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The Death of Corporate Law

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THE DEATH OF CORPORATE LAW

ZOHAR GOSHEN† & SHARON HANNES‡

For decades, corporate law played a pivotal role in regulating corporations across the United States. Consequently, Delaware, the leading state of incorporation, and its courts came to occupy a central and influential position in corporate law and governance. This, however, is no longer the case: The compositional shift in equity markets from retail to institutional ownership has relocated regulatory power over corporations from courts to markets. Corporate law has, as a result, and as illustrated by the declined role of the Delaware courts, lost its pride of place and is now eclipsed by shareholder activism.

What explains the connection between the rise of institutional ownership and the death of corporate law? We answer this question by unpacking the relationship between market dynamics and the role of corporate law. Our analysis uncovers a critical, yet hitherto unnoticed, insight: The more competent shareholders become, the less important corporate law will be. Increases in shareholder competence reduce management agency costs, intensify market actors' preference for private ordering outside of courts, and, ultimately, drive corporate law into the shadow.

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INTRODUCTION

For decades, Delaware law and Delaware courts have played a central part in corporate law and governance.[1] More than half of the publicly traded firms in the United States are incorporated in Delaware,[2] and in many U.S. law schools, Delaware corporate law has become virtually synonymous with American corporate law.[3] While

[1] For a representative sampling of the academic treatment of the Delaware courts, see Symposium, *The Delaware Court of Chancery: Change, Continuity—and Competition*, 2012 COLUM. BUS. L. REV. 387.

[2] *See* JEFFREY W. BULLOCK, DEL. DIV. OF CORPS., 2012 ANN. REP. 1, http://corp.delaware.gov/pdfs/2012CorpAR.pdf (noting that sixty-four percent of Fortune 500 companies are incorporated in Delaware); *see also* LEWIS S. BLACK, JR., DEL. DEP'T OF STATE, WHY CORPORATIONS CHOOSE DELAWARE 1 (2007), http://corp.delaware.gov/pdfs/whycorporations_english.pdf (explaining several reasons for Delaware's appeal).

[3] Tellingly, the most widely used casebooks for the class on Corporations focus, almost exclusively, on Delaware law. *See, e.g.*, MELVIN AARON EISENBERG & JAMES D. COX, BUSINESS ORGANIZATIONS: CASES AND MATERIALS, at iii (11th ed. 2014) (providing a Delaware-centric approach to corporate law); WILLIAM A. KLEIN, J. MARK RAMSEYER & STEPHEN M. BAINBRIDGE, BUSINESS ASSOCIATIONS: CASES AND MATERIALS ON AGENCY, PARTNERSHIPS, LLCS, AND CORPORATIONS, at iii (9th ed. 2015) (same). Many scholars have attributed the centrality of Delaware courts in corporate law to Delaware's unique judicial system. *See, e.g.*, Roberta Romano, *Law as a Product*, 1 J.L. ECON. & ORG. 225, 277–78 (1985) [hereinafter Romano, *Law as a Product*] (describing the benefits accruing from Delaware's "substantial body" of precedent, its "judicial expertise" in corporate law, and the predictability of its judicial decisions); Roberta Romano, *The State Competition*

some experts have praised Delaware courts for their efficiency and sophistication in adjudicating corporate disputes,[4] and others have accused the Delaware courts of pro-management leanings,[5] very few would dispute that Delaware courts have played a critical role in shaping corporate law in the United States.

This Article argues that corporate law is no longer vital to the regulation of U.S. corporations. The transformation of American equity markets from retail to institutional ownership[6] has relocated control over corporations from courts to markets and has led to the death of corporate law.[7] As a result, and as an illustration of this broader phenomenon, Delaware courts today play a fundamentally different—and much less influential—role in corporate disputes. Indeed, we show that corporate law jurisprudence originating from the Delaware courts is no longer active as a substantive regulatory influence. While other scholars have argued that Delaware's retreat reflects judicial volition,[8] our point here is different: We argue that the

Debate in Corporate Law, 8 CARDOZO L. REV. 709, 722 (1987) [hereinafter Romano, *State Competition*] (noting that Delaware's "case law" and "judicial expertise in corporate law" contribute to its dominance); *see also infra* notes 217–20 and accompanying text (exploring the dominance of the Delaware courts).

4 *See, e.g.*, William Savitt, *The Genius of the Modern Chancery System*, 2012 COLUM. BUS. L. REV. 570, 570–71 ("The Court's approach has allowed it to supervise the market for corporate control and clarify the competing rights and obligations of corporate stakeholders with efficiency uncommon for a common law court.").

5 *See, e.g.*, William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 670, 671–84 (1974) ("Judicial decisions in Delaware illustrate that the courts have undertaken to carry out the 'public policy' of the state and create a 'favorable climate' for management.").

6 *See infra* Section III.A.

7 Our title is intentionally similar to that of Professor Grant Gilmore's seminal book, THE DEATH OF CONTRACT (1974). Just as Gilmore argued that tort law had steadily absorbed and superseded contract law, *id.* at 87, we aim to demonstrate that market actors' use of discretionary control rights—i.e., shareholder activism—has largely displaced corporate law and corporate litigation. *See infra* Part I.

8 *See* James D. Cox & Randall S. Thomas, *Delaware's Retreat: Exploring Developing Fissures and Tectonic Shifts in Delaware Corporate Law*, 42 DEL. J. CORP. L. 323, 324–25 (2018) (documenting Delaware's doctrinal retreat in four leading corporate cases); Ronald J. Gilson, *From Corporate Law to Corporate Governance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 3, 15 n.47 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018), http://www.oxfordhandbooks.com/view/10.1093/oxfordhb/9780198743682.001.0001/oxfordhb-9780198743682-e-10 ("[T]he Delaware courts appear to have begun recognizing the impact on governance of the intermediation of equity."); Steven Davidoff Solomon & Randall S. Thomas, *The Rise and Fall of Delaware's Takeover Standards* 5 (European Corp. Governance Inst., Working Paper No. 329, 2016), https://ssrn.com/abstract=2830257 (arguing that Delaware's takeover standard first expounded in the 1980s has been watered down by its courts' attempts to give way to market forces). Others, however, continue to believe that the Delaware courts maintain their role as the final arbiters between shareholders and management. *See, e.g.*, Donald F. Parsons, Jr. & Jason S. Tyler, *Activist Stockholders, Corporate Governance Challenges, and Delaware Law*, *in*

transformation of U.S. equity markets has largely displaced much of Delaware courts' institutional centrality.[9]

We begin by showing the extent of the declined role of Delaware courts. Until recently, Delaware courts engaged in a high level of judicial involvement with corporate disputes. Historically, conflicts over corporate control in the United States frequently originated from hostile takeover attempts. In a series of landmark decisions beginning in the 1980s, Delaware courts played a pivotal role in the resolution of this breed of disputes. In its celebrated *Unocal* decision, the Delaware Supreme Court held that board-adopted defenses against hostile takeovers would receive enhanced judicial scrutiny.[10] Later decisions applying *Unocal* allowed boards to unilaterally adopt poison pills and then "just say no" to hostile takeovers, notwithstanding shareholders' desires.[11]

Meanwhile, the Court of Chancery's holding in *Blasius* provided courts with the means to scrutinize board interference with shareholder voting rights.[12] *Unocal* and *Blasius*—along with the Delaware Supreme Court's development of so-called "*Revlon* duties" that apply to board behavior in change-of-control scenarios[13]—entrenched the

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RESEARCH HANDBOOK ON MERGERS AND ACQUISITIONS 377, 394 (Claire A. Hill & Steven Davidoff Solomon eds., 2016).

[9] *See infra* Part II.

[10] *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) ("If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed.").

[11] *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346, 1357 (Del. 1985) (applying the business judgment rule to the board's adoption of a poison pill because it was adopted "in the good faith belief that it was necessary to protect" the corporation). While poison pills come in many different varieties, "the key concept behind [*Moran* and] the poison pill is that it deters a potential acquirer from purchasing the stock of the target by making a takeover unprofitable." Jordan M. Barry & John William Hatfield, *Pills and Partisans: Understanding Takeover Defenses*, 160 U. PA. L. REV. 633, 642 (2012); *see also* Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 209 (2005) ("Conventional wisdom is that the presence of an unredeemed poison pill makes a takeover prohibitively expensive for the bidder.").

[12] *See* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661–62 (Del. Ch. 1988) (holding that boards "bear[ ] the heavy burden of demonstrating a compelling justification" when taking any action "for the primary purpose of interfering with the effectiveness of a corporate vote"). *Blasius* was later approved by the Delaware Supreme Court. *See* Centaur Partners, IV v. Nat'l Intergroup, Inc., 582 A.2d 923, 927 (Del. 1990) (noting that the Delaware General Corporation Law has "a general policy against disenfranchisement" (quoting *Blasius*, 564 A.2d at 669)).

[13] *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986) (explaining that when the dissolution of a company becomes inevitable, "directors cannot fulfill their enhanced *Unocal* duties by playing favorites with the contending factions"). For background on *Revlon*'s role and development, see generally J. Travis Laster, Revlon *Is a Standard of Review: Why It's True and What It Means*, 19 FORDHAM J. CORP. & FIN. L. 5, 7 (2013).

