* at 270.

B. Management's Role in Corporate Losses

In this Section, we explore how management can cause a loss in corporate value and whether parties would prefer sanctions (judicial or shareholder-imposed) on managers in each scenario. Consider the following hypothetical: management invests $100 million in a research and development (R&D) project that fails, resulting in a loss in company value. Given that most public companies in the U.S. have ultimate dispersed ownership,[86] assume the company operates under such a structure and that shareholders own diverse portfolios.[87] Also, assume a world without informational asymmetries, where parties always know the exact cause of the loss in value.

There are several possible causes for loss, each falling into three general categories of harm. First, some losses are a natural and ordinary part of doing business. Since managing firms doesn't occur in a controlled environment, firms will inevitably experience harm even without any agent or principal costs. Second, some losses result from *mismanagement*, where the agent failed to exercise the necessary care and expertise or knowingly made a suboptimal decision, harming the firm. Third, some losses are due to *takings*, where the agent harms the firm to benefit personally at the firm's expense. In each of the following scenarios, consider whether it is a normal business loss, a mismanagement case, or a takings case, and whether sanctions should be imposed.

Misfortune. In Scenario 1, the agent was competent and loyal, but the project failed due to bad luck. The $100 million investment had a 90% chance of generating $300 million and a 10% chance of losing all $100 million, with an expected value of $260 million (90%*$300M – 10%*$100M). Unfortunately, the project failed, costing the company $100 million. For example, a competing AI technology with a low chance of success might have surfaced and rendered the R&D project obsolete. This loss cannot be classified as a takings case since the agent did not benefit from it, nor as mismanagement, as the decision properly accounted for the risks

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86 In a dispersed ownership structure, no single investor owns enough shares to control the firm, with ownership being dispersed among numerous shareholders.

87 If not dispersed directly, these companies have concentrated ownership in the hands of institutional investors who are themselves accountable to dispersed beneficial owners. *See* Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 723 (2019) (documenting the robust control of institutional investors). The literature is split as to whether concentrated ownership in the hands of institutional investors changes traditional corporate governance analysis. *Compare* Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89 (2017) (arguing that institutional investors are themselves inflicted by agency costs due to their own dispersed ownership), *with* Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders be Shareholders*, 100 B.U. L. REV. 1753 (2020) (arguing that institutional investors do have an incentive structure that changes the dispersed ownership model). We address the impact of concentrated ownership in *infra* Sections II.D, III.D.

involved. In such situations, sanctions should not be imposed on managers. Holding managers liable for investments that fail due to bad luck would lead to overly cautious behavior, deterring them from making smart business decisions.[88] To maximize company value, managers must feel comfortable pursuing desirable business risks without fearing negative consequences. From the shareholders' perspective, managers taking such calculated risks in all of their portfolio corporations will, on average, generate higher value than those who avoid risk.

Idiosyncratic Vision. In Scenario 2, the agent was competent and loyal, but the project failed because it was based on an idiosyncratic vision that needed more time to bear fruit.[89] For instance, the agent's project might have been a highly innovative and disruptive business idea that initially generated negative cash flow and was interrupted before it could turn a profit. This could be due to an unexpected loss of key employees or a temporary lack of necessary financing. This loss is neither a mismanagement nor a takings case; it is an interim consequence of pursuing highly innovative or long-term projects. In such situations, imposing liability or other consequences would be undesirable. Holding agents accountable for idiosyncratic visions that haven't yet turned profitable would deter them from pursuing innovative and long-term strategies. Agents would fear reprimand if their projects took too long to show promise or were too innovative to persuade others of their future viability, thereby reducing the innovation activities across all corporations in the shareholder's portfolio.

Honest Mistakes. In Scenario 3, the agent was competent and loyal, but his project failed due to an honest business mistake despite significant investment of time and effort.[90] For example, a manager plans a $100 million investment in a new medical device. If approved by regulatory agencies, it would generate substantial revenue; if denied, the investment is lost. To manage this risk, the manager commissions a report indicating a 1% probability of non-approval, implying an expected loss of $1 million. As a precaution, he invests $1 million and allocates top resources to meet health regulators' standards. Unfortunately, the product is not approved, resulting in a $100 million loss. It later emerges that although the manager read the commissioned report twice, he missed that the probability of non-approval is actually 2%. An additional $1 million in regulatory research could have prevented the loss. Should the agent be sanctioned for this honest mistake? The agent neither shirked duties nor diverted value for personal gain; his sole intention was to promote the firm's value. Sanctioning managers for

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[88] *See* Lori McMillan, *The Business Judgement Rule as an Immunity Doctrine*, 4 WM. & MARY BUS. L. REV. 521, 572 (2013) (noting that too stringent review of management decisions could have "a possible chilling effect on decision-making").

[89] *See* Goshen & Hamdani, *supra* note 63, at 578 (providing the paradigmatic example).

[90] *See* Robert Cooter & Ariel Porat, *Lapses of Attention in Medical Malpractice and Road Accidents*, 15 THEOR. INQ. L. 329 (2014) (explaining why lapses should not be subject to liability).

honest mistakes could lead to overinvestment in precautions, which would be detrimental. For instance, the manager might spend $5 million on regulatory diligence: $2 million for reasonable due diligence and an additional $3 million to avoid personal liability. Such excessive precautions would harm not only this firm but also other firms in the shareholder's portfolio.

Incompetence. In Scenario 4, the agent was loyal but incompetent, leading to the project's failure. He incorrectly assessed the investment's probabilities of success, estimating a 90% chance of generating $300 million and a 10% chance of losing $100 million, while the actual probabilities were reversed. Any experienced manager would have recognized this discrepancy. The agent did not benefit from the firm's loss nor shirk his duties; he simply made a poor decision due to incompetence. Should the principal impose sanctions on the agent? Sanctions might deter disloyal agents who misrepresent their competence, but such sanctions would also distort incentives for loyal and competent agents. Some individuals might honestly underestimate or overestimate their abilities.[91] Those underestimating their competence might avoid applying for jobs due to fear of liability, while over-estimators might still apply. If this latter group is held accountable for their mistakes, honest individuals might start underestimating their competence, applying only for jobs they are overqualified for to avoid liability. Sanctioning incompetence also distorts a principal's choice between hiring an inexperienced agent at a lower salary or an experienced one at a higher salary, as potential candidates might avoid liability-prone jobs. Principals would struggle to appoint agents highly competent in one area but less so in another, as no agent would accept liability for mistakes in their weaker areas. Employees offered promotions or transfers might refuse opportunities requiring a learning period to avoid liability.

In summary, imposing liability for incompetence is undesirable. Strong candidates will avoid the firm, and current employees will resist skill development in new areas and decline promotions. This outcome is unfavorable for shareholders, who cannot attract and retain talent, and for management, who might face unfair liability for honest mistakes. Neither sanctions nor rewards can increase an agent's competence; if an agent is loyally performing to the best of their ability, punishment will not improve their skills.

Negligence. In Scenario 5, the agent was competent but disloyal, and the project failed due to the agent's negligence.[92] The agent prioritized

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[91] Self-evaluations are notoriously susceptible to mistake. *See, e.g.*, Russell Korobkin, *The Endowment Effect and Legal Analysis*, 97 NW. U.L. REV. 1227, 1228 (2003) (depicting how individuals over-value things because they possess them).

[92] Negligence is understood objectively, rather than by a subjective determination of a particular actor's abilities. *See* Omri Ben-Shahar & Ariel Porat, *Personalizing Negligence Law,* 91 N.Y.U. L. REV. 627, 646-656 (2016); Metro Storage Int'l LLC v. Harron, 275

personal leisure over work, leading to financial loss for the company. For example, the agent went to a movie instead of reviewing the probability analysis of the project's chances of success. Consequently, he assumed the $100 million investment had a 90% chance of generating $300 million and a 10% chance of losing $100 million, whereas the actual probabilities were reversed. The agent's negligence caused the project to fail. Should sanctions be imposed on the agent?

Negligence, unlike incompetence, is about effort, not ability. The agent is knowingly mismanaging the firm. However, the harm to the corporation is not directly and proportionally tied to the manager's benefits from shirking duties. If managers could enjoy the benefits of their negligence without harming the corporation, they would prefer it. The agent's benefit from watching a movie is not correlated to the loss caused by his negligence. Watching a movie might be worth $500 to the agent, but the lack of diligence inflicted a $100 million loss on the company. Thus, if the sanctions for negligence cost the agent more than $500, they will reconsider neglecting their duties. Reducing managerial negligence can be addressed by imposing liability. Sanctioning the manager for the $100 million loss will deter them from shirking duties for a leisure activity valued at $500. We classify negligence as *mismanagement* because a competent agent *knowingly* decides not to invest the required effort in managing the firm.

Pet Project. In Scenario 6, the agent was competent but disloyal, and the project failed because it served the agent's personal interests rather than the company's. For example, the agent might have invested $100 million in an industry where the company had no expertise or potential for success, solely because the agent had a personal interest in learning about that industry. This kind of investment, known as a "pet project," generates personal benefits for the manager but does not provide an appropriate return for the firm.[93] Like negligence, the benefits to the manager from a pet project are not directly correlated with the damage to the firm. The manager might value the benefit gained from learning about the new industry at $100,000, while the company incurs a $100 million loss. However, there is a critical difference. Damages from negligence occur "accidentally" due to inappropriate precautions, whereas in a pet project scenario, *knowingly* making a bad investment is necessary to generate the manager's private benefits. Despite this difference, the key similarity is that the manager's benefits are not tied to the company's loss. Thus, like negligence, it is a form

A.3d 810, 844 (Del. Ch. 2022) (holding that a director's enhanced level of expertise does not change the liability analysis).

[93] *See, e.g.*, Steven Kaplan, *The Effects of Management Buyouts on Operating Performance and Value*, 24 J. FIN. ECON. 217 (1989) (offering evidence in support of the empire-building—pursuing size for the sake of size rather than profitability—hypothesis). Another example is managers diversifying their personal risk through inefficient acquisitions. *See* Yakov Amihud & Baruch Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605 (1981).

of mismanagement, involving a knowing decision to invest in a losing project for indirect benefits. Imposing liability greater than the $100,000 personal benefit the agent gains from the pet project, such as holding him accountable for the $100 million loss, will deter such behavior.

Self-Dealing. In Scenario 7, the agent was competent but disloyal, and the project failed because the $100 million investment was taken by the agent. For example, the agent may have outsourced R&D development to his spouse's inexperienced company at a substantial premium. A transaction between the agent (or his affiliates) and the company is known as "self-dealing."[94] In most self-dealing scenarios, unlike pet projects and negligence, there is a direct correlation between the firm's loss and the agent's benefits.[95] The $100 million the firm lost ends up in the agent's spouse's bank account. Unfair self-dealing can be seen as the agent taking value directly from the company—every dollar lost by the company goes to the manager's pocket. While both self-dealing and mismanagement involve intentional decisions, they differ in how they benefit the agent: directly in self-dealing and indirectly in mismanagement. Clearly, preventing unfair self-dealing is crucial, as it involves the agent simply taking money from the company. Holding agents accountable for unfair self-dealing will deter disloyal transactions that deplete company value.

The above analysis shows that sanctions should be imposed on the agent in cases of mismanagement (negligence and pet project scenarios) and takings (unfair self-dealing), but not for ordinary losses due to misfortune, unsuccessful pursuit of idiosyncratic vision, honest mistakes, or incompetence. In a world without informational asymmetries, it would be clear which scenario caused the loss and whether the agent should be sanctioned. Shareholders and courts could equally make this determination.

However, in the real world, informational asymmetries make it difficult to ascertain the true cause of a loss. Managers may always blame losses on bad luck or misunderstood idiosyncratic vision. Determining the real cause of the loss is crucial, as mistakenly assigning managerial liability—such as finding negligence where it was bad luck, or vice versa—will distort incentives for shareholders and managers, leading to inefficient firm operations. The critical question is who should determine whether sanctions should be imposed on the agent: courts or shareholders? Parts II and III answer these questions for mismanagement and takings cases, respectively.

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[94] It is important to recognize that some transactions should be pursued despite an element of self-dealing associated with them. *See infra* Part III.

[95] Other conflicted transactions involve the manager accepting a bribe to make the company enter a deal with a third party on non-market terms. These cases also constitute a taking from the company, although the premium given to the third party does not always directly correlate with the bribe amount.

II. DENYING LEGAL LIABILITY FOR MISMANAGEMENT

Informational asymmetries between principals and agents are commonplace. Due to the incomplete nature of contracts, principals have imperfect information about their agents' actions and motivations.[96] These asymmetries make it difficult for principals—and judges—to accurately diagnose the cause of any loss in corporate value among the different prototypical scenarios.[97] It is extremely challenging to distinguish between losses resulting from managerial mismanagement, such as negligence and pet projects (where sanctions are warranted), versus those resulting from misfortune, unrealized idiosyncratic vision, honest mistakes, or incompetence.[98] This difficulty suggests that imposing sanctions for mismanagement could frequently lead to erroneous liability for losses actually caused by bad luck (Scenario 1), idiosyncratic vision (Scenario 2), honest mistakes (Scenario 3), or incompetence (Scenario 4). Consequently, the harmful effects of wrongly imposing sanctions and the failure to impose sanctions in negligence or pet project scenarios are likely to occur, distorting managerial incentives.

In this Part, we analyze whether cases of mismanagement (Scenarios 5 and 6) still warrant the imposition of legal liability given the probability of mistakes. We address two key questions: First, who has a lower probability of mistake—judges or shareholder-principals? Second, who has a broader and more appropriate range of remedies to handle mismanagement?

Section II.A discusses the principal's lower probability of mistakes compared to the court in holding an agent accountable for mismanagement cases. Section II.B shows that principals, rather than courts, have a broader and more appropriate range of remedies to handle mismanagement. Together, these sections explain why principals, not courts, should handle mismanagement cases. Sections II.C and II.D demonstrate that the relative superiority of shareholders in addressing mismanagement is bolstered by various market mechanisms and the presence of concentrated ownership, respectively.

A. Probability of Mistakes in Holding Agents Accountable for Mismanagement

While informational asymmetries in cases of corporate loss inhibit both shareholders and the judiciary, shareholders are better suited to handle losses from mismanagement. The information asymmetry between

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[96] *See, e.g.*, *See* Goshen & Hamdani, *supra* note 63, at 566 ("Therefore, it is hard for investors to determine the real cause of a corporation's poor performance: it could be the entrepreneur's incompetence or laziness, temporary business setbacks, or simply bad luck.").

[97] As a result, these informational asymmetries create further control costs. *See* Goshen & Hamdani, *supra* note 63, at 565.

[98] *Id.*

managers and the court is more severe than between managers and shareholders. The principal-agent asymmetry is significantly diminished outside the context of a judicial proceeding, which must adhere to strict procedural and evidentiary rules.[99] While a court is limited in considering certain types of information, these limitations do not apply to principals.[100] For instance, a court cannot consider past acts as evidence,[101] but principals can, enabling them to review the agent's past business decisions and their outcomes. Shareholders can also consider hearsay statements and rely on third-party opinions, such as analysts' reports, which are not subject to cross-examination.[102] This allows shareholders to gather more information about the cause of a particular loss. Therefore, shareholders are less likely than the court to misinterpret the cause of a loss as negligence and erroneously sanction an innocent manager when the loss was actually due to an honest mistake or misfortune.