Delaware courts' position as the ultimate arbiter of corporate control disputes. This power effectively allowed the courts to dictate the allocation of control rights between boards and shareholders.[14]

All of this, however, has changed. Delaware courts no longer wield this same level of influence. With respect to control rights,[15] there are numerous manifestations of the courts' waning influence.[16] Consider the fact that while boards are free under Delaware jurisprudence to adopt a poison pill to fend off hostile takeovers,[17] directors might be hesitant to do so, fearing shareholders' reactions. Accordingly, in more than half of all contemporary hostile bids, a poison pill is never implemented, even after the hostile bid is launched.[18] Delaware default law which allows poison pills thus has become irrelevant, along with an elaborated case law setting the limits of poison pills' design and usage. Similarly, Delaware courts permit boards to use a poison pill together with a staggered board[19]—a combination some consider takeover-preclusive.[20] Since the 1990s, public companies have had difficulty in installing new staggered board charter provisions,[21] but those that already had such provisions have held on to them and were highly protected. Such law-driven path dependence is, however, no longer determinative as shareholder activists have managed to dismantle most staggered boards via pressure exerted outside

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

[15] With respect to cash flow rights, the Delaware courts have in several recent cases similarly, and explicitly, shifted power to shareholders. *See infra* Section I.B.3.

[16] For a more detailed list of such developments, see *infra* Section I.B.

[17] *See Moran*, 500 A.2d at 1357.

[18] *See* Guhan Subramanian, *Delaware's Choice*, 39 DEL. J. CORP. L. 1, 5 (2014) ("[I]n recent years 59% of companies without pills have not put them in when a [hostile] bid is brought.").

[19] *See, e.g.*, Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 57 (Del. Ch. 2011) (approving the board's continued use of a poison pill even when combined with a staggered board—a board in which only a third of its members are up for reelection every year). Combining a staggered board with a poison pill is significant because poison pills, which allow managers to stymie a hostile takeover attempt as long as the managers remain in office, operate under the assumption that the shareholders' ability to "vote out" the managers acts as a "safety valve" to this absolute blockade. *See* Lucian Arye Bebchuk, John C. Coates, IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 890 (2002). However, if a board is staggered, requiring multiple years of voting before a majority of the board can be voted out, "this safety valve is illusory." *Id.*

[20] *See* Bebchuk, Coates & Subramanian, *supra* note 19, at 919 ("[Staggered boards] should provide incumbents virtually complete protection from hostile bids, with all of the potential drawbacks in terms of managerial agency costs that are associated with such insulation.").

[21] *See* John C. Coates, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CALIF. L. REV. 1301, 1302 (2001).

the courtroom.[22] Sidestepping the courts, shareholder activists engaged in an extremely successful campaign, leading ultimately to an eighty percent drop in staggered boards among Standard & Poor (S&P) 500 companies.[23]

Moreover, and perhaps most strikingly, the use of "hedge-fund activism" has become a routine method for shareholders to wield control rights outside of courts.[24] Activist hedge funds procure a relatively small stake in a company, issue a "white paper" detailing criticisms of the company's management, and then campaign for other shareholders to vote against management in a proxy fight.[25] To avoid the fiasco of a public proxy dispute, and despite the Delaware courts' approval of anti-activist poison pills,[26] companies often settle with activists behind the scenes, for example, by allowing the activist to appoint individuals of its choosing to the company's board.[27] In other

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[22] *See* Steven Davidoff Solomon, *The Case Against Staggered Boards*, N.Y. TIMES: DEALBOOK (Mar. 20, 2012, 12:43 PM), http://dealbook.nytimes.com/2012/03/20/the-case-against-staggered-boards (describing activist shareholders' campaigns to de-stagger boards of public companies).

[23] Andrew Ross Sorkin, *An Unusual Boardroom Battle, in Academia*, N.Y. TIMES: DEALBOOK (Jan. 5, 2015, 9:42 PM), https://dealbook.nytimes.com/2015/01/05/an-unusual-boardroom-battle-in-academia/.

[24] For background on the ability of hedge fund activists to assert control rights, see generally Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013); Ken Squire, *A Golden Age for Activist Investing*, BARRON's (Feb. 16, 2009, 11:59 PM), https://www.barrons.com/articles/SB123457667407886821.

[25] A proxy fight is "a campaign to solicit votes (or proxies) in opposition to management at an annual or special meeting of stockholders or through action by written consent." Warren S. de Wied, *Proxy Contests*, PRACTICAL L.J., Nov. 2010, at 32, 33, https://www.wsgr.com/publications/pdfsearch/dewied1110.pdf (providing introductory information on modern proxy contests). For an overview of the toolkit used by activist investors, see also Martin Lipton, *Dealing with Activist Hedge Funds and Other Activist Investors*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 26, 2017), https://corpgov.law.harvard.edu/2017/01/26/dealing-with-activist-hedge-funds-and-other-activist-investors.

[26] *See* Third Point LLC v. Ruprecht, C.A. No. 9469-VCP, 2014 WL 1922029, at *16–17 & n.18 (Del. Ch. May 2, 2014) (applying the Delaware court's *Unocal* standard in judging the legitimacy of an anti-activist poison pill).

[27] In *Third Point*, for instance, the hedge fund plaintiff refused to abandon its campaign and instead used the threat of a proxy fight to leverage the board into partially acceding to its demands. *See* Agustino Fontevecchia, *Truce! Dan Loeb's Third Point Gets 3 Board Seats, but Sotheby's CEO Bill Ruprecht Stays on Board*, FORBES (May 5, 2014 12:49 PM), https://www.forbes.com/sites/afontevecchia/2014/05/05/truce-dan-loebs-third-point-gets-3-board-seats-but-sothebys-ceo-bill-ruprecht-stays-on-board (reporting that Third Point secured three board seats and the removal of a poison pill, while Sotheby's CEO Bill Ruprecht held on to his role as president and chairman of the board). Even in dramatic public proxy fights, settlements are not unprecedented. *See, e.g.*, Michael J. de la Merced, *Arconic Settles with Elliott After Bruising and Public Dispute*, N.Y. TIMES (May 22, 2017), https://www.nytimes.com/2017/05/22/business/dealbook/arconic-elliott-settlement.html (describing one such settlement after a very public, and highly contentious, proxy fight).

cases, institutional investors and proxy advisers preempt the court in deciding seemingly legal disputes between activists and management.[28] By taking advantage of the pressure generated through threatening a proxy fight, and by other means, activists can sidestep judicial oversight altogether, rendering corporate law largely irrelevant.[29] Litigation is no longer central in resolving control disputes.

What brought about the death of corporate law? This Article answers this complicated question with a theory that focuses on the relationship between market dynamics and the law. In short, the more competent shareholders become, the less important corporate law will be. This is why the dramatic rise of institutional ownership in the United States coincided with the eclipse of corporate law. By applying this general insight to the Delaware courts, we are able to explain the declined role of Delaware courts and to discuss this insight's legal and policy implications for the future of Delaware.

The starting point for our theory is the understanding that corporate contracts are always "incomplete."[30] The principal (the shareholders) invests in, and the agent (the board) manages, a firm in order to create future value. But beyond the general instruction to "maximize firm value,"[31] there are few (if any) enforceable precepts as to how to manage the firm. Instead, the parties agree to a general allocation of *control rights* (which govern the apportionment of decision-making power over the firm) and *cash-flow rights* (which govern the apportionment of firm-generated value). In this incomplete contract, conflicts may arise as to the allocation and use of these two types of rights.[32] The principal and the agent, therefore, must decide which

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[28] *See infra* notes 88–97 and accompanying text (discussing the disappearance of bylaw provisions that limit so-called "Golden Leashes," compensation arrangements of directors nominated by activist hedge funds).

[29] *See infra* Section I.B.2. Activists may only turn to a court if the threat of a proxy fight fails to generate the desired response. *See, e.g.*, Steven Davidoff Solomon, *Why Einhorn's Win May Be Apple's Gain* N.Y. TIMES (Feb. 26, 2013, 10:02 AM), https://dealbook.nytimes.com/2013/02/26/why-einhorns-win-may-be-apples-gain ("Had the proposal gone to a vote at the shareholder meeting on Wednesday, [the activist] would likely have lost and the charter would have been amended. So he took a different tactic. He sued.").

[30] *See* Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755, 755 (1988) ("Since it may be prohibitively costly to specify, in a way that can be enforced, the precise actions that each party should take in every conceivable eventuality, the parties are in practice likely to end up writing a highly incomplete contract.").

[31] For the classic 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.").

[32] Corporate *control rights* conflicts are most visible in contests for control over the entire corporation, such as a hostile takeover in which one corporation attempts to acquire

conflicts to resolve on their own—via discretionary control rights such as shareholder voting—and which conflicts to resolve with the aid of a court—via duty-enforcement rights such as the right to sue for breach of directors' fiduciary duties.

But when will shareholders and boards prefer to engage courts in resolving corporate disputes as opposed to resolving conflicts via discretionary control rights? Exercise of corporate control rights generates *control costs*, which include *competence* and *conflict* costs, for both the principal ("principal costs") and the agent ("agent costs").[33] Under conventional economic assumptions, shareholders and boards will aim to minimize the sum of those costs in order to increase firm value.[34] Critically, we observe that enlisting courts in an effort to reduce these control costs will itself impose both competence costs and conflict costs spawned by the adjudication process. Therefore, the use of courts will only be efficient when it minimizes the total control costs created by all three players—the principal, the agent, and the courts.

Our analysis shows that the relative magnitude of *principal competence* and *court competence* is a crucial determinant of whether the parties will prefer judicial intervention as opposed to the use of discretionary control rights. When the principal has relatively low competence (as with retail investors) the parties are more likely to rely on a court for dispute resolution. By contrast, when the principal has relatively high competence (as with institutional investors),[35] the parties are more likely to resolve these issues on their own through the use of

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another. 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. 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.

[33] Control costs include the efforts parties take to *avoid* the incursion of these costs. *See* Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 779 (2017) (providing a detailed description and discussion of both principal costs and agent costs). Control costs can also stem from asymmetric information and differences of opinion between principals and agents. *See* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 565 (2016).

[34] *See* Goshen & Squire, *supra* note 33, at 784, 829 (discussing minimizing control costs in the context of optimal governance structure).