The same is true regarding the size of damages. While sometimes damages are easily verified and calculated, many damages are not. For example, when a manager negligently invests in a project that results in a total loss, the damage is the amount of the lost investment. But what about a pet project that functions moderately rather than completely failing? Imagine the project generates a low return but unexpectedly boosts the firm's industry reputation, aiding recruitment of high-quality talent. Many mismanagement cases, such as investments and acquisitions, fall into this category. These transactions are motivated by personal interest and produce questionable benefits for the firm. Courts lack clear information sources to measure the damages and opportunity costs in such scenarios.[103] Shareholders and the investment community, including analysts, can better evaluate these inefficient transactions, reflecting their impact in the company's stock price.[104]

One might object that even if principals have lower informational asymmetry, judges might still have a lower risk of error in certain cases due

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[99] *See generally* ALEX STEIN, FOUNDATION OF EVIDENCE LAW (2005) (providing a broad introduction to the rules and function of evidence law).

[100] *See* Goshen & Hannes, *supra* note 65,, at 294 ("Courts . . . may lack . . . the information about the firm's business . . . that the agents and principal possess.").

[101] *See, e.g.*, Mercedes-Benz of N. Am. Inc. v. Norman Gershman's Things to Wear, Inc., 596 A.2d 1358, 1365 (Del. 1991) ("D.R.E. 404(b)3 [rule prohibiting admissibility of character evidence] has equal application to civil . . . cases.).

[102] *See, e.g.*, D.R.E. 802 ("Hearsay is not admissible except as provided by law or by these Rules.").

[103] *See, e.g.*, Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997) ("Courts are ill-fitted to attempt to weigh the 'adequacy' of consideration under the waste standard or, ex post, to judge appropriate degrees of business risk.").

[104] Reflection of these risks in the stock prices requires only minimal assumptions of market efficiency. *See* Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715, 717 (2003) (concluding that efficient market hypothesis remains predictive even when adjusted to the objections by behavioral finance).

to the judicial process. Formal procedures such as deposition or discovery can reveal hidden information, potentially offsetting the limited information judges are legally allowed to consider. This might be true in self-dealing scenarios, where the distinguishing facts depend on observable and verifiable conflicts of interest.[105] However, this is not the case in mismanagement scenarios, where the critical facts often involve the manager's intentions—facts that are not easily observable or verifiable. Observable facts in mismanagement cases typically pertain to flawed processes, which do not provide reliable differentiating data.[106]

B. The Range of Remedies to Handle Mismanagement

Informational asymmetries are not the only factor affecting the risk of mistakes in holding an agent accountable—the type of remedy also impacts this risk. The main remedy available to courts is the imposition of legal liability on the agent for damages caused to corporate value.[107] By its nature, the court must make a binary decision about a past event (liable or not liable) and provide a remedy that is usually monetary and irreversible.[108] Such a remedy can have significant side effects if the judgment is mistaken.[109] In contrast, principals have a broader range of potential remedies to both *ex ante* prevent damage and *ex post* discipline mismanagement. These remedial measures can minimize the risk of a mistaken response to an agent's loss of company value and its side effects.

Ex Ante Remedies. Principals can use *ex ante* remedies to prevent mismanagement by improving the agent's incentives and monitoring their actions.[110] Mismanagement reflects an indirect taking of private benefits, so even a small change in the incentive structure can deter such behavior.[111] For

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105 *See infra* Section III.A.

106 Indeed, given the difficulty of assessing process, courts maintain deference to agents and principals. *See, e.g.*, Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 45 (Del. 1994) ("There are many business and financial considerations implicated in investigating and selecting the best value reasonably available. The board of directors is the corporate decisionmaking body best equipped to make these judgments.").

107 *See, e.g.*, *In re* Orchard Enterprises, Inc. Stockholder Litig., 88 A.3d 1, 38-41 (Del. Ch. 2014) (explaining various forms of damages for corporate harm).

108 Assuming all appeals have been exercised.

109 A request for preliminary injunction has lower risk of mistakes, given the requirements of proving "irreparable harm" and "likelihood of success on the merits." Cantor Fitzgerald, L.P. v. Cantor, 724 A.2d 571, 579 (Del. Ch. 1998).

110 *See, e.g.*, Jensen & Meckling, *supra* note 53, at 308 ("The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs."); *see also* Steven Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 BELL J. ECON. 55 (1979).

111 In addition to incentive packages, companies that wish to discourage managers from thwarting certain proposals (such as a CEO who works to block a tender offer to maintain his position) provide management with special incentives to approve such proposals (such as a generous severance package, serving as a "golden parachute" if the company were to change hands). See Eliezer M. Fich, Anh L. Tran & Ralph A. Walkling, *On the Importance of Golden Parachutes*, 48 J. F. QUANTITATIVE ANALYSIS 1717 (2013).

instance, in the negligence scenario mentioned earlier, the manager's decision to watch a movie provided a benefit of $500. If the agent's compensation included 0.1% of the company's shares, a $100 million loss would result in a $100,000 personal loss, incentivizing the agent to avoid negligence and manage the firm properly. Additionally, managers' decisions are continuously monitored by the board of directors and third parties like analysts and rating agencies.[112] This allows principals to learn about the agent's motivation and competence before mismanagement occurs, providing the opportunity to preemptively remove the agent if necessary.[113]

Ex Post Remedies. Principals with discretionary control rights can replace an agent when loyalty and competence are questionable. While this remedy may entail side effects similar to erroneous impositions of liability, it differs significantly from judicially imposed legal liability. A court must make a definitive decision about the agent's legal liability based on the information presented at trial.[114] In contrast, the principal-owner can choose to wait and not immediately replace the agent after a loss occurs.[115] The principal-owner can observe the agent's conduct over a longer period (before and after the bad decision), work to reduce informational asymmetries, and decide whether to fire the agent based on past and future observations.[116] Additionally, while a court ruling is final, the owner can reverse a decision and rehire the agent if a mistake is realized.[117] This flexibility and discretion in dismissing an agent allow the principal to minimize the risks of mistakes compared to a court imposing legal liability.

In sum, the principal's informational and remedial advantages indicate that principals are better suited than courts to address losses from

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[112] Other times a corporation is monitored by third-parties designed to review remediation efforts. *See* Veronica Root Martinez, *Public Reporting of Monitorship Outcomes*, 136 HARV. L. REV. 757, 758 (2023).

[113] If the governance structure chosen by the parties allows the shareholders to replace the manager, they will decide whether to exercise that right; if the parties elected for a governance structure under which the investors waived the right to replace management, these investors would simply bear the costs of the investment's failure.

[114] *See, e.g.*, Beard Research, Inc. v. Kates, 8 A.3d 573, 613 (Del. Ch.) ("this Court may not set damages based on mere 'speculation or conjecture'").

[115] Indeed, determining if the cause of the loss was in fact managerial incompetence requires the gathering of information over a prolonged time period.

[116] A long-term relationship between the principal and the agent provides the former a broader perspective of the latter based on a larger number of observations. *See* Roy Radner, *Monitoring Cooperative Agreements in a Repeated Principal-Agent Relationship*, 49 ECONOMETRICA 1127 (1981). *See also* Bengt Holmstrom, *Managerial Incentive Problems: A Dynamic Perspective*, 66 REV. ECON. STUD. 169, 170 (1999); Joseph E. Stiglitz, *Principal and Agent*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS 966, 970 (John Eatwell, Murray Milgate & Peter Newman eds., 1987).

[117] For example, the firing and later rehiring of Steve Jobs from Apple. *See* WALTER ISAACSON, STEVE JOBS 186-206 (2011); Randal Lane, *John Sculley Just Gave His Most Detailed Account Ever of How Steve Jobs Got Fired from Apple*, FORBES (Sept. 9, 2013), http://www.forbes.com/sites/randalllane/2013/09/09/john-sculley-just-gave-his-most-detailed-account-ever-of-how-steve-jobs-got-fired-from-apple.

mismanagement. Put differently, the court's competence costs—its ability to correctly identify and sanction mismanagement cases—are higher than those of shareholders. Principals have a lower likelihood of making mistakes when distinguishing between mismanagement and other business-related losses. As the following Section demonstrates, this is even more evident considering the various markets in which principals and agents operate.

C. Mismanagement and the Market

Principals and agents do not operate in a vacuum. They exist within a larger market composed of various actors who can regulate corporate relationships. Shareholders not only enjoy informational and remedial advantages over courts but can also rely on market mechanisms to address mismanagement. Various markets, including the capital market, the market for corporate control, the product market, and the market for managers, regulate management's behavior and reduce the risk of mismanagement. These markets work in parallel to support the relative superiority of principals in addressing cases of mismanagement. Let us proceed in this order.

The capital markets, particularly the equity markets, disincentivize mismanagement.[118] When managers engage in mismanagement, informed and sophisticated investors will adjust the stock price to reflect the negative consequences.[119] An efficient equity market thus reduces the risk that corporate mismanagement will go unnoticed. Furthermore, the threat of exposure by these investors deters corporate directors and officers from engaging in mismanagement.[120] Shareholders can expect that, in some instances, even prospective investors will detect or address cases of mismanagement on their behalf.

The market for corporate control challenges inefficient managers. The fear of a hostile takeover is a strong deterrent against mismanagement, as managers risk being replaced immediately after a change of control.[121] Similarly, the threat of shareholder activism, particularly by activist hedge

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[118] *See* Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 750 (2006) ("The analysts' market reduces . . . mismanagement.").

[119] *Id.* at 750-51.

[120] *See* Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CALIF. L. REV. 393, 423 (2003) (explaining that the capital market serves "an important function: informing market participants about existing and potential expropriations and incorporating this information into the price of the stock.") [hereinafter Goshen]. *See also* Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 972-74 (2003) (explaining the corporate governance role of stock exchanges).

[121] *See, e.g.*, Easterbrook & Fischel, *supra* note 37, at 1173-74 (theorizing tender offers as a monitoring force); Andrei Shleifer & Robert W. Vishny, *Value Maximization and the Acquisition Process*, 2 J. ECON. PERSP. 7, 11-12 (1988) (discussing the same and offering suggestions for improving the takeover process).

funds, deters mismanagement.[122] The more an agent mismanages a company, the greater the likelihood it will become a target for activist hedge funds or hostile takeover raiders. Fearful that raiders or activist involvement will result in their replacement, agents are motivated to avoid mismanagement to protect their positions.

The products market in which the firm operates also deters mismanagement.[123] A mismanaged company is inefficient and will inevitably produce inferior and more expensive products compared to well-managed companies.[124] This is especially true in highly competitive markets, where the marginal costs of mismanagement can mean the difference between profitability and financial ruin.[125] In such environments, failing companies are driven out of the market, and managers who wish to maintain their positions cannot afford to mismanage. Admittedly, in uncompetitive markets, the products market's ability to regulate managers diminishes.[126] Managers in concentrated markets or monopolies can extract private benefits from consumers without risking the company's viability, as sizable margins allow them to extract value before jeopardizing their jobs.[127]

Finally, the risk of reputational harm regulates management's conduct.[128] Public exposure of mismanagement harms the manager's personal reputation, reducing their market value as a manager and negatively impacting both current compensation and future job prospects.

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122 *See* Paul Rose & Bernard S. Sharfman, *Shareholder Activism As A Corrective Mechanism in Corporate Governance*, 2014 B.Y.U.L. REV. 1015, 1051 (2014) (modeling the corrective role of shareholder activism).

123 *See* Oliver D. Hart, *The Market Mechanism as an Incentive Scheme*, 14 BELL J. ECON. 366 (1986) (theorizing the impact of products markets on agency costs); Rachel Griffith, *Product Market Competition, Efficiency and Agency Costs: An Empirical Analysis*, WP01/12 THE INSTITUTE FOR FISCAL STUDIES (IFS) (2001), available at https://www.econstor.eu/bitstream/10419/71529/1/33016659X.pdf (providing empirical evidence that the products market plays a key role in reducing agency costs); Klaus M. Schmidt, *Managerial Incentives and Product Market Competition,* 64 REV. ECON. STUD. 191 (1997) (theorizing that the disciplining impact of the products markets may sometimes harm profitability).

124 *See* Hart, *supra* note 123, at 366.

125 *Id.* at 370 (examining the products market under perfect competition conditions).

126 *Id.* at 372-73 (modeling the reduced discipline of the products markets under monopolistic conditions).

127 Although market competitiveness significantly regulates the agency problem between management and shareholders, it is primarily regulated through antitrust law and import/export regulations. *See generally* Ramsi A. Woodcock, *The Antitrust Case for Consumer Primacy in Corporate Governance*, 10 UC IRVINE L. REV. 1395, 1426 (2020) (analyzing the connections between antitrust and corporate governance).

128 *See, e.g.*, Claire A. Hill, *Marshalling Reputation to Minimize Problematic Business Conduct*, 99 B.U.L. REV. 1193, 1196) (2019) (discussing the role of reputation in the management of corporations); Thomas David, Alberta Di Giuli, & Arthur Romec, *CEO reputation and shareholder voting*, 83 J. CORP. FIN. 1 (2023) ("we find that shareholders . . . are more likely to vote with management . . . when the CEO is a superstar").

Consequently, mismanagement is discouraged by the fear of exposure and social punishment.[129]

The net result is that various market mechanisms help diminish the likelihood and costs of mismanagement. By reducing the expected losses from mismanagement, these mechanisms reinforce the idea that mismanagement cases are best resolved by principals directly. By deterring mismanagement, market mechanisms ensure that the expected losses regulated by principals are smaller than those from erroneous judicial impositions of unwarranted legal liability.[130]

D. Concentrated Ownership and its Effect on Mismanagement

Enter concentrated ownership. Some firms have a single shareholder or a small group of shareholders who control the majority of the firm's stock.[131] While the previous analysis highlights how market mechanisms deter mismanagement, this was based on the assumption of dispersed ownership. Firms with concentrated ownership, where a single investor or group of investors holds control, are relatively insulated from market mechanisms. No market for hostile takeovers exists when a firm has a controlling owner,[132] and the power of hedge fund activists is similarly limited,[133] as all other shareholders hold a minority or non-controlling stake.

Despite their relative immunity from market forces, firms with concentrated ownership can adequately guard against mismanagement costs without judicial intervention. When a firm has concentrated ownership, the principal-agent dynamics must be adjusted. A shareholder with a controlling block of shares effectively becomes the agent of the corporation and its minority shareholders, exerting control either directly or through appointed directors. The non-controlling shareholders remain the principals of the firm.

Importantly, when the controlling owner holds a considerable number of shares with cash-flow rights, they are more incentivized to discover and prevent mismanagement by hired managers without relying on market

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129 Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 291-91(1980) (describing the impact of reputation on managers competing in the labor market).

130 *See* Goshen, *supra* note 120, at 421 ("[I]f the legal system generates prohibitive adjudication costs, these [market] mechanisms are likely to produce less expensive means of enforcement or to reduce negotiation costs to a point where recourse to the courts is unnecessary.").

131 *See* Ann M. Lipton, *The Three Faces of Control*, 77 BUS. LAW. 801 (2022) (analyzing the controlling shareholder concept in corporate law).

132 *See, e.g.*, Zohar Goshen, *Controlling Corporate Agency Costs: A United States-Israeli Comparative View*, 6 CARDOZO J. INT'L & COMP. L. 99, 115 (1998) ("The market for corporate control is powerless when faced with the control problem.").

133 *See* Kobi Kastiel, *Against All Odds: Hedge Fund Activism in Controlled Companies*, 2016 COLUM. BUS. L. REV. 60, 101n.54 (2016) (describing the disciplining impact of activism in controlled companies as "almost impossible").

mechanisms for support.[134] Otherwise, the controlling owner will bear the greatest part of any damage caused by mismanagement. The controlling owner has the best incentives to accurately hold managers accountable because the damage from distorted incentives will primarily affect them.

Controlling shareholders can often leverage their position to act as the manager. However, even in cases of potential mismanagement by a controlling owner, there is no direct link between the private benefits they extract and the damage caused to the company. The indirect benefits a controlling owner-agent might receive from mismanagement are rarely greater than the substantial direct damages to their controlling stake.[135] In previous examples of mismanagement, the agent received a limited benefit while the company bore the damage. In a concentrated ownership structure, the controlling owner-agent experiences both the relative benefit that could incentivize mismanagement and the damage it causes. Since any benefits from mismanagement are slight compared to the damage to the company's value, mismanagement is disincentivized in a concentrated ownership structure.[136]

As illustrated in the following Part III, this is not true for self-dealing cases, where the damage to the firm is directly proportional to the benefit gained by controlling shareholders. However, in mismanagement cases, principals are better suited to address these scenarios than the courts, even with concentrated ownership. They rely on an owner-agent whose incentives are to closely monitor the firm, thereby reducing agent conflict and competence costs.

III. JUDICIAL INTERVENTION IN SELF-DEALING

The discussion above demonstrates that in cases of mismanagement legal liability ought to be avoided. Self-dealing scenarios are different. They present distinct considerations that often justify judicial intervention. As with cases of mismanagement, when reviewing a conflicted transaction, informational asymmetries between the court, principal, and agent make it difficult to determine the real reason for the company's losses. Acting under such uncertainties carries a risk that managers falsely suspected of unfair self-dealing will face liability. However, there are four important differences in cases of self-dealing. First, the risk of the judiciary mistakenly identifying

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[134] This analysis may raise questions with respect to dual-class companies, and companies that contractually assign control to another, without an investment of a considerable amount of capital. *See, e.g.*, Dorothy S. Lund, *Nonvoting Shares and Efficient Corporate Governance*, 71 STAN. L. REV. 687, 701 (2019) (providing a historical account of dual-class structures and regulations).

[135] This is not to say that managers appointed by the controlling owner are immune from committing negligence, but that the controlling owner has a greater incentive than any other shareholder to ensure that management does not act negligently.

[136] *See* Goshen & Hamdani, *supra* note 63, at 593 ("Substantial equity investment by the entrepreneur strongly aligns her interests with those of the investors, thereby reducing management agency costs.")

a self-dealing scenario (scenario 7 above) is significantly lower than mistakenly identifying a mismanagement case. Second, the principal's remedies are insufficient to deal with self-dealing alone. Third, market mechanisms do not provide adequate safeguards to support principals in combating takings scenarios. Lastly, the concentration of ownership does not reduce the incentive of the agent to divert value from the firm to themselves. Sections III.A, B, C, and D proceed in this order, respectively.

A. *Probability of Mistakes in Holding Agents Accountable for Unfair Self-Dealing*

When an agent engages in takings, or unfair self-dealing, they create a transaction between the company and themselves (or affiliates) that does not reflect fair market value, diverting economic benefits from the company to themselves.[137] The key difference between self-dealing (scenario 7) and other corporate losses (scenarios 1-6) is the conflict of interest, which can be objectively observed and verified with low risk of error. This contrasts with suspected mismanagement, where the crucial factor is the agent's *state of mind*, difficult to observe and verify, leading to a high risk of error. For example, if a director pressures the company to buy raw materials from his private metals company, courts can easily identify the conflict of interest by noting the contract's existence. However, if the chosen supplier was not the director's company, and the issue was whether it was an adequate choice, courts would still face a high risk of misjudging it as mismanagement.

Detecting self-dealing is not only easier than identifying mismanagement, but courts also have the tools to reveal instances of self-dealing. The hallmark of self-dealing is the objective presence of conflict, not the agent's subjective mental state, as in mismanagement cases.[138] This allows courts to use their authority and evidentiary tools to lower their probability of mistake. For example, courts can compel the discovery of documents and testimony to uncover conflicts of interest.[139] If a director might benefit from a contract between their firm and another company, the court could order the production of that company's stockholder ledger to reveal hidden connections.[140] Courts can also enforce the shareholder's

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137 *See* Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430 (2008) (offering a robust economic analysis of the law of self-dealing).

138 Self-dealing falls under the duty of loyalty, which otherwise also captures bad faith acts. *See* Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006) ("fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith.").

139 *See, e.g.*, Shapiro v. Nu-W., C.A. 15442-NC, 1998 WL 732891, at *1,*5 (Del. Ch. Oct. 1, 1998) (finding that discovery "reasonably calculated" to showing a conflict of interest may even outweigh expectations of privacy).

140 *See, e.g.*, Gill v. Regency Holdings, LLC, 2023-0349-BWD, 2023 WL 4607070, at *1 (Del. Ch. June 26, 2023) ("Plaintiffs are entitled to rely on the Company's membership

books and records right to obtain details on suspicious transactions.[141] For instance, if a shareholder requests a copy of materials provided to the board in connection with a transaction they approved, and the board refuses, the court can enforce this right if the request is made in "good faith" and serves a "proper purpose."[142] Principals lack access to these powerful investigative tools without court intervention, making the courts' probability of error significantly lower than that of principals acting independently.

Similar considerations apply to the court's ability to assess damages caused by self-dealing. Unlike the complexities in assessing damages in mismanagement cases, where the *quality of a business decision* is the issue, self-dealing damages can be assessed based on the *valuations of the exchanged values*.[143] In mismanagement cases, the agent benefits indirectly from an inefficient decision, requiring an estimate of how much worse the decision is compared to an optimal one. This complex task involves hypothetical and counterfactual analysis, making it difficult for courts to provide predictable and accurate answers.[144] As explained in Section II.A., principals are better suited to handle this task due to experiencing fewer informational asymmetries, having access to information about past and future managerial acts, and better competence to evaluate quality of business decisions.

In self-dealing scenarios, courts do not suffer from the same informational asymmetries. These cases involve determining the fairness of a transaction, asking whether the price paid in a conflicted transaction is comparable to non-conflicted ones. For example, the court would determine if the price paid to the raw materials company owned by the conflicted director is similar to what a non-owned company would have received. Although this is a complex task, the court can rely on expert opinions and acceptable valuation models, leading to predictable and accurate outcomes.[145] Unlike in mismanagement cases, courts examining self-dealing are not left to review damages based on inaccessible

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ledger to establish their standing to demand books and records.").

[141] Highland Select Equity Fund, L.P. v. Motient Corp., 906 A.2d 156, 164 (Del. Ch. 2006) ("Delaware law provides a statutory right for a stockholder to inspect the books and records of a corporation under 8 Del. C. § 220, so long as the form and manner requirements for making a demand are met, and the inspection is for a proper purpose.").

[142] Del. Code Ann. tit. 8, § 202 (2025) (procedurally, all requests must be "specifically related" to the stockholder's purpose, which must be communicated with "reasonable particularity").

[143] In tort terms, the harm is more akin to embezzlement than to accidental damage.

[144] *See, e.g.*, *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996) ("[There are] good policy reasons why it is so difficult to charge directors with responsibility for corporate losses for an alleged breach of care.").

[145] *See, e.g.*, William J. Carney & Keith Sharfman, *The Death of Appraisal Arbitrage: Ending Windfalls for Deal Dissenters*, 43 DEL. J. CORP. L. 61, 91 (2018) (analyzing corporate law's sensitivity to the field of finance).

information, such as the agent's motivations or hypothetical optimal decisions.

B. The Range of Remedies to Handle Self-Dealing

Beyond informational asymmetries, the range of remedies available to courts in self-dealing cases is superior to those available to principals. This contrasts with mismanagement scenarios, where principals have wide latitude in administering both *ex ante* and *ex post* remedies.[146] In self-dealing cases, the agent's extraction of value might be so substantial that the principal lacks leverage to discipline them, whether *ex ante* or *ex post*.

From an *ex ante* perspective, principals lack sufficient leverage to deter self-dealing effectively. In mismanagement cases, like the agent negligently causing $100 million in damages by watching a movie, granting the agent 0.1% of the shares can prevent such behavior due to the small indirect benefit. However, in self-dealing cases where the agent is taking $100 million, no incentive plan, not even granting 50% of the shares, can prevent it. Incentive structures effective against mismanagement fail here, as agents can often extract more from self-dealing than from any incentive-based compensation package.[147]

Principals are also ill-equipped to handle self-dealing cases *ex post*. In mismanagement cases, principals can use their access to past and future information and their ability to fire and rehire agents to discourage mismanagement. However, these remedies are ineffective against self-dealing. In takings cases, the agent can take a large amount and be indifferent to being removed or rehired. Only courts can effectively address self-dealing by forcing the agent to compensate the principal for the amount taken.

Monitoring the agent alone is insufficient to combat takings, despite the possibility of spotting suspected self-dealing transactions. The right to fire the agent is only effective if exercised before the private benefits are taken. If the agent can extract greater private benefits than the value of their position, the threat of eventual dismissal is not a deterrent. Thus, companies must establish means beyond monitoring to either prevent self-dealing ahead of time or recover the taken benefits afterward, which necessitates judicial action for enforcement.

Courts are better situated to address self-dealing cases than principals. When handling managerial takings, courts do not face the same informational asymmetries and possess the necessary remedial powers, making adjudication costs lower than principal costs in self-dealing cases. By

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[146] *See supra* Section II.B.

[147] For discussion on the effectiveness of compensation packages decreasing conflict costs, *see* Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71 (2003) (debating whether executive compensation is structured to reduce agency costs or is itself a manifestation of them).

focusing on whether self-dealing occurred and determining the difference between a fair and unfair price, courts avoid the heightened probability of mistakes and lack of remedial flexibility that they face in mismanagement cases. Principals, on the other hand, cannot use compensation packages or discretionary control rights to adequately deter or address self-dealings. The following Section demonstrates that this remains true even when considering the various market mechanisms that principals typically rely on.

C. *Self-Dealing and the Market*

While market mechanisms limit the principal costs associated with mismanagement, they are much less effective against managerial takings, further supporting the need for judicial intervention in self-dealing scenarios. Self-dealing occurs *despite* the potential deterrence of market mechanisms because the agent's direct taking of private benefits outweighs the expected costs. Agents will engage in self-dealing only if the benefits significantly exceed the costs imposed by markets, including the capital, corporate control, products, and managerial markets. Without court involvement, principals are ill-equipped to handle self-dealing, even with market mechanisms.

Market mechanisms fail to prevent self-dealing for the same reason owners struggle to do so: the agent's fear of a drop in corporate value and subsequent consequences cannot alone prevent self-dealing. Reduced company value may lower the agent’s compensation or lead to their replacement, but if the direct private benefits extracted are higher, or if the agent plans to loot the company before being fired, self-dealing remains a net gain. The market for corporate control is ineffective in deterring self-dealing because the takeover process is long and expensive, reducing the agent’s concern about post-merger replacement.[148] Similarly, hedge fund activism, with the time required to run a proxy fight to replace managers, allows managers sufficient leeway to extract private benefits before being fired.[149]

The product market alone cannot effectively deter self-dealing because an agent's incentives to self-deal outweigh potential repercussions if their company is driven out of the market. Admittedly, the product market can theoretically enhance the deterrent effect of reputational harm.[150] In the age

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[148] The market for corporate control is especially ineffective at preventing self-dealing because the threat of a takeover must be substantially possible in order to have any effect. *See* Goshen, *supra* note 120, at 422 (“the effectiveness of the market for corporate control depends, inter alia, on the prevalence of potential tender offerors who monitor the market to locate inefficient corporations . . . [and] the existence of a legal regime that makes it difficult for the current controlling owners to prevent takeovers.”).

[149] Hedge fund activism is also more likely to be falsely targeting the wrong firm. *See* Zohar Goshen & Reilly S. Steel, *Barbarians Inside the Gates: Raiders, Activists, and the Risk of Mistargeting*, 132 YALE L.J. 411, 414 (2022).

[150] *See supra* notes 123-126, 128-129 and accompanying discussion.

of social media, negative publicity and reputational damage from a self-dealing agent can lead to a consumer boycott of both the company and the agent, especially if the market offers sufficient substitutes.[151] However, the product market often lags behind instances of self-dealing, allowing the agent ample time to extract personal value before any reputational harm unfolds.[152] For example, a director might direct the company to use his own company for raw materials, knowing they are inferior. Consumers may eventually notice and create a negative buzz, but these events will occur long after the director has extracted personal value and prepared for any public fallout.

While market mechanisms can occasionally restrain self-dealing, they are far less effective than in preventing mismanagement. Principals cannot rely on market mechanisms to mitigate their limitations in addressing self-dealing, as agents retain incentives to commit takings despite these market forces—further supporting the need for judicial involvement. The following Section demonstrates that this holds true in firms with concentrated ownership.

D. Concentrated Ownership and its Effect on Self-Dealing

Judicial involvement in reviewing self-dealing is even more necessary in firms with concentrated ownership. In such structures, agents are largely unregulated by market mechanisms, as the controlling shareholder assumes the agent's role.[153] The threats of takeovers, activism, and consequences in the product markets or the agent's reputation are minimal. Controlling owner-agents do not fear intervention in company operations or being fired.[154] While insularity from markets exists in both mismanagement and self-dealing scenarios, its negative effects manifest only in self-dealing. Therefore, market mechanisms are ineffective at deterring a controlling owner from engaging in self-dealing.

Minority shareholders cannot prevent self-dealing on their own and lack effective market support to address losses from a controlling owner-agent's self-dealing. In these cases, judicial intervention may be their only option. The key difference between mismanagement and self-dealing explains why minority shareholders need the court for the latter: in mismanagement, the agent's personal gain (e.g., watching a movie) is not directly tied to the firm's loss (e.g., $100 million). In self-dealing, however, the agent's benefit (e.g., taking $100 million) is directly linked to the firm's loss. Thus, while controlling shareholders are disincentivized from mismanagement due to

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151 *Id.*

152 The products markets only respond once sales begin, which naturally come after any contract governing production is entered into.

153 *See* supra Section II.D.

154 *Id.*

the proportional harm to their stake, self-dealing remains unchecked since the agent's gain always surpasses their loss in firm value.

The types of cases warranting judicial intervention are consistent across firms with either concentrated or dispersed ownership. While market mechanisms guard against mismanagement risks in dispersed ownership firms, they are ineffective against self-dealing. In concentrated ownership firms, insulation from market discipline deters mismanagement but encourages self-dealing. Despite the different paths each ownership structure takes, the outcome is the same: judicial intervention is the most efficient solution only in cases of managerial takings.