[35] Institutional investors have higher competence as shareholders because they employ teams of professional investment managers who are knowledgeable and experienced in business and finance. *See, e.g.*, Asaf Eckstein, The Virtue of Common Ownership in an Era of Corporate Compliance 1 (2018) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3194605 (discussing institutional investors capacity to promote better governance).

discretionary control rights. The efficiency of extrajudicial conflict resolution positively correlates with the principal's competence. The more competent the principal, the greater the probability that actors will prefer using discretionary control rights to resolve disputes outside of the adjudication process.

As increased institutional ownership and complementary market mechanisms (such as hedge fund activism[36] and proxy advisors[37]) bolster the competence of U.S. investors, our theory predicts—and reality seems to vindicate—that judicial dispute resolution becomes a less desirable option. And as companies have grown accustomed to the ability of institutional investors to discipline management outside of the courtroom,[38] companies have come to care more about their investors' business opinions than the Delaware courts' judicial opinions.[39] Over time, this dynamic has marginalized corporate law and has eroded the significance of the Delaware courts.

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[36] For more on hedge fund activism, see *infra* Section I.B.2.

[37] Proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass, Lewis & Co. (Glass Lewis), provide institutional investors with recommendations on proxy votes, theoretically providing institutional investors with the opinion of experts wielding the time and resources to analyze individual proxy votes in ways that institutional shareholders cannot. *See generally* George W. Dent, Jr., *A Defense of Proxy Advisors*, 2014 MICH. ST. L. REV. 1287, 1290–96. Because proxy advisors, for a variety of reasons, have made votes against corporate management more common, their presence in the market has shifted the locus of power in any given proxy vote further toward the institutional owners. *See id.* at 1289.

[38] *See, e.g.*, Madison Marriage, *BlackRock Bulks Up Governance Staff*, FIN. TIMES (Jan. 30, 2017), https://www.ft.com/content/657b243c-e492-11e6-9645-c9357a75844a?mhq5j=e2 (discussing the sizeable expansions in corporate governance teams by BlackRock, Vanguard, and State Street in order to monitor and influence corporate behavior). It is worth noting that many have optimistically embraced the increased activism of institutional investors. *See, e.g.*, David Larrabee, *The Financial Industry: A New Discipline of Ownership*, CFA INST. ENTERPRISING INV. (June 6, 2017), https://blogs.cfainstitute.org/investor/2017/06/06/the-financial-industry-a-new-discipline-of-ownership (calling the present a "pivotal moment for the industry, when institutional investors went from being passive owners to embracing their roles as responsible stewards for the industry, their customers, and society"). Indeed, institutional investors have become aggressive in their disciplinary behavior, going as far as to threaten to vote against directors for all boards upon which they sit, even those not committing the disputed action. *See, e.g.*, Jessica Toonkel, *Big Fund Firm Blacklists Directors Who Support Poison Pills*, REUTERS (Apr. 29, 2015, 1:22 AM), http://www.reuters.com/article/us-dfa-poisonpills-boards-insight-idUSKBN0NK0AM20150429 (discussing one example where a mutual fund vocally threatened boards who took actions against shareholder approval).

[39] Many companies have responded by arranging to meet with large institutional investors throughout the year to discuss "strategy, performance, board membership and quality of management." Theodore Lynn, *Institutional Investor Monitoring*, *in* ENCYCLOPEDIA OF CORPORATE SOCIAL RESPONSIBILITY 1422, 1424 (S.O. Idowu et al. eds., 2013), https://link.springer.com/referenceworkentry/10.1007%2F978-3-642-28036-8_224. This strategy is called "shareholder engagement." *See, e.g.*, Russell Miller, *Engage Your Shareholders If You Want a "Yes Vote*," WORKSPAN, Feb. 2015, at 44, 46 ("Direct

The remainder of this Article proceeds as follows: Part I illustrates the death of corporate law through a discussion of the evolution and decline in the role of Delaware courts. Part II presents our principal-agent theory concerning the role of courts in corporate dispute resolution. Part III discusses the policy implications of the theory we present in Part II, as well as predictions for the future. We then briefly conclude.

I
The Declined Role of Delaware Courts

In the recent past, corporate America held its breath in anticipation of the Delaware courts' rulings—the Delaware courts held the ultimate power to influence and even craft the rules of the corporate game. The Delaware courts no longer occupy this same predominance as an arbiter of corporate conflict. This Part explores the special, and central, role of the Delaware courts (Section I.A) and the more recent decline that has occurred (Section I.B). We focus on Delaware in order to illustrate the death of corporate law more broadly because Delaware is widely considered the most important corporate law forum. But our theory, presented fully in Part II, is not forum-dependent.

A. The Delaware Courts as Arbiter of Corporate Conflict

In their seminal book *The Modern Corporation and Private Property*, Professor Adolf Berle and economist Gardiner Means highlighted the dispersed ownership structure of many U.S. public corporations.[40] Berle and Means suggested that the many minuscule retail investors populating the U.S. capital market were unable to exercise any control over the corporations in which they held shares.[41] Taking account of this weakness, the Delaware courts took up the role of shareholder guardian. The Delaware courts approached this role with a dichotomous focus, separating self-dealing transactions (transactions in which a controlling owner, the board, or management participates

shareholder engagement encourages a two-way dialogue between companies and their investors, allowing shareholders to share their thoughts and points of view.").

[40] Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 2–3 (1933) (observing that in the modern corporate structure, "tens or even hundreds of thousands of individuals are combined through the corporate mechanism into a single producing organization under unified control and management").

[41] *Id*. at 66.

on both sides),[42] on the one hand, from all other business decisions,[43] on the other.

The unprecedented wave of mergers and acquisitions during the 1980s intensified the role of the Delaware courts as arbiters between boards and shareholders over control rights conflicts.[44] Control fights between corporate boards and would-be acquirers required courts to determine the extent to which boards may decide, notwithstanding the desires of shareholders, whether, and to whom, to sell the company. Much of modernity's relevant takeover jurisprudence crystalized during this 1980s heyday. *Unocal* and its progeny, in developing a flexible and fact-intensive standard of review for anti-takeover mechanisms, affirmed an active role for the Delaware courts in the takeover context.[45] The Delaware Supreme Court made clear in *Unocal* that board anti-takeover measures would be reviewed under the business judgment rule only if such measures were found to be "reasonable in relation to the threat posed."[46] *Unocal* epitomizes the tendency of the Delaware courts, when faced with a dispute over control rights, to take on an interventionist role governed by a standard-like balancing test.[47]

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[42] In cases of self-dealing, the Delaware courts scrutinize the business terms of the transaction reached by the board under the so-called "entire fairness" doctrine. This assessment often requires the court to perform complicated financial valuations, a feat only practicable due to the relative financial savvy of Delaware judges. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 710, 714 (Del. 1983) (discussing and applying the "entire fairness" doctrine).

[43] For non-self-dealing corporate decisions and transactions, the court adheres to the deferential "business judgment rule" and refrains from second-guessing the business decisions of the board and the management. *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 811–13 (Del. 1984) (discussing and applying the "business judgment rule").

[44] *See, e.g.*, Edward F. Greene, *Regulatory and Legislative Responses to Takeover Activity in the 1980s: The United States and Europe*, 69 TEX. L. REV. 1539, 1560–61 (1991) (discussing Delaware's response to the takeover wave of the 1980s).

[45] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). The *Unocal* court explained that when a company is facing a takeover threat, the directors' own interest in maintaining control is necessarily conflicted with the interests of the shareholders. *Id.* at 955. In light of this conflict, in order to be protected by the business judgment rule, the directors taking defensive actions must show that they acted in good faith after reasonable investigation. *Id*. The defensive action must be shown to have been reasonable, considering the threat to the shareholders posed by the takeover. *Id*. For more on the *Unocal* standard of review, see Marcel Kahan, Paramount *or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 J. CORP. L. 583, 586–88 (1994) (discussing *Unocal* and its progeny).

[46] *Unocal Corp.*, 493 A.2d at 955; *see also* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1367, 1390 (Del. 1995) (glossing the *Unocal* standard such that defendant boards and directors must prove that the defensive tactics at issue are neither "preclusive [n]or coercive").

[47] *See, e.g.*, *supra* notes 42–46 and accompanying text; *infra* notes 48–70 and accompanying text (exploring different situations in which the Delaware Supreme Court adopts fact-intensive balancing tests).

Unocal was far from the last instance of the Delaware Supreme Court's willingness to redefine the corporate contract between a board and shareholders. In *Moran*, decided the same year as *Unocal*, the Delaware Supreme Court ruled upon the fate of the "poison pill," at the time a new defensive innovation.[48] The *Moran* opinion openly acknowledged the necessity of redrafting the corporate contract in response to the perceived potency of the pill,[49] reflecting self-awareness as to the importance of the Delaware Supreme Court's role.[50] The *Moran* court ultimately decided to validate the adoption of the poison pill subject to the discretion of the court to invalidate the pill when used in the future, once an actual takeover bid is launched.[51] Acknowledging the impact of the *Moran* decision on corporate law, one popular Corporate Law casebook observed that "[j]udicial acceptance of shareholders' right plans was a major evolutionary step in U.S. corporate law."[52]

Given the centrality of the Delaware courts in these high-stakes corporate scuffles, it is unsurprising that the Delaware courts became subject to heavy lobbying efforts.[53] A considerable portion of this lobbying targeted the issue left open by *Unocal* and *Moran*: How much discretion should a board be granted when maintaining a poison pill in the face of a lucrative takeover bid? This question, whether the board can "just say no,"[54] was contemporaneously described by Professors Ronald Gilson and Reinier Kraakman as the "single most important issue" regarding the market for corporate control.[55] Following the

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[48] Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985). Poison pills are also known as shareholders' right plans and they come in different variations. The pill in *Moran*, for example, set a threshold, where the acquisition of more than twenty percent of shares by a single entity without the board's consent triggered the heavy dilution of the bidder's control of the company by issuing massive amounts of rights to buy additional shares at a great discount to all other shareholders. *Id*. at 1348–49.