IV. THE ROLE OF SPECIALIZED COURTS

Principals are better equipped to handle mismanagement cases, while courts are necessary for self-dealing cases. But why should such a court be specialized? Does it matter if the court is experienced, like Delaware's Court of Chancery, or inexperienced, like the new Texas Business Court Tesla has moved to or the planned Nevada court? This Part answers these crucial questions and explains why specialized corporate law courts are necessary. While general courts can resolve complex factual disputes, such as those between a tort victim and a brain surgeon, specialization is necessary for corporate disputes.

Unlike other areas of law, such as medical malpractice or construction defects, corporate law adjudication involves ongoing, triangular relationships regulated by incomplete contracts.[155] In non-corporate cases, judges simply determine liability and damages without considering whether they are the most suitable party to resolve the dispute.[156] Conversely, courts dealing with corporate law must recognize they are one player alongside the shareholders and the managers in an ongoing relationship.[157] Corporate courts must consider the limits of their authority and sometimes defer to alternative mechanisms for protecting shareholders, such as the exercise of discretionary control rights or other external mechanisms.[158]

While specialized corporate courts understand their role in the tripartite arrangement between agents, principals, and courts, this alone does not explain the unique specialization of corporate law. This Part demonstrates the nexus between the adjudicatory tools developed by specialized courts and their essential functions. Sections IV.A and IV.B explain, respectively: the important and specialized functions of the business judgment rule in mismanagement cases, and the salient functions of the "Entire Fairness Test" in addressing self-dealing cases. Subsequently, Section IV.C situates the dynamics between corporate courts and legislatures in the

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155 *See supra* Section 1.A.
156 *Id.*
157 *Id.*
158 *See supra* Sections II.C and III.C.

development of these review doctrines. Together, this Part explains the necessity of specialized corporate law courts and the nexus between corporate law and specialization.

A. The Business Judgement Rule and Mismanagement

Part II concluded that both shareholders and management prefer that judges abstain from resolving mismanagement cases. To achieve this, business courts must develop specialized tools for screening the right cases. This Section explains how specialized courts use the business judgment rule (Section IV.A.1) and legislatively enabled exculpation provisions (Section IV.A.2) to accomplish this goal. Section IV.A.3 then reveals the nexus between judicial specialization and mismanagement.

1. The Role of the Business Judgment Rule

Specialized business courts' application of the business judgment rule fulfills their obligation to defer mismanagement cases to shareholders. The BJR stipulates that if management makes an informed decision in good faith and without conflicts of interest, the court applies a lenient rationality test, essentially deferring to management's judgment.[159] Any challenge against such a decision is dismissed unless the plaintiff can plead that the decision was irrational.[160] The threshold for irrationality is extremely high—demonstrating unreasonableness or stupidity is not enough.[161] Plaintiffs almost never meet this heavy burden.[162]

The four prerequisites for the business judgement rule's applicability are: (1) an informed (2) action[163](3) in good faith (4) unencumbered by a conflict of interest.[164] If either of the first two prerequisites are not met (i.e., uninformed action or omission), the decision is regarded as mismanagement or a duty of care violation.[165] If the third or fourth

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[159] *See Aronson v. Lewis*, 473 A.2d 805, 811-13 (Del. 1984) (providing overview of the business judgement rule); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) ("A board of directors enjoys a presumption of sound business judgement, and its decisions will not be disturbed if they can be attributed to any rational business purpose.").

[160] Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) ("irrationality is the outer limit of the business judgment rule.")

[161] *Id.*

[162] Mary Siegel, *The Problems and Promise of "Enhanced Business Judgment"*, 17 U. PA. J. BUS. L. 47, 50n.12 (2014) (providing examples).

[163] Cases of omissions are captured by the duty to monitor, which also provides a high bar for directors' liability. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A. 2d 959, 971 (Del. Ch., 1996) ("Such a test of liability—lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight—is quite high.").

[164] *See, e.g.*, *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 43 (Del. Ch. 2013) ("The rule presumes that 'in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.'").

[165] *See, e.g.*, Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150, 192 (Del. Ch. 2005)

prerequisites are not met, it is considered a breach of the duty of loyalty.[166] In addressing duty of care violations, courts limit their review to defective decision-making processes that amount to gross negligence.[167] The practical implication of the business judgment rule is that courts will not intervene or impose legal liability on managerial decisions.

Scholarly explorations of the rationale for the business judgment rule are voluminous. Scholars argue that the rule ensures management is not overly cautious in overseeing a corporation's operations due to liability fears.[168] Corporate law scholar Bernard Sharfman tied this justification to courts' historical status as courts of equity, noting that the "raw power of equity" can sometimes override explicit statutory provisions.[169] Courts of equity might otherwise apply a strict "entire fairness" standard to all challenged management decisions.[170] Sharfman argues that preventing equitable courts from imposing such an exacting standard in every case is the business judgment rule's "most important function."[171]

Other scholars focus on the policy concerns driving the business judgment rule's application. The most cited policy justification is that it protects corporate management from liability for honest mistakes.[172] Judges applying the BJR often cite their lack of business expertise relative to corporate directors as a reason for not intervening.[173] In the foundational case of *Dodge v. Ford Motor Co.*, the Michigan Supreme Court stated,

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("The duty of care includes a duty that directors inform themselves, before making a business decision, of all material information reasonably available to them.").

166 *See supra* note 138.

167 Benihana of Tokyo v. Benihana, Inc., s*upra* note 165, at 192 ("Director liability for breaching the duty of care 'is predicated upon concepts of gross negligence.'"). With respect to the court's focus on the decision-making process rather than the decision itself, *See*, *e.g.*, *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) ("Courts do not measure, weigh or quantify directors' judgements. We do not even decide if they are reasonable in this context. Due care in the decision-making context is *process* due care only.") (emphasis added).

168 *See* Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 465 (1993) ("One explanation is . . . we want to give you a certain amount of running room so that you are not unduly risk averse or otherwise preoccupied with liability.").

169 *See* Bernard Sharfman, *The Importance of The Business Judgement Rule*, 14 N.Y.U. J. L. & BUS. 27 (2017).

170 *Id.*

171 *Id.*

172 *See* Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 271 (1967) (explaining that the rule "precludes the courts from any consideration of honest if inept business decisions, and that seems to be the purpose of the Rule.")

173 *See* Bernard S. Sharfman, *Shareholder Wealth Maximization and Its Implementation Under Corporate Law*, 66 FLA. L. REV. 389, 406-09 (2014); Sharfman, *supra* note 169, at 46 ("Judges recognize that they lack information, decision-making skills, expertise, and vested interest (i.e., stake in the company) relative to corporate management.").

"judges are not business experts."[174] Some scholars see the BJR as courts recognizing the private ordering of corporate authority, which typically grants decision-making power to management. Professor Jonathan Macey argues that private ordering leads to more efficient outcomes than formal legal rules, as it considers market factors and informal norms.[175]

Professor Stephen Bainbridge describes the BJR as an abstention doctrine.[176] He notes that challenges to corporate actions require courts to balance deference and accountability, with the BJR allowing courts to hear some claims but not others.[177] Bainbridge states that "[g]iven the significant virtues of discretion . . . one must not lightly interfere with management or the board's decision-making authority in the name of accountability."[178] Thus, courts usually refrain from hearing duty of care claims if certain conditions are met.[179] Professor Holger Spamann argues that the BJR prevents courts from hearing duty of care claims because it functions as a cost-benefit analysis device.[180] He contends that the potential benefits of judicial intervention (e.g., monetary payment based on judicial evaluations of business decisions) are usually outweighed by the costs (e.g., litigation costs, risk of erroneous judgment).[181]

Despite the various persuasive explanations scholars have offered for the business judgement rule, little attention has been given to how business courts' *specialized* nature colors our understanding of what role the business judgement rule plays.

A specialized court recognizes that the principal and agent are in an ongoing business relationship governed by an incomplete contract, with the court as a third player. The goal of all three parties is to minimize total control costs (conflict and competence), which include agent, principal, and adjudication costs. When the principal is using duty enforcement rights against the agent, the court is invited to determine the scope of fiduciary duties. While determining the scope of the fiduciary duties the court has to consider the existence of the principal's other route of accountability, the use of discretionary control rights. The wider the court expands the scope of fiduciary duties, the narrower the space it leaves for the use of discretionary control rights, and vice versa. The wisdom of knowing how to strike a balance between the two is a unique need in corporate law and is

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174 *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919).

175 *See* Jonathan R. Macey, *Public and Private Ordering and the production of Legitimate and Illegitimate Legal Rules*, 82 CORNELL L. REV. 1123 (1997).

176 Stephen M. Bainbridge, *The Business Judgement Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004).

177 *Id.* at 109.

178 *Id.*

179 *Id.* at 95 ("The whole point of the business judgment rule is to prevent courts from even asking the question: did the board breach its duty of care?").

180 *See* Holger Spamann, *Monetary Liability for Breach of the Duty of Care?*, 8 J. LEGAL ANALYSIS 2 (2016).

181 *Id.*

the essential driver behind the need for specialized corporate courts. Moreover, when the court determines the scope of fiduciary duties it also defines the court's own authority relative to the principal. This task of delineating the line between the court's authority and the principal's authority requires a court willing to avoid unnecessary intervention.

Specialized corporate courts are needed not only because of *how* they resolve corporate disputes but because they know *when* to do so and, most importantly, *when not* to do so. Instead of presuming they must resolve all corporate governance disputes, specialized courts consider the most efficient resolution method. Sometimes, this means resolving the matter directly; other times, it involves creating rules for shareholders to address the issue themselves. The utility of specialized corporate courts lies in their understanding of their role as a party to an ongoing triangular relationship, not just as an adjudicator of isolated disputes.

As explained above, shareholders are better positioned than courts to prevent and deter managers' mismanagement.[182] Shareholders have a lower likelihood of mistaking mismanagement for ordinary business failures and possess a greater variety of flexible remedies.[183] Specialized courts recognize shareholders' superiority in these cases and direct them through the use of the BJR.

The business judgment rule limits judicial intervention to cases where the likelihood of mistakes in distinguishing mismanagement is minimal. The first step is focusing on the decision-making "process" (i.e., informed) rather than the "substance" of the decision.[184] Specialized courts understand that evaluating the substance of managerial decisions carries a higher risk of mistaking bad luck for negligence or idiosyncratic vision for a pet project. But even a process-oriented review can incentivize an overly detailed decision-making process, risking wrongful liability for managers in too many opportunities. Consequently, courts further require a showing of gross negligence (rather than simple negligence) before imposing legal liability for a defective decision-making process.[185]

The business judgment rule reflects specialized courts' recognition of shareholders' superior ability to handle mismanagement cases. Unlike generalist courts, which see themselves as the final safeguards of plaintiff rights, specialized courts understand that the efficiency gains from court resolution are limited compared to shareholders' capabilities. This is not to say specialized courts are incapable of addressing mismanagement cases; they could, if necessary, handle corporate governance disputes like any other claim of professional malpractice.[186] However, due to the time and

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[182] *See supra* Part II.

[183] *Id.*

[184] *See supra* note 167.

[185] *See, e.g.*, *id.*

[186] *See, e.g.,* Charles M. Elson, *Why Delaware Must Retain Its Corporate Dominance and Why It May Not*, in CAN DELAWARE BE DETHRONED? 225, 227 (Stephen M.

costs involved in gathering information, the quality of judicial decisions would be lower than if shareholders addressed it themselves. Given the large number of daily business decisions that go awry in the market, the possibility of framing any potential negative outcome as mismanagement would create excessive litigation, thereby increasing adjudication costs. Furthermore, the issues stemming from the court's limited remedies, and the finality of its judgement, would persist. Proper application of the business judgment rule is thus what makes specialized courts special. Their expertise in knowing when to intervene, and when not to, is at the heart of what specialized courts are good for and is embodied in the specialized courts' application of the business judgement rule.

Furthermore, the business judgment rule does not act alone. Legislatively enabled exculpatory clauses in corporate charters also limit specialized courts' review of mismanagement cases, even when gross negligence is present. Section IV.A.2 below provides background on these clauses and analyzes how they work in tandem with the BJR to restrict judicial intervention to takings cases only.

2. Exculpatory Clauses and Mismanagement

Smith v. Van Gorkom marked a shift in the business judgment rule, making *gross negligence*, rather than *bad faith*, sufficient for director and officer liability.[187] In response, the Delaware legislature enabled exculpation clauses which emerged as a mechanism allowing shareholders to restore the pre-*Smith v. Van Gorkom* balance, requiring *bad faith* for liability.[188] Section 102(b)(7) of the Delaware General Corporation Law allows shareholders to protect directors and officers from grossly negligent breaches of their duty of care.[189] The exculpatory clause must be included in the corporation's

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Bainbridge et al. eds., 2018) (arguing that Delaware's dominance is due to its judicial competence); Leo Herzel & Laura D. Richman, *Delaware's Predominance by Design, Foreword* to R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS F-1, F-15-16 (3d ed. Supp. 2001) (highlighting Delaware's depth of precedent and quality of judges); Michael Klausner, *Corporations, Corporate Law, and Network of Contracts*, 81 VA. L. REV. 757, 776 (1995); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 722 (1987) (describing the Delawares strong judicial quality and volume of precedent).

[187] *See* Smith v. Van Gorkum, 488 A.2d 858 (1985) (ruling that the business judgement rule will not protect directors who were grossly negligent by not informing themselves of "all material information reasonably available to them").

[188] Del. Code Ann. tit. 8, § 102 (2022) ("provision eliminating or limiting the personal liability of a director or officer . . . provided that such provision shall not eliminate or limit the liability of . . . acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law").

[189] The original version of Section 102(b)(7) only covered directors, but the statute was amended on August 1, 2022, to include officers as well (albeit only to shareholder rather than corporate harms). *Id.* ("not eliminate or limit the liability of . . . An officer in any action by or in the right of the corporation"). The justification for this legal difference is

charter, requiring consent from both directors and shareholders.[190] The exculpatory clause shields directors and officers from liability even when they were grossly negligent in failing to be properly informed or in establishing a reasonable decision-making process.[191] However, exculpation clauses cannot exempt liability for bad faith,[192] defined as a conscious disregard of one's duties,[193] or in conflict of interest cases. Similarly, following an analogous shift in the treatment of controlling shareholders in cases such as *In re Sears Hometown & Outlet Stores, Inc. Stockholder Litigation*,[194] the legislature enabled a default (i.e., an opt-out) exculpation clause for gross negligence claims levied against controlling shareholders, allowing only for "duty of loyalty," "bad faith," and "improper personal benefit" claims to proceed.[195]

By exempting agents (whether directors, officers, or controlling shareholders) from monetary liability for gross negligence, shareholders signal to the judiciary that they prefer no intervention in mismanagement cases, even when gross negligence is apparent and the business judgment rule's prerequisites are not satisfied.[196] From shareholders' perspective, imposing legal liability on the agent in mismanagement cases is unwarranted, even if the decision-making processes appear defective.

While gross negligence might justify judicial intervention, courts might mistakenly assign liability for a suspected case of mismanagement that was actually a normal business decision, imposing adjudication costs that disturb the principal-agent arrangement. For instance, highly informed directors may make quick decisions without external experts,[197] but fear of judicial review may force them into lengthy, technical procedures. This is unproductive because while well-organized and documented decision-making processes could help prevent some bad deals, they also serve to

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that when officers commit corporate harms, they are generally addressed by the directors (i.e., managers with superior authority), and not the shareholders.

190 *See* Del. Code Ann. tit. 8, § 242 (2023) (outlining procedure for amending the certificate of incorporation after payment for stock).

191 While the clause protects management from monetary liability, it doesn't prevent plaintiffs from seeking injunctive relief. Since these remedies are temporary and fully reversible, they maintain the shareholders' ongoing authority and flexibility. *See* Del. Code Ann. tit. 8, § 102 (2022).

192 *See supra* note 188.

193 *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 64 (Del. 2006) (explaining that bad faith includes conscious disregard of duties).

194 *In re* Sears Hometown & Outlet Stores, Inc. Stockholder Litig., 309 A.3d 474, 483–84 (Del. Ch. 2024) ("The controller also owes a duty of care that demands the controller not harm the corporation or its minority stockholders through grossly negligent action.").

195 Del. Code Ann. tit. 8, § 144 (d)(5) (2025).

196 Here the focus is the conditions of making an informed decision. Acting with bad faith in the sense of having a subjective intent to harm the corporation will be considered as a takings case. See *infra* Section IV.B.

197 This sort of facts is precisely what prompted Smith v. Van Gorkom, 488 A.2d 858, 865 (Del. 1985) ("based on 'rough calculations' without 'any benefit of experts'").

thwart beneficial transactions by the imposition of onerous transaction costs, thereby preventing the maximization of profits.[198] In real world scenarios, many business opportunities cannot be captured through a slow and methodical business process, but rather must be capitalized on through a swift and certain decision, or else the value would be lost.[199] The prominence of exculpatory clauses indicates shareholders believe the business judgment rule alone does not sufficiently limit court intervention to avoid mistakes in mismanagement cases.[200] These provisions are common in the charters of great many public companies incorporated in Delaware.[201]

The application of the business judgment rule and inclusion of exculpatory clauses in corporate charters show that both specialized courts and the parties recognize the need to limit judicial intervention in mismanagement cases. The only cases carved out of the business judgment rule involve managerial bad faith or conflict of interest. Bad faith includes knowingly breaching the law, intent to harm the corporation, and conscious disregard of duties. These cases do not involve decisions where there is a risk that they might be mistaken for misfortune, honest mistake, idiosyncratic vision, or incompetence. The no-conflict requirement isolates self-dealing cases, where courts have an advantage in adjudicating. With the business judgment rule limiting judicial analysis to the decision-making process and exculpatory clauses further constraining intervention to bad faith or self-dealing, specialized courts effectively return mismanagement cases to shareholders, who can resolve them more efficiently. That there was a need for legislative intervention in support of this goal of specialized courts and the BJR, fully explored in Section C below, only highlights the importance of protecting the court's essential specialization.[202]

3. The Required Specialty in Mismanagement Cases

The combination of the business judgment rule and exculpatory clauses streamlines the task for specialized courts. By limiting review to the decision-

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198 *See, e.g.*, Applebaum v. Avaya, Inc., 812 A.2d 880, 886–87 (Del. 2002) ("[T]his Court should not create a safeguard against stockholder inequality that does not appear in the statute . . . the proposed transaction was designed in good faith to accomplish a rational business purpose—saving transaction costs.").

199 *See, e.g.*, Jacob A. Kling, *Rethinking 363 Sales*, 17 STAN. J.L. BUS. & FIN. 258, 272 (2012) ("Even when a company's assets are not perishable, the court reasoned, a 'good business opportunity' might be available that requires the company to act quickly") (citing *In re* Lionel Corp., 722 F.2d 1063, 1064 (2d Cir. 1983)).

200 *See* Gabriel Rauterberg & Eric Talley, *Contracting Out of The Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075, 1084 (2017) ("Public Companies regularly execute such exoneration provisions.") (citing Holger Spamann, *Monetary Liability for Breach of the Duty of Care?*, 8. J. LEGAL ANALYSIS 337, 338 (2016)).

201 *Id. See also* Sarath Sanga, *Network Effects in Corporate Governance*, 63 J.L. & ECON. 1 (2020) (documenting an increase in reincorporation in Delaware following the passage of the exculpation clause provision).

202 *See infra* Section IV.C.

making process and constraining intervention even in cases of gross negligence, specialized courts and corporate actors ensure judicial intervention only occurs in cases of self-dealing or bad faith. Specialized courts recognize that deciding mismanagement cases instead of shareholders increases costs.[203] Ideally, courts direct mismanagement cases back to principals without added costs. Realistically, once mismanagement cases enter the court system, inefficient judicial costs are imposed.[204] Therefore, specialized courts are needed to minimize these costs when mismanagement cases are erroneously brought forth.

The benefit of the business judgment rule and exculpatory clauses is that they allow defendants to swiftly remove cases from the court's docket via a motion to dismiss. This occurs early in the litigation process, before extensive discovery or other pretrial factual development.[205] If the defendant can show the four elements of the business judgment rule are present, the case will be dismissed.[206] In the context of exculpatory clauses, simply pointing to their inclusion in the corporate charter (or non-exclusion in the case of controlling shareholders) will warrant dismissal if the plaintiff is seeking monetary relief and is only alleging a breach of the duty of care.[207]

This highlights the first type of specialization needed by courts handling corporate governance disputes: *claim dismissal specialization*. Courts must differentiate between takings cases, warranting judicial intervention, and mismanagement instances, where dismissal is more efficient. Allowing mismanagement cases to proceed beyond the motion to dismiss stage undermines the efficiency gains of the business judgment rule and exculpatory clauses, especially if cases advance to costly discovery phases.[208] Courts need expertise to quickly distinguish between mismanagement and takings cases early in the litigation process to realize these efficiency gains.

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[203] *See supra* Part II.

[204] Judicial intervention can increase conflict costs, particularly due to the plaintiff's bar, which may pursue unnecessary litigation for attorney's fees. This adds adjudication costs and heightens judicial intervention inefficiency. *See* Goshen & Hannes, *supra* note 65, at 294-95 (explaining how the potential awarding of attorney's fees can shape counsel's incentives and create adjudicatory conflict costs). For further discussion on agency costs associated with potentially frivolous litigation, see Gilson & Mnookin, *supra* note 41; John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions,* 86 COLUM. L. REV. 669, 679-80 (1986) (describing that certain types of suits, such as derivative or class actions, can create high agency costs).

[205] *See* McMillan, *supra* note 88, at 568 ("[T]he true value . . . is not only in preventing judgment or liability from attaching to a defendant, but also in keeping the defendant's legal bills and troubles to a minimum by abbreviating the ordeal.").

[206] *See supra* notes 159-164.

[207] *See* Malpiede v. Townson, 780 A.2d 1075 (Del. 2001); *In re* Cornerstone Therapeutics Inc. Stockholder Litigation, 115 A.3d 1173 (Del. 2015); *supra* note 195.

[208] For discussion on the costs and burdens imposed through discovery obligations, *see* Jonathan Remy Nash & Joanna Shepherd, *Aligning Incentives and Cost Allocation in Discovery*, 71 VAND. L. REV. 2015 (2019).

If courts unfamiliar with corporate law had to conduct research or hear evidence to determine if dismissal is warranted, it would delay the case's dismissal. Longer delays will increase the costs and reduce efficiency.

Specialized courts understand that claims of mismanagement should be dismissed immediately, knowing that shareholders' discretionary control rights and other mechanisms are better suited to regulate this aspect of the incomplete contract.[209] Specialization in "claim dismissal" lowers judicial competence costs and aligns with shareholders' advantage and preference to handle mismanagement cases independently.[210]

The preceding analysis highlights why specialized courts refrain from intervening in mismanagement cases and how they accomplish this via the business judgment rule and exculpatory clauses. Judicial specialization is crucial in mismanagement cases, culminating in claim dismissal specialization. Section IV.B completes the specialization picture by showing why specialized courts are also needed to address self-dealing cases.

B. The Entire Fairness Test and Self-Dealing

Screening out mismanagement cases through the claim dismissal process is necessary for a specialized court, but this is only the first of its benefits. Specialization in claim dismissal is also essential for handling self-dealing cases. Specialized courts must distinguish between self-dealing and non-self-dealing cases and identify which self-dealing cases do not require judicial intervention and should be dismissed or receive lighter review. Once the cases that merit judicial intervention are identified, specialized courts are needed to administer remedial procedures effectively. Section IV.B.1 explains how specialized courts use the entire fairness doctrine to fulfill these functions. Additionally, as shown in Section IV.B.2, court specialization is crucial for limiting judicial intervention to avoid deterring beneficial self-dealing transactions, initially achieved through judicial doctrines and later by legislatively enabled "safe harbors." Section IV.B.3 highlights the necessary connection between judicial specialization and self-dealing.

1. *The Role of the Entire Fairness Standard*

The business judgment rule, as previously explained, does not apply if its prerequisites are unmet, particularly in conflict of interest cases.[211] Instead, courts use the "entire fairness" standard for transactions involving conflicts of interest.[212] This standard applies both when the conflict is

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[209] *See supra* Section I.A.

[210] Also preventing the inefficiency that will result if strike suits are not promptly rejected—creating positive settlement value at the expense of the firm.

[211] New Enter. Associates 14, L.P. v. Rich, 292 A.3d 112, 163 (Del. Ch. 2023) ("When directors . . . engage in self-interested conduct . . . Absent some cleansing mechanism, the decision will 'lie outside the business judgment rule's presumptive protection'").

[212] Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1163 (Del. 1995).

between a managerial agent (director or officer) and the corporation, and when it is between the corporation and a controlling shareholder.[213] The entire fairness standard is "strict," offering no deference to the board's judgment.[214] The burden of proof falls on the conflicted party to demonstrate that the transaction was conducted with a fair process and at a fair price.[215] This standard examines fairness holistically, treating process and price as interrelated components.[216]

Avoiding Transaction Execution Review. Specialization is essential for adjudicating self-dealing transactions because not every aspect of a conflicted transaction requires judicial intervention. Judicial review of conflicted transactions can involve the *execution* of the transaction (whether the self-dealing should occur at all and at any price) and the *price* of the transaction (whether the self-dealing was conducted with adequate compensation). Specialized courts, using the entire fairness standard, understand they must focus on price review only. Execution review requires determining in advance whether transactions are beneficial or harmful, which is challenging even for principals. When courts attempt this task, adjudication costs escalate similarly to when courts mistakenly adjudicate mismanagement cases instead of deferring to principals.

Principals naturally suspect that an agent's support of a conflicted transaction, even those conducted at arm's length and representing fair market value, might be motivated by the agent's self-interest. Due to informational asymmetries, principals cannot determine whether an agent's support of a conflicted transaction is properly motivated. Coping with this issue requires either giving the principal a veto right over self-dealing transactions or allowing the agent to unilaterally execute such deals, subjecting only their price to judicial review. While allowing principals to veto conflicted transactions *ex ante* reduces the risk of unfair self-dealing, it simultaneously introduces the risk of mistakenly blocking beneficial transactions.[217] Agents facing such a regime would have only two options: abandon the transaction entirely, or pursue a less suitable alternative. Either way, the principal's mistaken veto of a beneficial transaction would harm the corporation.

The risk of mistakes only increases when courts have the power to review the execution of transactions. As with mismanagement cases,

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[213] *See, e.g., In re* Match Group, Inc. Derivative Litig., 315 A.3d 446, 460 (Del. 2024) (noting the entire fairness test also applies to controlling shareholders).

[214] *See* Golden Cycle, LLC v. Allan, CIV.A. 16301, 1998 WL 276224, at *6 (Del. Ch. May 20, 1998) (equating entire fairness and strict scrutiny).

[215] *In re* Match Group, Inc. Derivative Litig., *supra* note 213, at 459 ("the defendants bear the burden of demonstrating that the corporate act being challenged is entirely fair").

[216] *Id.* ("unitary test").

[217] The risk is exacerbated when one considers that a principal's decision may be driven by their own self-interests, especially when the principal is a group. See Goshen, *supra* note 120, at 402 (when veto power is placed in the hands "of a small group, the threat of strategic voting increases.").

informational asymmetries regarding the agent's motivation and business plans are greater between courts and agents than between agents and principals.[218] Consequently, courts attempting to veto conflicted transactions would be more problematic than when principals do so. Additionally, the court's limited remedial options and the finality of its judgments, which are issues in mismanagement contexts, also impair court reviews of transaction execution. Furthermore, some business opportunities are unique to the agent involved in a self-dealing transaction, and litigation delays could reduce or entirely preclude the benefits of such transactions.[219] Put differently, when a conflicted transaction is priced at fair market value, the only risk is that the agent may gain *indirect* benefits. Specialized courts using the entire fairness standard recognize that their limitations in this scenario are like those in mismanagement cases. Thus, they understand that they should not attempt to preclude the execution of the transaction entirely.

On the other hand, transaction prices that do not reflect fair market value are the root problem in self-dealing cases.[220] The private benefits an agent extracts from improper self-dealing amount to the difference between the agreed-upon transaction price and the fair market value. When a significant price difference exists, the risk that the agent is illicitly extracting private benefits at the principal's expense is greater than the risk of the court erroneously imposing unwarranted liability. Therefore, while specialized courts avoid reviewing the execution of self-dealing transactions, they do review the transaction price. This approach targets the root of self-dealing issues (the price difference) without undermining management's fundamental control rights.

Appraisal specialization. The entire fairness standard requires examining whether the process and price of a transaction are comparable to similar transactions. This standard is non-deferential when reviewing for "fair price and fair dealings," but it respects the agent's judgment regarding the execution of the transaction.[221]

When courts provide remedies for unfair self-dealing, they must use their price review mechanisms to quantify the difference between fair and unfair prices. This need highlights the importance of courts' *appraisal specialization*. Courts must possess the expertise to accurately appraise remedies based on detailed financial valuations and expert reports. Consider the expertise required to determine the "fair value" of self-dealing transactions, which can range from buying land to purchasing a whole corporation, intellectual property like patents, or managerial services.[222]

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[218] See *supra* Section II.A.

[219] *See, e.g.,* Goshen, *supra* note 120, at 400 ("Indeed, in some cases, an important transaction may simply be impossible without such self-dealing.").

[220] *See supra* Section I.B. (detailing Scenario 7—self-dealing).

[221] *See, e.g., In re* Match Group, Inc. Derivative Litig., 315 A.3d 446, 461 (Del. 2024) (explaining that conflict alone is not a cognizable harm and may be beneficial).