[49] *Id.* at 1348 ("This case presents to this Court for review the most recent defensive mechanism in the arsenal of corporate takeover weaponry . . . .").

[50] *Id*. ("The validity of this mechanism has attracted national attention.").

[51] *Id*. at 1357 ("While we conclude for present purposes that the Household directors are protected by the business judgment rule, that does not end the matter. The ultimate response to an actual takeover bid must be judged by the Directors' actions at that time . . . . Their use of the Plan will be evaluated when and if the issue arises.").

[52] WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 522 (4th ed. 2012).

[53] *See, e.g.*, *infra* notes 58–60 and accompanying text (exploring reactions by a major corporate law firm to various decisions).

[54] This now-familiar phrase refers to "the ultimate power of the board of a Delaware corporation to block an unwanted takeover bid." Jeffrey N. Gordon, *"Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffet*, 19 CARDOZO L. REV. 511, 522 (1997).

[55] *See* Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 258

Delaware Chancery's ruling in *City Capital Associates v. Interco, Inc.*,[56] implying that the ability to "just say no" ran afoul of *Unocal*'s proportionality requirement,[57] lobbying intensified.

Martin Lipton, leveraging his clout as legal counsel to some of the nation's largest corporations, sent a well-publicized client memo in an effort to exert pressure on the *Interco* verdict.[58] Lipton characterized *Interco* as a "dagger aimed at the hearts of all Delaware corporations"[59] and urged Delaware corporations to incorporate elsewhere, sending the clear message that the Delaware Supreme Court ought to revisit the issue.[60]

In *Paramount Communications, Inc. v. Time Inc.*,[61] the Delaware Supreme Court took up the invitation to revisit *Interco* and in so doing redrew the lines of U.S. corporate control once again. The Delaware Supreme Court characterized *Interco* as a "narrow and rigid" interpretation of *Unocal* and ultimately permitted Time's board to reject a $200 per share bid from Paramount (nearly a sixty percent premium over market price).[62] *Paramount* led many to conclude that boards could in fact "just say no,"[63] a result many scholars deemed to have a major impact on the market as a whole.[64]

(1989) (discussing the lack of guidance offered for "what 'threats' will support preclusive defenses by target managers").

[56] 551 A.2d 787, 798 (Del. Ch. 1988).

[57] *See id*. at 799–800 ("[T]he board's decision not to redeem the rights following the amendment of the offer to $74 per share cannot be justified in the way *Unocal* requires.").

[58] The Interco Case, Memorandum from Wachtell, Lipton, Rosen & Katz to clients (Nov. 3, 1988), https://www.law.upenn.edu/live/files/7876-culled-martin-lipton-publicationspdf.

[59] *Id*.

[60] *Id*. ("New Jersey, Ohio and Pennsylvania, among others, are far more desirable states for incorporation than Delaware in this takeover era. Perhaps it is time to migrate out of Delaware."). In a second memo, published after Grand Metro. Pub. Ltd. v. Pillsbury Co., 558 A.2d 1049 (Del. Ch. 1988), Lipton continued with the same tone: "Unless Delaware acts quickly to correct the *Pillsbury* decision, the only avenues open to the half of major American companies incorporated in Delaware will be federal legislation . . . or leaving Delaware for a more hospitable state of incorporation." You Can't Just Say No in Delaware No More, Memorandum from Wachtell, Lipton, Rosen & Katz (Dec. 17, 1988), https://www.law.upenn.edu/live/files/7876-culled-martin-lipton-publicationspdf.

[61] 571 A.2d 1140 (Del. 1989).

[62] *See id.* at 1142, 1149, 1153. For the sake of comparison, consider the fact that in *Interco*, the board rejected a $74 per share bid from Cardinal Acquisition Corporation, with a much lower premium over market value than was offered in *Paramount*. *See Capital Associates v. Interco, Inc.*, 551 A.2d at 799–800.

[63] *See, e.g.*, Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 859 n.4 (1993) (arguing that most commentators believe that the *Paramount* decision reinforced the board's ability to "just say no"); Kahan, *supra* note 45, at 604.

[64] *See, e.g.*, Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 878–79 (2002) (explaining that in the aftermath of the *Paramount* decision "the value of M&A deals fell

Later decisions made clear that the Delaware courts intended to cement the proxy mechanism as an avenue for replacing directors via the shareholder vote, notwithstanding the significant leeway granted to boards under *Paramount* with respect to tender offers.[65] This strict preservation of the shareholder franchise came to a head in *Blasius Industries Inc. v. Atlas Corp.*,[66] in which the Court of Chancery prevented the Atlas board from amending the company's bylaws in order to add two new board seats and then fill the newly created vacancies, a maneuver clearly intended to preempt an attempt by one of its shareholders to nominate a majority of new directors.[67] Chancellor Allen's decision expressly acknowledged that it is the role of the courts to set the boundaries of control over the company.[68] The *Blasius* court held that absent a "compelling justification," boards may not interfere with the proxy mechanism, thereby providing a protective counterweight to the board discretion afforded under *Unocal*.[69]

When the dust settled, the outcome of 1980s Delaware jurisprudence was a new allocative equilibrium of control rights between boards and shareholders.[70] Given the malleability of *Unocal*'s bal-

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from its 1988 peak of $247 billion, to $108 billion in 1990, to $221 billion in 1989, and then to $71 billion in 1991").

[65] The proxy mechanism allows shareholders to manifest their franchise by delegating their voting power to another person or body. *See Proxy Access*, COUNCIL INSTITUTIONAL INV., http://www.cii.org/proxy_access (last visited Oct. 18, 2018) (describing "proxy access" as the ability for shareholders to offer their own candidates to election to the board).

[66] 564 A.2d 651 (Del. Ch. 1988).

[67] The question, as Chancellor Allen described it, was whether the board "even if it *is* acting with subjective good faith . . . may validly act for the principle purpose of preventing the shareholders from electing a majority of new directors." *Id.* at 658.

[68] *Id*. at 660 ("A board's decision to act to prevent the shareholders from creating a majority of new board positions . . . does not involve the exercise of *the corporation's power* . . . rather, it involves allocation, between shareholders as a class and the board, of effective power with respect to governance of the corporation."). For a fascinating description of the origin of the *Blasius* standard, see Leo E. Strine, Jr., *The Story of* Blasius Industries v. Atlas Corp.*: Keeping the Electoral Path to Takeovers Clear*, *in* CORPORATE LAW STORIES 243, 290–91 (J. Mark Ramseyer ed., 2009).

[69] *Blasius*, 564 A.2d at 661 ("[T]he board bears the heavy burden of demonstrating a compelling justification for such action."); *see also* Aprahamian v. HBO & Co., 531 A.2d 1204, 1206–07 (Del. Ch. 1987) (emphasizing that director elections must be conducted "with scrupulous fairness" and that the business judgment presumptions will not protect obvious interference). Gilson questions the logic behind this policy decision to protect shareholders' right to vote but not to sell their shares: "[T]he lesson of *Unocal*'s first fifteen years is that the Delaware Supreme Court's march toward an unarticulated and unjustified preference for elections over markets . . . has proven to be a failure." Ronald J. Gilson, Unocal *Fifteen Years Later (And What We Can Do About It)*, 26 DEL. J. CORP. L. 491, 512 (2001).

[70] The Delaware courts continued, beyond the 1980s, to play an important role in maintaining this allocation of control rights. *See* Quickturn Design Sys. v. Shapiro, 721 A.2d 1281, 1291 (Del. 1998) (rejecting a no-hand poison pill, i.e., an unremovable pill);

ancing analysis, a great many control contests found their way to the Delaware courts, repeatedly giving Delaware courts the final say on shaping corporate behavior in the context of control tussles.[71]

B. The Changed Role of the Delaware Courts

In recent years there has been a noticeable decline in the role played by the Delaware courts, such that their decisions no longer mark the exclusive or final chapter over *control rights* conflicts. This Section begins by illustrating the declined role of Delaware courts with a few telling examples (Section I.B.1) before discussing hedge fund activism as the most salient manifestation of extrajudicial corporate control dispute resolution (Section I.B.2). Finally, we show that the Delaware courts' reaction to its reduced role has also been generally welcoming in the context of *cash-flow rights* conflicts (Section I.B.3).

1. Examples of the Decline: Poison Pills, Staggered Boards, Golden Leashes, and Indices Exclusion

One of the most striking examples of the declined role of the Delaware courts has been the marked shifts regarding poison pills and staggered boards. As already noted, the Delaware courts created a longstanding equilibrium in which target companies could—and often did—maintain staggered boards and poison pills,[72] thereby forcing would-be acquirers to cope with these obstacles.[73] Today, both stag-

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Chesapeake Corp. v. Shore, 771 A.2d 293, 297 (Del. Ch. 2000) (rejecting supermajority bylaw provisions that de facto impaired the ability of stockholders to influence their company's policies via the ballot box); Carmody v. Toll Bros., 723 A.2d 1180, 1182 (Del. Ch. 1998) (rejecting a "dead hand" rights plan, which allowed only incumbent directors to remove the pill).

[71] Kahan and Kamar for this reason referred to Delaware law as "litigation intensive." Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1232 (2001); *see also* Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168, 1191 (1999) ("Delaware courts have consistently filled Delaware jurisprudence with principles that are open-ended and unclear. The principles throughout Delaware law contain terms which call for a case-specific assessment by the court. Moreover, there is always some room for the chancery court's equitable intervention.").

[72] *See, e.g.*, Airgas, Inc. v. Air Prod. & Chems., Inc., 8 A.3d 1182, 1194–95 (Del. 2010) (finding a bylaw invalid which impermissibly shortened directors' three-year staggered terms); *see also supra* Section I.A.

[73] Bebchuk and others have demonstrated the power of a staggered board, showing that an effective staggered board nearly doubles the likelihood that the average target will remain independent. Bebchuk, Coates & Subramanian, *supra* note 19, at 890–91 ("A staggered board . . . offers a more powerful antitakeover defense than has previously been recognized . . . . [They] make it extremely difficult for a hostile bidder to gain control over the incumbents' objections.").

gered boards and poison pills are fading from the market, leaving managers far more vulnerable.[74] The courts had no role in this watershed change, and the new reality turned obsolete an elaborated case law setting the limits of antitakeover mechanisms' design and usage. Rather than lobby the Delaware courts directly for revision to the doctrine governing staggered boards and poison pills, critics of these takeover protection mechanisms simply exerted extrajudicial pressure to de facto "rule" on the permissibility of these tools.

Staggered Boards. Consider first staggered boards.[75] During the first decade of the millennium, staggered boards were highly popular. In 2000, 300 companies in the S&P 500 had staggered boards.[76] In the last half decade, the number of companies with staggered boards has fallen dramatically.[77] Much of this change was the product of cooperation between large pension funds and the Shareholder Rights Project (SRP),[78] a clinical program at Harvard Law School directed by Professor Lucian Bebchuk.[79] The SRP's work during 2012–2014 focused on dismantling staggered boards.[80] The campaign was tremendously successful and led to the declassification of around 100 S&P

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[74] *See infra* note 86 and accompanying text (exploring directors' hesitance to adopt poison pills).

[75] The de-staggering campaign's dramatic influence on the market led to harsh reactions from policy makers and practitioners. These reactions stress the importance of the shift. *See* Daniel M. Gallagher & Joseph A. Grundfest, *Did Harvard Violate Federal Securities Law? The Campaign Against Classified Boards of Directors* 3–4 (Rock Ctr. for Corp. Governance at Stanford Univ., Working Paper No. 199, 2014), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2536586 (reflecting on the vast scope of recent board declassification and thus the number of parties implicated in the debates over whether the practice is harmful or not); Martin Lipton, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 26, 2013), https://corpgov.law.harvard.edu/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy (calling for effective action to deal with the "misuse of shareholder power").

[76] Maxwell Murphy, *Classified Boards Remain in the Crosshairs*, WALL ST. J. (Sept. 5, 2012, 11:51 AM), https://blogs.wsj.com/cfo/2012/09/05/classified-boards-remain-in-the-crosshairs.

[77] *See infra* notes 81–82 (providing evidence of this decline).

[78] *Shareholder Rights Project*, HARV. L. SCH., http://srp.law.harvard.edu/index.shtml (last visited Oct. 20, 2018). These public pension funds had an aggregate value of assets exceeding $400 billion and served over three million members. *Id.* The decline in the usage of staggered boards started before the SRP. Institutional investors and other shareholders opposed them in light of studies that found a negative relationship between staggered boards and share price. Matthew D. Cain et al., *How Corporate Governance Is Made: The Case of the Golden Leash*, 164 U. PA. L. REV. 649, 657 (2016) (reviewing evidence of this correlation).

[79] *See Lucian Arye Bebchuk: Biographical Information*, HARV. L. SCH., http://www.law.harvard.edu/faculty/bebchuk/bio.shtml (last visited Oct. 31, 2018).

[80] *Shareholder Rights Project*, *supra* note 78.

500 and Fortune 500 companies by the end of 2014.[81] As of January 2017, fewer than 50 of the corporations in the S&P 500 had staggered boards.[82]

Poison Pills. Poison pills have similarly faced a sharp decline. In 2000, 299 companies in the S&P 500 had a poison pill in place.[83] By January 2017, that number shrank to 17.[84] In the interim, and continuing to this day, influential proxy advisors announced their objection to the adoption of poison pills without shareholder approval and threatened to recommend voting against the renomination of directors who implement such pills.[85] As a result, while boards are free under Delaware law to adopt a poison pill, directors are, as a practical matter, hesitant and constrained in their ability to do so, fearing the wrath of proxy advisors and institutional investors.[86] In fact, in more than half of all contemporary hostile bids, a poison pill is never implemented, even after the hostile bid has launched.[87] This

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[81] Lucian Bebchuk, Scott Hirst & June Rhee, *Toward Board Declassification in 100 S&P 500 and Fortune 500 Companies: The SRP's Report for the 2012 and 2013 Proxy Seasons*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 25, 2014, 9:12 AM), http://blogs.law.harvard.edu/corpgov/2014/02/25/toward-board-declassification-in-100-sp-500-and-fortune-500-companies-the-srps-report-for-the-2012-and-2013-proxy-seasons.

[82] *Governance Trends at Russell 2000 Companies*, BOARD MATTERS Q., Jan. 2017, at 4 https://www.ey.com/publication/vwluassetsdld/boardmattersquarterly_04552-161us_january2017/$file/boardmattersquarterly_04552-161us_january2017.pdf (ninety-one percent of S&P 500 companies have annual elections rather than staggered elections).

[83] Michael Useem, *The Ascent of Shareholder Monitoring and Strategic Partnering: The Dual Functions of the Corporate Board*, *in* THE SAGE HANDBOOK OF CORPORATE GOVERNANCE 136, 143 (Thomas Clarke & Douglas Branson eds., 2012).

[84] *Id*.

[85] *See* John C. Coffee, Jr., *Hedge Fund Activism: What Do We Know and Not Know?*, *in* INSTITUTIONAL INVESTOR ACTIVISM: HEDGE FUNDS AND PRIVATE EQUITY, ECONOMICS AND REGULATION 693, 699 (William W. Bratton & Joseph A. McCahery eds., 2015) (noting that the rise of hedge fund activism is partly due to "the success of proxy advisors in forcing target companies to place a short time limit on their 'poison pills' (usually one year) under the threat that the proxy advisors would otherwise recommend a vote against management's nominees in any proxy contest"). The 2017 Glass Lewis proxy guidelines advised shareholders to vote against "[a]ll board members who served at a time when a poison pill with a term of longer than one year was adopted without shareholder approval within the prior twelve months." GLASS LEWIS, 2017 PROXY PAPER GUIDELINES: AN OVERVIEW OF THE GLASS LEWIS APPROACH TO PROXY ADVICE 15–16 (2017), http://www.glasslewis.com/wp-content/uploads/2016/11/Guidelines_US.pdf; *see also* Toonkel, *supra* note 38.

[86] *See* SHEARMAN & STERLING LLP, 2009 TRENDS IN CORPORATE GOVERNANCE OF THE LARGEST US PUBLIC COMPANIES 24 (2009), https://capitalaberto.com.br/wp-content/uploads/2012/04/General_Governance_Practices_1_.pdf ("Eighteen of the 40 institutional shareholders surveyed would consider poison pill proposals on a case-by-case basis. Eleven . . . would generally vote against poison pill proposals, but would consider the proposal on a case-by-case basis under some circumstances. However, nine . . . are against poison pills without exception.").

[87] *See* Subramanian, *supra* note 18, at 5 ("[I]n recent years 59% of companies without pills have not put them in when a [hostile] bid is brought.").

reduction in the implementation and use of two of the most popular (and powerful) takeover defenses has reshaped the corporate control equilibrium almost entirely outside the Delaware courts.

Golden Leashes. The trend of market forces acting as the primary engine reallocating corporate control has not been limited to staggered boards and poison pills. Another telling example is the rise and fall of restrictions on "golden leashes," a favorite tool of activist hedge funds. A golden leash is an incentive compensation scheme granted to a director nominated to a board by an activist shareholder, whereby the director receives a compensatory reward from the hedge fund for achieving certain activist-determined goals.[88] In the early days of golden leashes, dozens of public companies facing or expecting activism campaigns reacted by restricting the use of golden leashes in their corporate bylaws.[89] From a legal standpoint, it is an open (and intriguing) question as to whether golden leashes compromise the fiduciary duties of the director "held" by the leash, so to speak.[90] It is an equally open question as to whether bylaws provisions prohibiting such pay schemes are even permissible under Delaware law.[91] However, as described below,[92] these questions were not litigated in court but rather were de facto decided through the exercise of discretionary control rights.

In May of 2013, the law firm Wachtell, Lipton, Rosen & Katz (Wachtell) issued a memorandum recommending corporations adopt a bylaw prohibiting golden leashes.[93] Soon thereafter, thirty-two com-

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[88] Yaron Nili, *Servants of Two Masters? The Feigned Hysteria over Activist-Paid Directors*, 18 U. PA. J. BUS. L. 509, 512 (2016); *see also* Gregory H. Shill, *The Golden Leash and the Fiduciary Duty of Loyalty*, 64 UCLA L. REV. 1246, 1249–50 (2017) (describing the dual compensation structure of the "golden leash" and its use to "enlist an unaffiliated outsider as a candidate for director").

[89] *See infra* note 91 (exploring the interplay between golden leashes and reactive changes to corporate bylaws).

[90] *See* Shill, *supra* note 88, at 1274 (introducing some of the issues surrounding golden leashes insofar as they intersect with potential fiduciary duty violations).

[91] *Id.* at 1246. Commentators have observed that Delaware judges are skeptical of golden leashes as sources of potential conflicts of interest. *See, e.g.*, Shill, *supra* note 88, at 1276–86 (surveying cases in which Delaware judges closely scrutinize golden leash arrangements when assessing whether directors violated their duties of loyalty). Some leading corporate law scholars have gone further, likening golden leashes to bribery, and urging that they be banned. *See, e.g.*, Stephen Bainbridge, *Can Corporate Directors Take Third Party Pay from Hedge Funds?*, PROFESSORBAINBRIDGE.COM (Apr. 8, 2013), http://www.professorbainbridge.com/professorbainbridgecom/2013/04/can-corporate-directors-take-third-party-pay-from-hedge-funds.html ("If this nonsense is not illegal, it ought to be.").