[222] *See, e.g.*, Cede & Co. v. Technicolor, Inc., CIV.A. 7129, 2003 WL 23700218, at *2

Assessing fair price involves understanding complex asset valuations, routinely disputed by both parties.[223] Each party in entire fairness litigation typically hires specialized counsel and financial professionals who provide differing appraisals of the asset's fair value and use varying financial methodologies.[224] Financial professionals might use models that project future earnings and discount them to present value (the "discounted cash-flows" approach), compare the relevant asset to similar market transactions (the "comparables approach"), or rely on the deal terms or market price of the asset if it is publicly traded.[225]

An unspecialized and inexperienced court would struggle with this complex factual analysis and its application to the legal standard of "fairness," leading to increased adjudication costs. Conversely, a specialized court, well-versed in different valuation models and fairness standards, can efficiently navigate between financial valuations and legal principles to administer a fair price remedy with ease and predictability. However, it is important to note that the appraisal complexity is not different from the complexity involved in adjudicating the medical malpractice of a brain surgeon. This part of court specialization alone is thus not what makes specialized corporate courts unique, but it does add another layer atop the need for claim dismissal specialization.

The entire fairness standard highlights the need for specialized courts by focusing on transaction price rather than execution. Yet, judicial specialization in self-dealing transactions extends further. As the following Section demonstrates, specialized courts have also developed cleansing doctrines, now altered and reinforced as "safe harbors," to complement the entire fairness standard, further curtailing judicial intervention and ensuring that beneficial conflicted transactions are not prevented from occurring in the first place.

2. *Safe Harbors and Self-Dealing*

Even when a court limits its review of a conflicted transaction to price, self-dealing transactions remain costly due to the expense of entire fairness litigation. This added cost can deter parties from entering beneficial conflicted transactions. Specialized courts thus face the challenge of structuring review mechanisms that provide remedies for improper self-dealing while ensuring that efficient conflicted transactions are not discouraged. To address this challenge, specialized courts developed

(Del. Ch. Dec. 31, 2003) ("Valuing an entity is a difficult intellectual exercise.").

223 *See, e.g.*, Carl L. Stine, *MFW and the Legal Fiction of Market Equivalency*, 44 DEL. J. CORP. L. 57, 66–67 (2020) ("Cases were no longer filed in Delaware immediately . . . Instead, financial experts were hired and detailed complaints were filed").

224 *Id.*

225 *In re* Appraisal of Regal Entm't Group, CV 2018-0266-JTL, 2021 WL 1916364, at *18 (Del. Ch. May 13, 2021) (explaining the various methodologies and their treatment under Delaware law).

"cleansing mechanisms"—when legislators did not provide them—to prevent beneficial conflicted transactions from being overly deterred by the costly entire fairness litigation process.

Prior to 2025, Delaware courts created "cleansing doctrines" that allowed transactions involving conflicted managers and controlling shareholders to be structured *ex ante* so that any litigation would be reviewed under the business judgment rule rather than the entire fairness standard.[226] These doctrines "neutralized" or "cleansed" transactions of the risk of expensive entire fairness litigation,[227] thereby further limiting judicial intervention. Once parties complied with the cleansing requirements, the court no longer needed to conduct complex fair price valuations but instead focused solely on verifying the appropriateness of the cleansing process.[228]

In Delaware, when a conflicted transaction involved a managerial agent (a director or officer), the transaction could be cleansed back into the business judgment rule if approved by a committee of disinterested directors *or* by a vote of fully informed, disinterested shareholders.[229] However, if the conflict of interest involved a controlling shareholder, both cleansing mechanisms were required.[230] This additional requirement arose because Delaware courts doubted whether directors are truly independent, given that their positions depend on the controlling shareholder's confidence. Similarly, Delaware courts viewed the vote of disinterested shareholders as not entirely free, due to implicit concerns over retaliation from the controlling owner. Therefore, both cleansing mechanisms were thought necessary in all types of controller self-dealing.[231] For similar reasons, the court further required that the controlling shareholder's cleansing commitment be made before the start of any substantive negotiations (known as the "ab initio" requirement) and that all voting directors be disinterested, rather than just a majority.[232]

Although Delaware's cleansing doctrines were moderately effective in reducing the chilling effect on beneficial conflicted transactions,[233] many

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226 *In re* Match Group, Inc. Derivative Litig., 315 A.3d 446, 463 (Del. 2024) (explaining that business judgment rule applies if conditions for cleansing of controlling shareholder transactions were satisfied); Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 312–13 (Del. 2015) (explaining the same in director and officer cases).

227 *Id.*

228 *Id.*

229 *See* Corwin v. KKR Fin. Holdings LLC *supra* note 226.

230 *See In re* Match Group, Inc. Derivative Litig., *supra* note 226.

231 *See* J. Travis Laster, *The Effect of Stockholder Approval on Enhanced Scrutiny*, 40 WM. MITCHELL L. REV. 1443 (2014) (explaining Delaware's cleansing doctrines).

232 *See* Salladay v. Lev, CV 2019-0048-SG, 2020 WL 954032, at *10 (Del. Ch. Feb. 27, 2020) (explaining the development of the ab initio requirement), and *In re* Match Group, Inc. Derivative Litig., 315 A.3d 446, 472–73 (Del. 2024) (explaining the unanimous independence condition).

233 *See, e.g.*, *id.* at 461 ("'an interest conflict is not in itself a crime or a tort or necessarily injurious to others.' In other words, 'having a 'conflict of interest' is not something one is 'guilty of.'' Indeed, a corporation and its stockholders may benefit.").

corporations seeking to comply with the cleansing mechanisms still failed in litigation.[234] Some market participants and the Delaware legislature believed that the bar for meeting the cleansing conditions was too high, failing to properly reduce the chilling effect on beneficial conflicted transactions.[235] To reduce the level of judicial intervention, the Delaware legislature enacted "safe harbor" provisions to streamline the process for effectuating these transactions, thereby allowing specialized courts to focus their review on truly harmful self-dealings.[236]

The new provisions explicitly state that compliance with the necessary procedures for avoiding fairness litigation creates an irrebuttable presumption of validity under the business judgment rule.[237] In other words, meeting these procedures enables courts to immediately apply their claim dismissal specialization without engaging in any assessment of the transaction's "rationality."

Additionally, the new provisions sought to streamline the procedures for avoiding fairness litigation along three main parameters. First, all safe harbors now require only a majority of the shareholder votes cast, rather than a majority of outstanding shares.[238] Second, the approval requirements for transactions involving controlling shareholders—except for "going-private" transactions (i.e., when a controller acquire all minority shares)—were aligned with those governing managerial agents, requiring either director or shareholder approval, but not both.[239] This reflected the legislative view that concerns over underlying approvals of controlling shareholder conflicts are only warranted in going-private transactions. Third, the ab initio requirement was relaxed to allow shareholder approval, so long as the approval requirement was established before the transaction was submitted for a shareholder vote.[240]

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234 *See* Nathaniel J. Stuhlmiller and Brian T.M. Mammarella, *'MFW' Just Turned 10, but Is It Worth the Candle?*, DEL. BUS. CT. INSIDER (July 4, 2024) (between mid-2019 to mid-2024, MFW cleansing defenses succeeded in only 4 of 15 cases).

235 *See* Morris, Nichols, Arsht & Tunnell LLP, *Thirty Years Later – Why Corporations Continue to Choose Delaware: General Perspectives and Thoughts on Proposed Amendments*, https://www.morrisnichols.com/insights-thirty-years-later-why-companies-continue-to-choose-delaware-general-perspectives-and-thoughts-on-proposed-amendments (explaining the legislative proposals as "balancing amendments" heeding market demands).

236 Del. Code Ann. tit. 8, § 144 (a)-(c) (2025).

237 *See* Morris, Nichols, Arsht & Tunnell LLP, *supra* note 235 (explaining that the new statute is "merely a recitation of the consequence of the invocation of an irrebuttable version of the business judgment rule.").

238 Del. Code Ann. tit. 8, § 144 (a)(2), (b)(2), and (c)(1) (2025).

239 Del. Code Ann. tit. 8, § 144 (b) (2025).

240 Del. Code Ann. tit. 8, § 144 (b)(2) and (c)(1)(2025). Other relevant changes included tweaks to the analysis of whether directors are conflicted. *See* Del. Code Ann. tit. 8, § 144 (d)(2)-(d)(3) (2025) (aligning the definition of pubic company director conflict with stock exchange definitions, unless rebutted by "substantial and particularized facts").

At the time of writing this Article, the efficacy of these amendments remains uncertain. In particular, questions persist regarding the application of safe harbors to transactions approved solely by directors when a controlling shareholder is involved.[241] Importantly, corporations wishing to opt out and revert to the previous cleansing mechanisms can do so through their charters or bylaws.[242] However, the essential point is that safe harbors, like their cleansing predecessors, are designed to supplement the entire fairness standard while reinforcing the court's claim dismissal specialization.

Safe harbors thus enable principals and agents to avoid the high costs of entire fairness litigation. Beneficial self-dealing transactions can proceed without fear of costly litigation, knowing that securing the requisite approvals afford an irrebuttable presumption of validity under the business judgment rule. Consequently, if such self-dealing cases are brought to court, the court's role shifts from conducting fair price valuation to verifying whether the safe harbor mechanisms were properly followed—after which it promptly applies the business judgment rule. In essence, safe harbor mechanisms reengage the court's specialization in claim dismissal.

As explored further in Section C, the legislative support provided by the safe harbors—much like the enactment of the exculpation provisions—underscores the importance of protecting the court's essential specialization.[243]

3. *The Required Specialty in Self-Dealing Cases*

Recall that claim dismissal specialization is first designed to swiftly dismiss mismanagement cases. This unique specialization carries past this first screening and extends to self-dealing cases as well. As previously discussed, specialized courts avoid intervening in the execution of self-dealing transactions and develop cleansing mechanisms to limit their intervention even further. More importantly, as shown next, the claim dismissal specialization allows for accurately identifying harmful self-dealings while dismissing the rest, ensuring only the truly damaging cases proceed to judicial review.

Correctly identifying self-dealing requires a recognition that not all conflicted transactions are harmful and violate the duty of loyalty.[244] Since the corporate contract is incomplete, the exercise of identifying self-dealing transactions that violate the duty of loyalty requires answering a counterfactual question: what would the parties have agreed to if they had

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[241] These open questions stem from the concern that motivated the previous cleansing mechanisms: it is unclear if directors of controlled companies are ever sufficiently independent.

[242] Del. Code Ann. tit. 8, § 144 (c)(6)(a) (2025).

[243] *See infra* Section IV.C.

[244] Goshen, *supra* note 120, at 400 (noting that conflicted transactions may benefit shareholders).

the opportunity to negotiate this scenario contractually?[245] Answering this question leans on the claim dismissal specialization to properly identify when what may appear as a conflict of interest is not so. Specialized courts are able to do so both when reviewing corporate *transactions*, investigating whether the agent is effectively standing on "both sides" of a deal, and when reviewing corporate *actions* (e.g., issuing a dividend or adopting bylaws), investigating whether the function or structural nature of the action admits of takings by the agent.

Identifying self-dealing when the agent stands on "both sides" of a transaction (i.e., the agent contracts with the firm) is relatively straightforward for courts. Courts can utilize their experience in reviewing contracts and ownership documents to determine if an agent is acting for both the firm and themselves (e.g., an agent buying real estate from the firm through a corporation they own).[246] Similarly, the courts can utilize their experience to see if the relationship between the agent and a third-party is sufficiently close so as to be effectively the same as standing on both sides of a transaction (e.g., deciphering between cases where a director makes the company sell real estate to his spouse, on one end of the spectrum, and cases where the director pushed for a sale to a mere business acquaintance, on the other).[247]

Matters become more complex when the potential conflict concerns a corporate action. In corporate actions, correctly identifying whether it is a self-dealing case requires an understanding of the *function* of the corporate action (i.e., is it de facto a benefit to the agent) as well as the *structural* context of the action (i.e., are there inherent entity conflicts). We address both, in this order.

When there is a potential *functional conflict* with the firm, courts are required to investigate corporate actions with equal *legal* effects on all parties but different *economic* impacts on the agent.[248] Specialized courts must discern when these economic differences warrant the entire fairness

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245 *See* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 429 (describing gap filing in corporate contracts).

246 Strassburger v. Earley, 752 A.2d 557, 570 (Del. Ch. 2000) ("Where the controlling shareholder and the directors stand on both sides of the transaction, they bear the burden to demonstrate that the transaction was entirely fair").

247 *See, e.g.*, Marchand v. Barnhill, 212 A.3d 805, 820 (Del. 2019) (analyzing that directors may even be considered independent of one another in the face of some level of friendship).

248 *See* Cinerama, Inc. v. Technicolor, Inc., CIV. A. 8358, 1991 WL 111134, at *11 (Del. Ch. June 24, 1991 ("To follow a rule, however, that mechanically invokes the consequences of the entire fairness . . . is not required. What is required . . . is that the plaintiff plead and prove . . . [the] directors involved had material financial or other interest in the transaction different from the shareholders generally."); William T. Allen, Jack B. Jacobs, Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287 (2001) (analyzing the role of functional analysis in Delaware law).

standard. For example, consider the famous *Sinclair Oil Corp. v. Levien* case,[249] involving a parent company that is a controlling shareholder of a subsidiary in the same industry. The parent company appoints its employees as the subsidiary's directors and then has the subsidiary's board pay large dividends to all shareholders pro rata. The dividend could provide the parent company with resources to pursue its business opportunities while leaving the subsidiary without resources to pursue its own business opportunities. Although the dividend decision legally affects all shareholders equally, it provides the controller with a unique economic benefit. Is this a self-dealing?

An experienced court is necessary to understand that such facts alone should not trigger the entire fairness standard. Expert courts recognize that if all shareholders receive their share of the cash dividends, their corporate ownership *rights* are not excluded or harmed, even if the outcome is not everyone's *preference*.[250] Specialized courts also understand that a parent company's pursuit of a corporate opportunity in the same industry does not necessarily mean that opportunity belongs to the subsidiary.[251] In short, properly classifying functional conflicts is part of the claim dismissal specialization.

When there is a potential *structural conflict* within a firm, the court must investigate a corporate action inherently mired in a conflict of interest due to the nature of the corporate structure. For example, consider a board employing defensive measures to block a hostile takeover or deter a hedge fund activist. Is this action self-dealing? Here, mixed motives are present. Blocking a hostile raider or activist helps directors keep their jobs but may also be motivated by a desire to protect the company from harmful acquisitions or activism.[252] Specialized courts recognize that such structural conflicts of interest are unavoidable and that effectively regulating them requires a nuanced approach. Instead of immediately subjecting such actions to costly entire fairness review or dismissing the case through the BJR, specialized courts employ an intermediate standard of review to determine if the corporate action is reasonable and proportional.[253] This reasonableness analysis further underscores the need for specialization, as courts must utilize familiarity and expertise in assessing various unique corporate technologies and their impact on both agent and principal costs.[254]

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[249] Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

[250] *Id.*

[251] This skill includes the need for specialized courts in interpreting and enforcing corporate opportunity waivers. *See* Rauterberg & Talley *supra* note 200.

[252] *See* Goshen & Steele, supra note 149, at 420.

[253] *See, e.g.*, Kellner v. AIM ImmunoTech Inc., 3, 2024, 2024 WL 3370273, at *10 (Del. July 11, 2024) (articulating the standard of review).

[254] *See, e.g.,* Marcel Kahan & Edward B. Rock, *Anti-Activist Poison Pills*, 99 B.U. L. REV. 915, (2019) (discussing the innovative use of poison pills in the activism context).

The combined utility of claim dismissal and appraisal specialization allows courts to address unfair self-dealing without vetoing beneficial conflicted transactions *ex post* or chilling them *ex ante*. In conflicted transactions, as in mismanagement cases, claim dismissal is crucial. Courts must provide remedies for unfair self-dealing when necessary and recognize when principals and agents can resolve conflicts on their own. To this end, courts utilize the safe harbor procedures to delineate which conflicted actions should not be subjected to entire fairness litigation. Essentially, courts need to discern between self-dealing cases where adjudication costs are higher than principal costs, and vice versa.

C. Specialized Courts and Legislative Interventions

Adequately effectuating the role of specialized courts utilized legislatively enabled exculpation provisions in mismanagement cases and legislatively enabled safe harbors in self-dealing cases. This raises the question: if specialized courts have such a high level of competence, why did the legislature need to intervene? One might argue, for instance, that such legislative intervention is itself evidence that the court is not adequately specialized. Conversely, others might argue that legislative intervention in a specialized corporate court's incremental doctrinal development is categorically wrong. Neither position is defensible. Legislative intervention does not entail an unspecialized court, nor are specialized courts infallible institutions immune from mistakes requiring legislative correction. Instead, the relationship between specialized courts and the legislature reinforces and safeguards the courts' essential function: claim dismissal. This Section demonstrates that legislative interventions are sometimes necessary to correct judicial errors in a *timely fashion,* particularly in the area where specialized corporate courts have an inherent tendency for excessive intervention—namely, the *presence of conflict*.

While the careful and incremental development of judge-made law is much to credit for the unique specialization of corporate courts, it is important to acknowledge that legislative interventions in corporate law are a feature, not a bug.[255] Beyond exculpation provisions and safe harbors, corporate legislation has included, for instance, the authorization of corporate opportunity waivers (allowing agents to take corporate opportunities under prescribed conditions), the establishment of corporate "captive insurance" (allowing internal corporate entities to insure agents), and the extension of a long-arm personal jurisdiction statute over corporate officers.[256] These examples show that specialized courts do not act alone, and never have. Before Delaware ascended to preeminence in corporate

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[255] *See* Assaf Hamdani & Kobi Kastiel, *Courts, Legislation and Delaware Corporate Law*, J. CORP. LAW (forthcoming, 2025) (detailing and classifying the history of legislative interventions in Delaware).

[256] *See* Morris, Nichols, Arsht & Tunnell LLP *supra* note 237.

law, New Jersey led the field, and it was Delaware's *legislative* decision to amend its constitution and adopt a statutory corporate law that ignited the judicial engine that later evolved into a specialized court.[257] Similarly, it was the legislative authorization of exculpation provisions that ultimately enabled Delaware to overtake New Jersey.[258]

The historical and contemporary significance of legislative interventions in corporate law, however, does not suggest that a court has failed to be specialized. Even the most skilled professionals make mistakes, and judges specializing in corporate law are no exception. The mere fact that judges have occasionally taken corporate law in the wrong direction is insufficient to undermine the designation of a specialized corporate court. Indeed, as shown in the preceding Sections, the Delaware Chancery Court's development of the business judgment rule and its related doctrines is a landmark achievement, solidifying its status as a specialized court—even if legislative adjustments to exculpation and safe harbors were necessary.

While some level of judicial error is inevitable, it is important to recognize that when specialized corporate courts make mistakes, judicial course correction is inherently slow. First, judge-made law is limited to the disputes that reach the court; judges cannot revisit a legal question unless litigants bring it before them.[259] Second, appeals processes are expensive and time-consuming.[260] Lastly, courts—out of respect for their own incrementalism—are very reluctant to overturn precedent, even when they disagree with it: "Mere disagreement with the reasoning and outcome of a prior case, even *strong* disagreement, cannot be adequate justification for departing from precedent or *stare decisis* would have no meaning."[261]

Courts are slow and methodical for good reasons, but markets move quickly. Specialized corporate courts thus occupy a unique position: their expertise lies in knowing when to dismiss cases and allow shareholders and managers to resolve disputes privately. However, judicial errors can create

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257 *See* Amy Simmerman, William B. Chandler III, and David Berger, *Delaware's Status as the Favored Corporate Home: Reflections and Considerations*, Harvard Law School Forum on Corporate Governance, available at (https://corpgov.law.harvard.edu/2024/05/08/delawares-status-as-the-favored-corporate-home-reflections-and-considerations/) (February 25, 12:08 PM).

258 *See* Sanga *supra* note 201; Andrew Verstein, *The Corporate Census* (March 22, 2025) (documenting that 1986, the year the exculpation amendment was adopted, temporally coincided with Delaware's ascent). Available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5154952.

259 *See generally,* Stephen Darwall, *Law and the Second-Person Standpoint*, 40 LOY. L.A.L. Rev. 891 (2007) (conceptualizing this foundational legal structure).

260 *See, e.g.*, Gail Weinstein, Steven J. Steinman, and Steven Epstein, *Sponsor-Controller Cleared of Conflicts in Sale Near Fund's Term End*, Harvard Law School Forum on Corporate Governance, https://corpgov.law.harvard.edu/2025/03/02/sponsor-controller-cleared-of-conflicts-in-sale-near-funds-term-end/ (March 2, 2025) ("Now, *seven years later*, the court, in a post-trial decision issued January 7, 2025, concluded instead that the Merger was not a conflicted-controller transaction.") (emphasis added).

261 Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1280 (Del. 2021).

environments in which disputes that should have been left to private ordering become mired in unnecessary litigation and costs. Given the rapid pace of the markets and the high volume of transactions, judicial mistakes can at times impose unacceptably high costs. In such cases, legislative intervention becomes not only necessary but also beneficial, as it preserves the incrementalism that specialized judges rely on to develop their claim dismissal expertise.

The areas of corporate law in which legislative interventions are most likely to be needed are also predictable. Since specialized courts' essential function is claim dismissal, they are designed to focus on and offer remedy to cases involving *conflict*. Specialized courts understand that in the absence of conflict, cases should be dismissed, while the presence of conflict may warrant judicial involvement. The complexity, as demonstrated by Parts III and IV, lies in the fact that some conflicts are better left to shareholders and managers. And although specialized courts develop doctrines to focus on harmful self-dealing transactions rather than all conflict cases, they have a natural and inherent tendency to overreach in conflict-laden cases. In other words, what makes specialized corporate courts special is also precisely what sometimes leads to judicial error.

This is why exculpation clauses are to mismanagement cases what safe harbors are to self-dealing cases: legislative interventions designed to protect and reinforce the claim dismissal role of specialized courts after the presence of conflict led to over-intervention. In *Smith v. Van Gorkom*, the case that triggered the need for exculpation provisions, the charge was mismanagement, but the underlying concern was the defendant's motivation to secure a cash-out deal before his nearing mandatory retirement.[262] The Delaware Supreme Court's narrowing of the business judgment rule stemmed from concerns that the transaction approval process was rushed—a speed driven by Van Gorkem's personal need for a payout rather than the corporation's best interest.[263] While the court did not find that the board acted in bad faith, it sought to adjust the business judgment rule to ensure shareholders had a remedy in similar conflict cases.[264]

The safe harbor amendments,[265] similarly, were triggered by cases in which the Chancery Court gradually expanded its involvement in conflicted transactions by broadening the definition of a controller,[266] and

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[262] *See supra* Section IV.A.2. and Smith v. Van Gorkum, 488 A.2d 858, 866 (1985) (explaining the retirement incentive).

[263] *Id.*

[264] *Id.*

[265] Del. Code Ann. tit. 8, § 144 (a)-(c) (2025).

[266] Originally, courts defined a controller as anyone who either (1) held a majority of the voting shares or (2) was deemed a *de facto* controller, typically requiring at least 35% of voting power and additional managerial influence. Over time, courts broadened this definition, finding *de facto* control even when an individual held a small percentage—or even none—of the corporation's stock (e.g., lenders). *See* Tomer S. Stein, *Debt as Corporate Governance*, 74 HASTINGS L.J. 1281, 1296 (2023) (describing this

incrementally heightened the requirements to cleanse non-harmful self-dealing transactions,[267] as it was naturally reluctant to curtail its role in resolving conflict cases. Obviously, the cases triggering the judicial broadening of the controller definition involved conflicts that the court believed required its specialization in providing a remedy. However, not all conflicts warrant judicial intervention. Recognizing this overreach, in 2025 the Delaware legislature intervened, limiting courts' ability to designate a person as a controller subject to fiduciary duties,[268] and relaxing the cleansing requirements.[269]

This legislative intervention was predictable because courts are facing a conflicts case when they need to determine whether someone is a controlling shareholder subject to fiduciary duties. The challenge is that such determinations are not based solely on the presence of conflict—many third parties (e.g., customers) may have a conflict with a corporation—but rather on whether the conflict is the kind that warrants fiduciary duties. If the court were to hold that such a defendant is not subject to fiduciary duties, it would be creating a rule that would freeze them out of such conflict cases going forward. This is inherently difficult for even a specialized court to do, as, again, the very specialty and essence of a specialized corporate court is standing ready to aid in conflicted transactions. The legislative intervention thus provided a clear claim dismissal mechanism, allowing courts to simply check whether the defendant meets the minimum ownership threshold.

Legislative interventions in doctrines developed by specialized courts are neither a stain on the success of specialized courts nor necessarily deleterious interventions. Legislatures play a critical role in ensuring timely, cost-effective mechanisms for facilitating claim dismissal, particularly in conflict cases, where specialized courts may mistakenly overreach.

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development in controller doctrine).

Delaware courts also labeled individuals as controllers for specific transactions, even if they were not controllers in a general sense. Tornetta v. Musk, 310 A.3d 430, 500 (Del. Ch. 2024) (delineating transaction-specific control); Basho Techs. Holdco B, LLC v. Georgetown Basho Inv'rs, LLC, CV 11802-VCL, 2018 WL 3326693, at *29-*30 (Del. Ch. July 6, 2018) (finding that an investor is a controlling shareholder for a specific transaction because the investor could use its contractual rights to effectively block other fundraising efforts); Williamson v. Cox Communications, Inc., CIV.A. 1663-N, 2006 WL 1586375, at *4-*6 (Del. Ch. June 5, 2006)(finding that a controlling shareholder litigation can proceed past the motion to dismiss based on allegations of transaction-specific control stemming from contractual rights and the contractual leverage of being the sole significant customer); Elizabeth Pollman and Lori Will, *The Lost History of Transaction-Specific Control*, J. CORP. LAW (forthcoming, 2025), available at SSRN: https://ssrn.com/abstract=5138377 (detailing the historical development of the doctrine and pointing to the challenges it presents).

[267] *See supra* Section IV.B.2.

[268] Under the new amendment, courts cannot find *de facto* control unless the individual owns at least one-third of the voting shares. Del. Code Ann. tit. 8, § 144 (e)(2) (2025).

[269] *See supra* Section IV.B.2.

V. MOVING TO TEXAS? IMPLICATIONS FOR THE FUTURE OF STATE CORPORATE LAW

Specialized corporate law courts are a necessity. The chief contribution of this Article is in unmasking this all-important judicial role and delineating how it is achieved, and ought to be further realized, through the various foundational legal doctrines of corporate law. This Part takes this insight even further. Given the need for specialized courts, was Elon Musk correct in moving Tesla to Texas?[270] Were the shareholders wise to vote in favor of this move?[271] What can other states, such as Navada, learn from Texas's efforts, and what if Musk convinces Congress to intervene? Armed with the novel insights of the foregoing Part, we can finally answer these questions and prescribe policy recommendations for the political economy of corporate law.

Regarding the ability of the Texas business law court to serve as an effective adjudicator of corporate disputes, similar to Delaware courts, the task ahead is difficult but attainable. To do so, it will have to ensure the hiring of competent judges and the development of laws that demonstrate expertise in participating in the special triangular relationship among courts, principals, and agents.[272] As a first step, the Texas court must understand that it is not the sole recourse for corporate harms.[273] Unlike the adjudication of isolated disputes, the court will need to demonstrate the prowess necessary to distinguish between cases that require its intervention and those that do not. Following the blueprint proposed in this Article, the Texas business law court should specialize in distinguishing between mismanagement and self-dealing cases.[274]

To achieve this specialization, judges must develop the ability to defer to corporate directors in business decisions and swiftly dismiss improperly brought cases.[275] Additionally, they need to develop appraisal specialization focusing on price review while avoiding reviewing transaction execution. To further limit their intervention, judges should develop cleansing mechanisms or utilize legislatively enabled safe harbors to help principals and agents avoid the burden of entire fairness review. Moreover, when identifying potentially conflicted actions, they must distinguish between cases that should be dismissed and those that merit enhanced judicial scrutiny.[276] Overall, the Texas Business Court should specialize in identifying when resolution is best left to the principals and when it is best served through judicial intervention.

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270 *See supra* note 1.
271 *See supra* note 3.
272 *See supra* Section 1.A.
273 *See supra* Part II.
274 *Id.*
275 *See supra* Section IV.A.3.
276 *See supra* Section IV.B.

Currently, the Texas business law court is in its infancy, and it faces a few particularly difficult obstacles: jury trials, lack of precedent, and limited judicial experience.[277] But with dedication to the expert skills discussed here, Texas may yet, over time, develop the specialized court required for corporate disputes. Indeed, a February 2025 legislative proposal demonstrates that Texas is aimed at heading in that direction.[278] Most importantly, the proposal will allow corporations to opt out of jury trials.[279] This is crucial, as jurors, unlike judges, are unable to lean on economies of scale and scope to develop the claim dismissal expertise. Such legislative intervention could potentially enable the Texas court to develop its necessary claim dismissal function, reducing adjudication costs and improving firm value.

Scholars and commentators who are sensitive to Delaware's proven track record have painted Tesla's move to Texas as a hopeless endeavor.[280] They argue that since even a successful Texas business law court will resemble Delaware's court, the move at best imposes unnecessary transaction costs.[281] They further contend that Elon Musk and the Tesla board's push for this move is driven by the expectation that Texas judges and legislators, with whom they have relationships, will design laws allowing them to entrench themselves in the Tesla corporation—thereby reducing shareholders' oversight.[282] Supporters of Tesla's move, on the other hand,

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[277] *See* Shane Goodwin, *The Lone Star Docket: How the Texas Business Court Will Shape the Corporate Landscape* (November 18, 2024). Available at SSRN: https://ssrn.com/abstract=5024710 or http://dx.doi.org/10.2139/ssrn.5024710 (detailing the Texas specific rules).

[278] *See* Foley & Lardner LLP, *Newly Filed Legislation Positions Texas as a Leading State for Incorporations* (Feb. 27, 2025), https://www.foley.com/insights/publications/2025/02/newly-filed-legislation-positions-texas-leading-state-incorporations/.