[92] *See infra* notes 93–97 and accompanying text.

[93] *See* Steven Davidoff Solomon, *A Strong Response to Paying Board Nominees*, N.Y. TIMES: DEALBOOK (May 10, 2013, 3:13 PM), https://dealbook.nytimes.com/2013/05/10/a-strong-response-to-paying-board-nominees ("[T]he memo proposes that company boards

panies did so.[94] In response, the proxy advisor Institutional Shareholder Services (ISS) recommended that shareholders withhold votes from the members of the Nominating and Governance Committee of Provident (NGCP), one of the firms that had adopted the bylaw. In turn, NGCP's director nominees received a withhold vote of thirty-four percent, signaling widespread investor dissatisfaction.[95] ISS later threatened more withhold recommendations with respect to firms adopting golden leash restrictions. By May 2014, twenty-eight of the thirty-two companies that had adopted anti-golden leash bylaws had removed them,[96] and, by January 2016, only three issuers retained the bylaw.[97] Here again, a complex and pressing corporate governance issue was addressed entirely outside litigation, resolved instead through pressure exerted by market actors (i.e., institutional investors and proxy advisors).

Indices Exclusion. As of this writing, yet another extrajudicial change of major legal consequence is brewing among private actors. Certain shareholder advocates are seeking to eliminate the increasing use of multi-class share structures that limit or eliminate the voting rights of certain classes of shareholders by excluding issuers of multi-class shares from stock indices.[98] Shortly after Snap, Inc.'s $3.4 billion initial public offering (IPO) in March 2017, wherein Snap controversially offered common stock without voting rights, S&P announced its intent to bar companies with "multi-class share structures" from inclu-

consider adopting a bylaw prohibiting shareholder activitsts from compensating director nominees.").

94 Cain et al., *supra* note 78, at 672; *see also id.* at 699 ("[T]he golden leash . . . and the bylaw proposed in response to it [are] . . . case stud[ies] of corporate governance innovation in contemporary capital markets.").

95 *Id.* at 673.

96 *Id.* at 653.

97 *Id.* at 667.

98 Shares of companies that have gone through an initial public offering are frequently included in indices based on criteria that have nothing to do with corporate governance. For instance, the committee reviewing applications for inclusion in the S&P 500 index determines a company's eligibility with eight primary criteria: domicile, listing on a qualified exchange, organizational structure and share type, market capitalization, liquidity, investable weight factor, financial viability, and length of time trading publicly. *See* S&P DOW JONES INDICES, S&P U.S. INDICES METHODOLOGY 5–8 (Sept. 2018), https://us.spindices.com/documents/methodologies/methodology-sp-us-indices.pdf. Many passive investors have a policy of automatically buying shares of every company included in a given index. *See* Madison Marriage, *Passive Funds Take Third of US Market*, FIN. TIMES (Sept. 11, 2016), https://www.ft.com/content/4cdf2f88-7695-11e6-b60a-de4532d5ea35 (noting the increased market share of passive index-tracking funds). Because passive investors make up a substantial portion of the investors that own and trade U.S. firms, exclusion from indices can result in a significant loss of investment capital. *Id.*

sion in the S&P 500 index.[99] This important policy change came only after S&P consulted with the institutional investors that serve as its clients.[100] Whatever one's views of the merits of multi-class share structures,[101] S&P's attempt to impinge on the contracting freedom typically awarded to private parties at the IPO stage, rather than waiting to challenge this behavior in court or lobby legislators, is telling. This is yet another extraordinary illustration of extrajudicial actors replacing the Delaware courts (and corporate law more generally) as arbiters of consequential issues of corporate law and governance.[102]

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[99] While new companies with multiple share classes will not be permitted to join the S&P 500 moving forward, companies already listed on the exchange with multiple share classes will be able to remain. *See* Nicole Bullock, *Investors Hail S&P 500 Move over Multiple Class Shares*, FIN. TIMES (Aug. 1, 2017), https://www.ft.com/content/0a441900-76ca-11e7-a3e8-60495fe6ca71. Another major index provider, FTSE Russell, announced a similar restriction on low-voting stock of the kind at issue in the Snap, Inc. IPO. *See* Abe M. Friedman et al., *S&P and FTSE Russell on Exclusion of Companies with Multi-Class Shares*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 5, 2017), https://corpgov.law.harvard.edu/2017/08/05/sp-and-ftse-russell-on-exclusion-of-companies-with-multi-class-shares (noting that inclusion in the Russell indices now requires a firm to have at least five percent of voting rights in the hands of unrestricted public shareholders).

[100] *See* Friedman et al., *supra* note 99 ("Over the past week, two of the world's largest index providers have announced decisions to partially or fully exclude companies with multiple-class share structures from their indices. These new policies [were] made after substantive consultation with index users and other stakeholders . . . ."); *see also* E-mail from Kenneth A. Bertsch, Exec. Dir., Council of Institutional Inv'rs, to Members of the MSCI Equity Index Comm. (Aug. 3, 2017), https://www.cii.org/files/issues_and_advocacy/correspondence/8-3-17%20CII%20response%20to%20MSCI%20Consutation.pdf ("[W]e believe that major index providers have a critical role to play in preventing non-voting and multi-class equity structures from gaining unstoppable momentum.").

[101] *See generally* Andrea Tan & Benjamin Robertson, *Why Investors Are Fretting over Dual-Class Shares*, BLOOMBERG: BUSINESSWEEK (July 10, 2017, 12:00 AM), https://www.bloomberg.com/news/articles/2017-07-10/why-investors-are-fretting-over-dual-class-shares-quicktake-q-a (describing some of shareholders' concerns with multi-class share structures).

[102] Still outside of the courtroom, shareholders successfully managed to change public corporations' bylaws in order to implement "majority vote" requirements in the election of directors and "proxy-access" shareholder proposals, thereby gaining additional control rights. A majority vote provision requires that a director receive the support of a majority of shareholders for reappointment, as opposed to a plurality vote, which only requires getting more votes than the competing candidate (if one is even present). *See, e.g.*, SHEARMAN & STERLING LLP, CORPORATE GOVERNANCE & EXECUTIVE COMPENSATION 34–35 (2015), http://shearman.uberflip.com/i/581509-2015-corporate-governance-executive-compensation-survey/0? (describing the "dramatic" increase in the use of majority, as opposed to plurality, voting in director elections between 2006 and 2015). A proxy-access provision requires boards to include shareholder-nominated director candidates in companies' annual proxy statements. For an overview of the significance and success of votes adding proxy access provisions to firm bylaws, see SULLIVAN & CROMWELL LLP, 2016 PROXY SEASON REVIEW (July 11, 2016), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_2016_Proxy_Season_Review.pdf; *see also* Lisa M. Fairfax, *The Model Business Corporation Act at Sixty: Shareholders and Their Influence*, LAW &

2. *Hedge Fund Activism and Extrajudicial Resolution of Corporate Conflict*

Section I.B.1 discussed several symptoms of the death of corporate law. In this Section, we turn to the mechanics of hedge fund activism, a major extrajudicial force allowing market participants to sidestep the Delaware courts.

Hedge fund activism constitutes a significant channel through which shareholders increasingly settle controversies with management almost entirely outside the courtroom. Hedge funds agitate for corporate reform on a case-by-case basis, with institutional investors largely determining the fate of these initiatives via the exercise of their voting rights.[103] Over the past two decades, hedge fund activism has emerged as a viable, and prominent, corporate governance mechanism.[104] Activist funds seek to secure value for shareholders (and boost profits for investors in the funds themselves) by nudging, with varying degrees of force, corporations to act in certain ways.[105] To this end, hedge funds have promoted, among other initiatives, stock buybacks, dividend distributions, spin-offs of major units, mergers or sales of the company, and replacements of management.[106] In 2015, 556 activist hedge funds held a total of $142 billion in assets under management.[107] Since 2006, nearly one of every six S&P 500 corporations has

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CONTEMP. PROBS., Winter 2011, at 19, 25 ("In recent years not only has there been an increase in proxy fights, but there also has been an increase in the relative success of such fights.").

103 For helpful background, see generally Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 682–85 (2007) (discussing the legal backdrop of hedge fund activism and its relationship to non-activist shareholder control).

104 For a description of the rise of hedge fund activism and some of the ways in which hedge fund activism is distinguishable from other institutional activism, see, for example, Alon Brav, Wei Jiang & Hyunseob Kim, *Hedge Fund Activism: A Review*, 4 FOUND. & TRENDS FIN. 185, 186–87 (2010) (arguing that on average, activist hedge funds have stronger financial incentives to increase a firm's profits and face fewer conflicts of interest than institutional investors).

105 *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1026 (2007) (analyzing "the implications of the rise of hedge funds for corporate governance and corporate control").

106 Sharon Hannes, *Super Hedge Fund*, 40 DEL. J. CORP. L. 163, 190–91 (2015); *id*. at 163 (suggesting that "a novel market mechanism, a 'super hedge fund,' would maintain the benefits of hedge fund activism, while curbing its downsides"); *see also* Brav, Jiang & Kim, *supra* note 104, at 198 (displaying a distribution of activist funds' stated objectives).

107 TOPPAN VITE NEW YORK, ACTIVIST INVESTING: IMPACT ON 2016 DEALMAKING 7 (2016), http://www.thedeal.com/pdf/ActivistInvesting.pdf. For the 2016 data, see SULLIVAN & CROMWELL LLP, 2016 U.S. SHAREHOLDER ACTIVISM REVIEW AND ANALYSIS 7–9 (Nov. 28, 2016), https://sullcrom.com/siteFiles/Publications/SC_Publication_2016_U.S._Shareholder_Activism_Review_and_Analysis.pdf (noting a drop in assets under management in 2016 for activist funds, after rapid growth between 2013 and 2015).

been the target of an activist campaign, and the numbers continue to rise.[108]

When conflicts between hedge funds and targeted management do reach a court, judicial intervention is unlikely to be decisive. That is to say, when hedge funds initiate a legal procedure, it is often meant to either place additional pressure on the management or address a protective measure taken by the target board, rather than to secure a particular disposition. Consider *Third Point LLC v. Ruprecht*,[109] wherein defendant Sotheby's adopted a two-tiered poison pill[110] specifically intended to thwart activist hedge funds.[111] Third Point, an activist hedge fund, filed a motion to preliminarily enjoin Sotheby's pill.[112] In denying the motion, the court found that Third Point did not have a reasonable probability of success on the merits, since Third Point posed a legally cognizable threat to Sotheby's corporate interests and that its response was proportional under the *Unocal* standard.[113]

Third Point granted Sotheby's board an ostensible victory in court, but in reality, this victory was decidedly hollow. In May 2014, after a grueling proxy fight, Sotheby's and Third Point reached an agreement whereby Sotheby's expanded its board to fifteen members and reserved three seats for Third Point candidates, including Third Point's founder Dan Loeb.[114] In addition, Sotheby's agreed to remove its poison pill, thus allowing Third Point to raise its stake in Sotheby's to fifteen percent.[115] This deal was struck just one day before Sotheby's annual meeting, reflecting the immense pressure Sotheby's shareholders and ISS exerted on the board.[116]

This result is not unique to Sotheby's. In fact, despite the court's approval of management's unilateral adoption of anti-activist poison pills in *Third Point*, corporations appear to be increasingly settling

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[108] AJAY KHORANA ET AL., CITI CORP. & INV. BANKING DIV., RISING TIDE OF GLOBAL SHAREHOLDER ACTIVISM 4 (2013), https://thetyee.ca/Documents/2014/08/06/Citi-FSG-Shareholder-Activism-November-2013.pdf.

[109] C.A. No. 9469-VCP, 2014 WL 1922029 (Del. Ch. May 2, 2014).

[110] The "two-tiered" pill at issue triggered at 10% for activist Schedule 13D filers and 20% for passive Schedule 13G filers. *See id.* at *1, *22–23.

[111] *Id.* at *1 (noting Sotheby's adoption of the pill in response to increasing threats from activists).

[112] *Id.* at *2.

[113] *Id.* at *39–40, *45–46 (declaring that the pill was not draconian nor an unreasonable response).

[114] Press Release, Sotheby's, Sotheby's and Third Point Reach Agreement (May 5, 2014), https://www.sec.gov/Archives/edgar/data/823094/000119312514183175/d723453dex998.htm.

[115] *Id*. (detailing the terms of the agreement reached).

[116] Fontevecchia, *supra* note 27 (noting the importance of ISS giving Loeb its blessing).

with activists instead of litigating the merits of a dispute.[117] And even more telling, the institutional investors who are dissatisfied with such settlements are not suing boards in courts for breach of fiduciary duties, but rather voice their dissatisfaction publicly or directly toward boards.[118]

3. Delaware Courts' Welcoming of Market Primacy

There is little to suggest that the Delaware courts have actively resisted the move toward extrajudicial market actors playing the predominant role in resolving corporate disputes. To the contrary, the courts often seem to accept and acknowledge the change.[119] One clear manifestation of this judicial behavior is the increasing deference to both independent directors and the shareholder vote as a tool to legitimize challenged corporate decisionmaking over cash flow rights, illustrated by the recent holdings in *Cornerstone*,[120] *Corwin*,[121] and *MFW*.[122]

In *Cornerstone*, the Delaware Supreme Court held that independent directors facing a lawsuit challenging a controlling-owner conflicted transaction are protected by the business judgment rule and entitled to a motion to dismiss, absent specifically pled loyalty claims.[123] The practical result of granting motions to dismiss is

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[117] *See* SULLIVAN & CROMWELL LLP, *supra* note 102, at 22 ("The percentage of settlement agreements that have been filed with the SEC for 2016 campaigns to date as compared to the total number of completed activist campaigns has increased significantly from 2015 . . . ."); Jay Frankl & Steve Balet, *The Rise of Settled Proxy Fights*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 22, 2017), https://corpgov.law.harvard.edu/2017/03/22/the-rise-of-settled-proxy-fights ("Of the 110 proxy fights in 2016, 50 ended in settlement, the most we have ever seen in a given year."); *see also* John C. Coffee, Jr., *The Agency Cost of Activism: Information Leakage, Thwarted Majorities, and the Public Morality* 2–5, 10 (European Corp. Governance Inst., Working Paper No. 373, 2017), https://ssrn.com/abstract=3058319 (exploring the settlement process and its potential costs to non-activist shareholders).

[118] *See* Coffee, *supra* note 117, at 23–25; J.P. MORGAN, THE 2017 PROXY SEASON 3 (2017), https://www.jpmorgan.com/jpmpdf/1320739681811.pdf (noting that index investors have expressed frustration with the number of rapid settlements, "viewing them as a usurpation of their right to elect directors" and have "publicly urged portfolio companies to solicit their feedback before settling," as "[f]ailure to do so risks investors voting against incumbent directors following any unacceptable settlement").

[119] Note, however, our saying that the court has "accepted" the move to extrajudicial market actors is not the same as saying that the court has caused this change. *See supra* notes 54–60 and accompanying text.

[120] Leal v. Meeks (*In re* Cornerstone Therapeutics Inc. Stockholder Litig.), 115 A.3d 1173, 1183 (Del. 2015).

[121] Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 306 (Del. 2015).

[122] *In re* MFW S'holders Litig., 67 A.3d 496, 502–03 (Del. Ch. 2013), *aff'd sub nom.* Kahn v. M & F Worldwide Corp., 88 A.3d 635 (Del. 2014).

[123] *In re Cornerstone*, 115 A.3d at 1183 (noting that protection under the business judgement rule is initially presumed for independent directors, even in controlling-owner

avoiding discovery, relieving directors of the need to answer a disgruntled shareholder's questions, and exempting the directors from judicial disciplining. Instead, this disciplining role is transferred to the market, where institutional investors can leverage their control rights to punish directors they believe improperly approved an unfair conflicted transaction.[124]

In *Corwin*, the court issued another market-centric ruling, holding that a merger approved by a majority of fully informed and disinterested shareholders is subject to the deferential business judgment rule, even if the corporation's directors were negligent in the stages preceding the closing or suffered from a conflict of interest.[125] The court stressed the advantage engrained in voting rights as compared to litigation: "When . . . disinterested equity owners . . . can easily protect themselves at the ballot box by simply voting no, the utility of a litigation-intrusive standard of review promises more costs to stockholders in the form of litigation rents and inhibitions on risk-taking than it promises in terms of benefits to them."[126] Fortifying *Corwin*'s cleansing effect, *Singh* held in part that "[w]hen the business judgment rule standard of review is invoked because of a vote, dismissal is typically the result."[127] Delaware courts have followed *Corwin* and announced that fully informed and uncoerced share-

transactions). This ruling reversed the Court of Chancery's finding that entire fairness was the applicable standard with respect to independent directors. *Id*. at 1175.

[124] *See* Brian R. Cheffins, *Delaware and the Transformation of Corporate Governance*, 40 DEL. J. CORP. L. 1, 13 (2015) ("Over the past decade, though, the support mainstream institutional shareholders have increasingly afforded to 'activist' hedge funds specializing in buying up sizeable stakes in target companies and agitating for change has meant that the activist agenda has had an increasingly pronounced influence in the boardroom."); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 807 (2007) ("Today, shareholders have much greater ability to act in concert and to influence boards as a result of a variety of developments that include the increasing clout of institutional investors like pension funds and mutual funds.").

[125] *Corwin*, 125 A.3d at 305–06, 312. Practically, this ruling allows shareholders to ratify a breach of *Revlon* duties. *Id.* at 312 (noting that *Revlon* was intended to apply to pre-closing disputes).

[126] *Id*. at 313.

[127] Singh v. Attenborough, 137 A.3d 151, 151–52 (Del. 2016). The court explained that dismissal is likely upon invocation of *Corwin*'s protection because, at that point, the plaintiff's only route to victory is to allege waste, and as a practical matter, "the vestigial waste exception has long had little real-world relevance." *Id.* at 152; *see also In re* Columbia Pipeline Grp., Inc. Stockholder Litig., C.A. No. 12152-VCL, 2017 WL 898382 (Del. Ch. Mar. 7, 2017). The *Columbia Pipeline* court "(i) found that the stockholders had approved the transaction in a fully informed vote; (ii) held that, as a result, under *Corwin*, the business judgment rule standard of review applied; and (iii) dismissed the case." Gail Weinstein & Warren S. de Wied, Columbia Pipeline*: Directors' Self-Interest Does Not Exclude "Cleansing" Under* Corwin, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Apr. 3, 2017), https://corpgov.law.harvard.edu/2017/04/03/columbia-pipeline-directors-self-interest-does-not-exclude-cleansing-under-corwin.

holder approval will render business judgment rule protection "irrebuttable."[128]

In the context of controlled corporations, *MFW* provides yet another clear example of the Delaware courts deferring to a shareholder vote when evaluating a challenged transaction.[129] *MFW* concerned a classic going-private merger, wherein the controller, Ron Perelman, sought to take his company private by buying out the minority shareholders.[130] Under the governing standard at the time of *MFW*, controllers seeking to enact a going-private merger were subject to entire fairness scrutiny, with the ability merely to shift the burden of proof to plaintiffs if the controller made use of *either* a fully functioning special committee of independent directors *or* a requirement that a majority of the minority shareholders approve the merger.[131] However, *MFW* contained a crucial factual wrinkle: Perelman conditioned the transaction on the use of *both* of these protections.[132] Ruling as a matter of first impression, then Chancellor Strine held that a transaction conditioned upon the approval of both an empowered, dutiful special committee and an informed, uncoerced minority shareholder vote, rather than simply one or the other, is entitled to business judgment review, rather than a simple burden shift within entire fairness review.[133] In so doing, *MFW* offered a path to extract the court from the searching entire fairness review, *so long as the parties involved had the opportunity to exercise their control rights*.[134]

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[128] *See, e.g.*, *In re* Volcano Corp. Stockholder Litig., 143 A.3d 727, 738 (Del. Ch. 2016); *In re* OM Grp., Inc. Stockholders Litig., C.A. No. 11216-VCS, 2016 WL 5929951, at *24 (Del. Ch. Oct. 12, 2016); Larkin v. Shah, C.A. No. 10918-VCS, 2016 WL 4485447, at *2 (Del. Ch. Aug. 25, 2016).