[279] *Id.*

[280] *See, e.g.*, Gareth Vipers. Ryan Felton, and Ginger Adams Oti, *Elon Musk Wants to Move Tesla's Incorporation From Delaware to Texas*, THE WALL STREET JOURNAL (Feb. 1, 2024 4:12 PM), https://www.wsj.com/business/tesla-to-hold-shareholder-vote-to-incorporate-in-texas-elon-musk-says-8eb78eef ("'The capital you're going to have to expend to create a real business court with that expertise is going to be a lot more, frankly, than the income it produces,' . . . 'Frankly, to move because [Musk] is unhappy with a particular judge's ruling at a particular point in time is very ill-advised,'"—quoting Professor Charles Elson); Ann Lipton, *You'll Never Guess What Today's Blog Post is About*, BUSINESS LAW PROF BLOG (May 31, 2024), https://lawprofessors.typepad.com/business_law/2024/05/youll-never-guess-what-todays-blog-post-is-about.html (arguing that the timing of the Texas moves is likely about a conflict of interest and otherwise has no discernible benefits).

[281] *See, e.g.*, *id.* ("[C]ontemplating an expensive switch – involving special committee payments, advisors, hours, and expert analysis, not to mention vote whipping – for benefits that even the company itself claims largely are about branding.").

[282] *See, e.g.*, Matt Levine, *Texas Tempts Tesla*, BLOOMBERG (Feb. 1, 2024 2:51 PM), https://www.bloomberg.com/opinion/articles/2024-02-01/texas-tempts-tesla ("Elon Musk comes into court saying 'well that may all be true but what you are missing is that I am Elon Musk' and Texas Governor Greg Abbott is in the first row of spectators with

point to Delaware's treatment of Musk's compensation package as a sign that Delaware has veered off its path of success.[283] They argue that the move to Texas might be justified precisely because while Texas has yet to prove that its court can achieve the required specialization, Delaware has begun to undue their own specialized doctrines anyways.[284]

Both the move's supporters and its objectors are mistaken. Regarding the move's supporters, a sober look at Delaware's specialized courts, as detailed in this Article, shows that even if we may disagree with some of its recent decisions, they are certainly not remotely close to undoing Delaware's entire jurisprudential nexus between corporate law and specialization. To be sure, while the factual and doctrinal questions surrounding the ratification of Musk's compensation package are thorny, we are sympathetic to the possibility that invalidating the ratification was wrong. Indeed, if and to the extent this decision was improper, it was improper precisely for the reasons uncovered in this Article: A court that dispels conflicted yet potentially beneficial transactions (i.e., the compensation package) ex ante (i.e., invalidating the original shareholder approval) and ex post (i.e., ignoring the post-invalidation shareholder ratification) elevates its role above that of the shareholders. It could very well be that Delaware law was in need of an ironing to its controlling shareholder wrinkles in this regard,[285] and, at any rate, the legislative amendments discussed in Section IV.B.2 and IV.C were designed to do exactly that.[286] But even if that's the case, it does not discredit the well thought out and carefully developed specialization that Delaware otherwise offers by its application of the BJR and all related review doctrines.

Nevertheless, the objectors to Tesla's move are also wrong to paint Tesla's move as ill-advised. This objection is mistaken because it fails to properly account for the impact of home incorporation on the triangular relationship among agents, principals, and courts; and incorrectly assumes that board and controller entrenching mechanisms will necessarily be detrimental rather than beneficial.

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a big sign saying 'TX <3 U ELON,' is the Texas business court, in its first real high-profile case, going to say 'actually it's illegal to pay Elon Musk that much'? It absolutely is not.").

[283] Keith Paul Bishop, *Delaware Court Awards Attorneys Nearly $18,000/Hour for Frustrating the Will of the Stockholders*, CALIFORNIA CORPORATE & SECURITIES LAW (Dec. 10, 2024), https://www.calcorporatelaw.com/delaware-court-awards-attorneys-nearly-18000/hour-for-frustrating-the-will-of-the-stockholders.

[284] *Id.*

[285] *See, e.g.*, Zohar Goshen, Assaf Hamdani, and Dorothy Lund, *Fixing MFW: Fairness and Vision in Controller Self-Dealing*, Harv. Bus. Law Rev. (forthcoming 2025), available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5061341 (offering improvements to current Delaware controlling shareholder law).

[286] *See supra Section IV.B.2.*

Tesla's headquarters and part of its factories are in Texas, making the Texas reincorporation decision a home-state incorporation decision.[287] To understand the value of this decision, we must first understand why home-state incorporations have been a recurring phenomenon since at least the 1980s.[288] In the 1980s, a takeover boom struck corporate America, sparking debates about their impact on corporate value and society.[289] Raiders would take over a corporation, close factories, and lay off many employees.[290] One response was successful campaigns by boards of directors in home-state incorporation regimes for legislative and judicial interventions that allowed management to resist these takeovers.[291] For example, in 1990, Massachusetts amended its Business Corporation Act to offer anti-takeover protections to corporations incorporated in Massachusetts.[292] This law applied a staggered board structure to all public corporations in Massachusetts, making it harder to take over the corporation by requiring two annual shareholder meetings to achieve control.[293]

The prevailing corporate theory at the time predicted that management entrenching laws would harm corporate value.[294] However, the outcome was different: some firms lost value, but others thrived.[295] Insulating managers from hostile takeovers allowed loyal and competent managers to pursue long-term innovative projects without fearing disruption by raiders seeking short-term profits.[296] These corporations benefited from the anti-takeover law, while others with disloyal and incompetent managers did not.[297]

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287 *See supra* note 3 (providing Texas address for principal offices).

288 *See, e.g.*, Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987) (analyzing the phenomena); Lucian A. Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 406 (2003) (providing an empirical study).

289 *See, e.g.,* Jonathan R. Macey, *State Anti-Takeover Legislation and the National Economy*, 1988 WIS. L. REV. 467, 471 (1988) (introducing and opining on the debate); Easterbrook & Fischel *supra* note 37.

290 *See* David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 234 (1991) (describing such events).

291 *See, e.g.*, Macey, *supra* note 289, at 470 (documenting successful lobbying by Goodyear Tire in Ohio, Boeing in Washington, Burlington Industries in North Carolina, Gillette at Massachusetts, and others).

292 Robert Daines, Shelley Xin Li & Charles C.Y. Wang, *Can Staggered Boards Improve Value? Evidence from the Massachusetts Natural Experiment,* 8-10 available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2836463 (describing the Massachusetts legislation).

293 *Id.* While a regular board allows shareholders to replace the whole board in every annual meeting, a staggered board allows the replacement only of a third of the board every year.

294 *See* Goshen & Squire, *supra* note 36, at 820 (tying this prediction to existing agency costs theory).

295 Daines, Xin Li & Wang, *supra* note 292, at 3-4.

296 *Id.*

297 *Id.*

Understanding the triangular and incomplete corporate contract explained in Part I, we can appreciate the value of home-state incorporation. Shareholders live all over the US and the world, not just in Delaware.[298] Managers are located where their corporations' headquarters are, often not in Delaware.[299] Employees are located where the factories are, usually not in Delaware.[300] Only the shareholders or the managers decide where to incorporate. Therefore, when a corporation is incorporated in Delaware, where there is no nexus with corporate operations, the triangle includes shareholders, managers, and the courts. The court is dealing with the allocation of powers (control rights) between shareholders and managers, regardless of the effects its decisions might have on other stakeholders, such as employees. Delaware courts' rulings are viewed through their effect on a single goal—maximizing shareholder value.[301] Thus, even when shareholders pressure managers to avoid long-term projects or other innovative investments and pursue short-term profits, shareholders' interests still enjoy supremacy.[302]

However, when a corporation incorporates in its home state, the legislature and the court must also consider the effects on employees and other state residents. The home state cannot succumb to shareholders' pressure for short-term profitability—commonly through hostile raiders and hedge fund activists—as that would lead to reduced investments and massive layoffs of employees.[303] Thus, the home state might insulate managers from market pressures, allowing them to pursue long-term investments that protect employment and only eventually benefit shareholders.[304]

Returning to the case of Texas, while current Texas law is not particularly management-friendly, it may soon become so, especially if the February 2025 amendments are successfully adopted.[305] Critics of Tesla's home reincorporation are not wrong about the motivations but are incorrect in assuming those motivations are necessarily bad for the firm. On the contrary, it may be exactly what Tesla needs. Not only could the Texas Business Court develop the specialization necessary to adjudicate corporate

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298 Ann M. Lipton, *Inside Out (or, One State to Rule Them All): New Challenges to the Internal Affairs Doctrine*, 58 WAKE FOREST L. REV. 321, 323 (2023) (describing the law allowing incorporation state to impact shareholders and employees residing outside the state of incorporation—the internal affairs doctrine).

299 *Id.*

300 *Id.*

301 McRitchie v. Zuckerberg, 315 A.3d 518, 562-64 (Del. Ch. 2024) (delineating Delaware' commitment to shareholder wealth maximization and the connection to long-term value).

302 *Id.*

303 *See supra* notes 288-292 and accompanying discussion.

304 *See* Macey, supra note 289, at 470; Goshen & Squire, *supra* note 36, at 820 (together, showing the legislative efforts, and noting they may be beneficial, respectively).

305 *See* Foley & Lardner, *supra* note 278.

disputes, but it may also reflect the directors' and shareholders' judgment that incorporating in Texas is better for firm value.

Tesla is one of the most innovative corporations in the world, and its CEO, Elon Musk, has already proven he can successfully pursue his idiosyncratic vision.[306] This is a classic case where shareholders would prefer insulating management from disruptive market forces, such as hostile takeovers and hedge-fund activism.[307] Indeed, other innovative corporations achieve such insulation for their management by adopting a dual-class structure.[308] Incorporating in the home state is an alternative way to achieve the same goal.

To be sure, the move to Texas introduces uncertainty because it will take time for the Texas Court to develop the necessary specialization and avoid judicial mistakes. Yet, the evaluation of Tesla's move to Texas is justified because the reduction in principal costs outweighs the possible increase in adjudication and agent costs. Implementing such beneficial changes to the firm's total control costs may very well outweigh any transaction costs associated with moving the corporate charter from Delaware to Texas. For the same reasons, corporations such as Meta[309] and other businesses with successful controllers with idiosyncratic vision may improve firm value in Texas as well: While lacking operational nexus to Texas, the reduction in principal costs may well outweigh all other impacts on the firm's overall value.

Extrapolating beyond this analysis of the Tesla case, we can draw important lessons for the future of state corporate law, which are particularly apt in the context of the jurisdictional competition between both the various states and the federal government.

The reason states have the desire to attract incorporations to their states is, most directly, that corporations pay franchise taxes to the state in which they incorporate.[310] For a state to be successful in this market it must provide a system of corporate law and courts that is appealing to the businesses they want to attract. While this has proven to be a difficult task given Delaware's dominance in the market, the Tesla saga illustrates one avenue for aspiring states: states can be competitive in gaining the charters of the businesses that have substantial operations in their state. They ought to establish specialized

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[306] *See* Assaf Hamdani & Kobi Kastiel, *Superstar CEOs and Corporate Law*, 100 WASH. U.L. REV. 1353, 1368 (2023) ("Under Elon Musk's leadership, Tesla's share price increased over 23,000% in a little more than a decade since its 2010 IPO.").

[307] *See* Goshen & Steel, *supra* note 149 (discussing the potential reduction in principal cost from fighting against such control contests).

[308] *See* Goshen & Squire, *supra* note 36, at 806-07 (illustrating the benefits that the dual-class structure may bring).

[309] *See* Emily Glazer, Berber Jin, and Meghan Bobrowsky, *Meta in Talks to Reincorporate in Texas or Another State, Exit Delaware,* WALL STREET JOURNAL (Jan. 31, 2025 5:18 PM), https://www.wsj.com/tech/meta-incorporation-texas-delware-f06e8bab (reporting the possible reincorporation of Meta in Texas).

[310] *See, e.g.*, Bebchuk, *supra* note 26, at 1443 (describing the states' incentives).

courts that understand they are but one party in a triangular arrangement and use it together with the calibrated aim of insulating management and reducing principal costs. And even absent the home incorporation nexus, specialization coupled with reduction in principal costs may at times be enough.

This insight also explains the value and limits of interstate competition over corporate charters. Many scholars have wrestled with the question of whether state competition over the regulation of corporate charters is desirable or not.[311] Supporters of interstate competition claim that when states compete for corporate charters, they are designing laws and courts that appeal to shareholders—the so-called "race to the top" theory.[312] Opponents of this regulatory competition, on the other hand, claim that competing states design laws and courts that appeal to management in lieu of shareholders—the so-called "race to the bottom" theory.[313] The underlying assumption of this debate, however, is clearly demonstrated as a mistake by this Article: we cannot equate either appeal to shareholders or appeal to management as categorically good or bad, respectively. Since courts, management, and shareholders each contribute to the total control costs of the firm, it is the idiosyncratic balancing of these actors that holds the secret to a successful jurisdiction.

Enter the federal government. It is not a coincidence that Musk has also invoked an appeal to federalism in his fight with Delaware.[314] As demonstrated by Professor Mark Roe, states competing over corporate charters may explain some of the reasons for the development of corporate law and courts, but it is only a part of the story.[315] For a state like Delaware, which has come to rely on collecting franchise fees as a significant source of revenues, the federalization of corporate law is a bigger threat than any state is able to levy against it.[316] If all public corporations had to charter federally, for instance, Delaware would lose a significant source of its state's revenues.[317] Indeed, federal intervention in corporate law is already ongoing, particularly in laws designed to regulate the shareholder voting process (e.g., proxy rules, tender offer rules, and stock exchange listing standards).[318] Since the Tesla dispute concerns the power of shareholders to vote their way in their ongoing relationship with management, this would not be an

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311 *See, e.g.*, *id.* at 1438 (1992) (describing the debate between the two competing accounts); Romano, *supra* note 186, at 720-25 (describing the debate and advocating for a race to the top theory).

312 *See, e.g.*, Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977), 289-92 (providing a seminal race to the top articulation).

313 *See, e.g.*, Cary, *supra* note 12, at 665-66 (providing a seminal race to the bottom theory).

314 *See supra* note 9.

315 Roe, *supra* note 27, at 588.

316 *Id.* at 601-07 (describing the leverage of the federal threat).

317 *See supra* note 18.

318 *See* Roe, *supra* note 27, at 607-34 (describing the historical incursion of federal law).

unfamiliar avenue for congressional intervention. We can therefore draw an important and timely cautionary tale for specialized courts, and particularly for Delaware: if corporate courts fail to understand their limited role in the tripartite arrangement with management and shareholders, they risk federal intervention, especially if they wield powers in ways that threaten the shareholder voting process. But there is also an inverse lesson for the federal government to heed: establishing a specialized court with the experience and prowess to fully realize the claim dismissal specialization is an expensive, time-consuming, and difficult process—one that sweep federalization will not be able to easily accomplish.

CONCLUSION

This Article explains why courts specializing in corporate law have been successful and necessary, enabling the judiciary to fulfill its unique role in the triangular relationship among courts, shareholders, and directors. Specialized courts acknowledge that judicial review is not warranted for mismanagement cases and is only justified for self-dealing when the reduction in overall principal and agent costs outweighs the added adjudication costs. Most importantly, specialized corporate courts recognize the trade-offs between imposing legal liability and allowing the principal to exercise control rights (or deferring to market mechanisms), thus functioning as a third party to the incomplete contract dedicated to maximizing corporate value. Whether it's Delaware, Texas, Nevada, or the federal government, the lessons learned from the nature of specialized corporate courts are essential for the development of corporate law and policy.

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