[129] *In re* MFW S'holders Litig., 67 A.3d 496 (Del. Ch. 2013), *aff'd sub nom.* Kahn v. M & F Worldwide Corp., 88 A.3d 635 (Del. 2014).

[130] *Id*. at 499.

[131] *See id.* at 500; Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994) (holding that entire fairness review governs cash-out mergers by a controlling shareholder, and that the controller bears the burden of proof initially but can shift the burden to the plaintiff with either approval by an independent committee or the majority of the minority vote).

[132] *In re MFW*, 67 A.3d at 499–500.

[133] *Id*. at 517, 535.

[134] Indeed, following the *MFW* decision more than ninety percent of the going-private mergers accepted the court's offer of a path to the business judgment rule, with controlling owners adding a majority-of-the-minority condition to the already common use of a special committee approval. *See* Fernán Restrepo, Judicial Deference, Procedural Protections, and Deal Outcomes in Freezeout Transactions: Evidence from the Effect of *MFW* 17 (Mar. 5, 2018) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3105169.

Continuing in this same vein, Delaware courts have met recent appraisal actions with an increasing tendency to defer to deal price as the dispositive indicator of fair value, again suggesting that market actors are better positioned to resolve a corporate cash flow conflict than Delaware chancellors.[135]

Relaxed judicial scrutiny and increased reliance on market forces have also appeared outside deal ratification and appraisal, perhaps most notably in the contexts of "disclosure-only" settlements. In the deal litigation context, plaintiffs often obtain settlements that do not provide for money damages but rather only require defendants to make a few trivial disclosures.[136] These settlements are problematic not only because they waste corporate resources in the form of attorneys' fees, but also because they can result in sweeping releases for the defendants from potentially meritorious litigation.[137] In *Trulia*,[138] the Delaware court declined to approve settlements relating to so-

[135] In a recent decision, the Delaware Supreme Court overturned the trial court's refusal to defer to the deal price on the basis of perceived "regulatory uncertainty." DFC Glob. Corp. v. Muirfield Value Partners, L.P., 172 A.3d 346, 387 (Del. 2017). However, the court stopped short of adopting a full-on presumption of the accuracy of the deal price. *Id.* at 363. A similar decision was also reached in Dell, Inc. v. Magnetar Glob. Event Driven Master Fund, 177 A.3d 1, 6 (Del. 2017) (finding that the trial court erred in giving a firm's current stock price zero weight in an appraisal determination). For additional similar decisions, see Merion Capital LP v. BMC Software, Inc., C.A. No. 8900-VCG, 2015 WL 6164771, at *38 (Del. Ch. Oct. 21, 2015) ("[W]here the sales process is thorough, effective, and free from any spectre of self-interest or disloyalty, the deal price is a relevant measure of fair value."); LongPath Capital, LLC v. Ramtron Int'l Corp., C.A. No. 8094-VCP, 2015 WL 4540443, at *20 (Del. Ch. June 30, 2015) ("Neither [a discounted cash flow nor a comparables] approach yields a reliable measure of fair value in this case. Instead, I conclude that the Merger price offers the best indication of fair value."); Merlin Partners LP v. AutoInfo, Inc., C.A. No. 8509-VCN, 2015 WL 2069417, at *41 (Del. Ch. Apr. 30, 2015) ("Nonetheless, because the Merger price appears to be the best estimate of value, the Court will put full weight on that price."); *see also* Albert Choi & Eric Talley, *Appraising the "Merger Price" Appraisal Rule*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 6, 2017), https://corpgov.law.harvard.edu/2017/01/06/appraising-the-merger-price-appraisal-rule ("[E]ven in deals that engage a single bidder in bilateral negotiations, courts increasingly accord the merger price 'substantial evidentiary weight.'" (quoting *In re* Appraisal of Ancestry.com, Inc., No. 8173-VCG, 2015 WL 399726, at *15 (Del. Ch. Jan. 30, 2015))).

[136] *See* Peter J. Walsh Jr. & Aaron R. Sims, *Delaware Insider:* Trulia *and the Demise of "Disclosure Only" Settlements in Delaware*, BUS. L. TODAY (Feb. 2016), http://www.americanbar.org/content/dam/aba/publications/blt/2016/02/delaware-insider-201602.authcheckdam.pdf (noting the historical prevalence of such settlements, despite their questionable utility for non-activist shareholders).

[137] *See id.* (critiquing the settlements for disincentivizing plaintiff's attorneys from pursuing meritorious claims due to the potential uncertainty of trial outcome, opting instead for a certain settlement).

[138] *In re* Trulia, Inc. Stockholder Litig., 129 A.3d 884 (Del. Ch. 2016).

called disclosure-only class actions.[139] Chancellor Bouchard repeatedly returned to the strong support of the shareholder vote for the merger at issue, suggesting that shareholder ratification bolstered the grounds for dismissal.[140] The Delaware courts thus increasingly appear to doubt that additional fine-grained disclosures benefit sophisticated shareholders and, as a result, have dramatically curtailed disclosure-only settlements (and suits).[141]

In sum, the increased deference of the Delaware courts to market actors reflects the Delaware courts' correct understanding that sophisticated shareholders are better positioned to adjudge the merits of board decisions and to discipline disloyalty and incompetence. As our theory presented in the next Part will show, Delaware's retreat in the context of cash-flow conflicts is not purely the result of judicial volition,[142] but rather a necessity in order for Delaware to preserve its place as the leading state of incorporation.

II
A Theory of the Role of Courts in Resolving Corporate Disputes

Part I chronicled the declined role of Delaware courts, which epitomizes the broader death of corporate law. What has led to the death of corporate law and why? This Part presents a novel theory through which we can explain the underlying market dynamics and provide answers.

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[139] *Id.* at 907–08 (denying the settlement because it failed to provide shareholders with material information, rendering it neither fair nor reasonable). Recent data concerning litigation rates imply that these decisions had a major impact in deterring litigation, at least in the short run. *See, e.g.*, Meredith E. Kotler & Vanessa C. Richardson, *Disclosure-Only Settlements in M&A Litigation*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Sept. 5, 2016), https://corpgov.law.harvard.edu/2016/09/05/disclosure-only-settlements-in-ma-litigation ("[O]nly 64 percent of M&A deals faced litigation during the first six months of 2016, which is the lowest rate since 2009.").

[140] *In re Trulia*, 129 A.3d at 889 ("Trulia's stockholders overwhelmingly supported the transaction. Of the Trulia shares that voted, 99.15% voted in favor of the transaction.").

[141] *See id*. at 898 ("[P]ractitioners should expect that disclosure settlements are likely to be met with continued disfavor in the future unless the supplemental disclosures address a plainly material misrepresentation or omission . . . ."); *see also* Jill E. Fisch, Sean J. Griffith & Steven Davidoff Solomon, *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform*, 93 Tex. L. Rev. 557, 561–62, 585–87 (2015) (arguing that disclosure-only settlements produce no economic benefit to the stockholder class as evidenced by the lack of a relationship between disclosure-settlements, which should ostensibly disclose information of sufficient import to alter shareholder votes, and actual changes in shareholder voting following such disclosures).

[142] *See supra* note 8 (collecting scholarly work reporting that the retreat reflects judicial volition).

A. The Role of Courts in an Incomplete Corporate Contract

The basic corporate contract between boards and shareholders is always "incomplete."[143] Suppose Marco, an entrepreneur with an idea for a social media business, and Sarah, a venture capitalist (VC) looking for promising investments, enter a contract wherein Sarah provides financing to Marco in exchange for a portion of the firm's future profits. At its core, the bargain is financial: Sarah provides cash to Marco now in exchange for Marco's promise to generate more cash in the future. However, the contract does not specify *how* Marco will generate more cash in the future. The future also necessarily entails uncertainty, such as the emergence of new competitors requiring recalibration of the business plan. Since Marco and Sarah cannot contractually enumerate every possible future decision,[144] their contract is incomplete.

This "incomplete-contracts" approach has generated a substantial literature.[145] In their seminal work on contract design, Professors

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[143] *See supra* notes 32–33 and accompanying text (noting that shareholders and the board agree to an allocation of control and cash-flow rights, rather than specifics as to how the firm should be managed). For helpful background on "incomplete contracts," see generally Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691, 691–93, 696–97 (1986) (arguing that purchasing residual rights—everything that was *not* specified in a contract—sometimes offers a lower transaction cost method of contracting as opposed to specifying all possible contingencies). For work applying, either implicitly or explicitly, the "incomplete contract" framework in the corporate context, see John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. L. 1, 27, 27–29 (1999) (discussing the role of common law courts in filling gaps in incomplete contracts, including corporate charters); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) (discussing the flexible, contractual relationship between firms and their investors enabled by corporate law); Jonathan R. Macey, *Corporate Law and Corporate Governance: A Contractual Perspective*, 18 J. CORP. L. 185, 190 (1993) (analyzing the desirability of flexible, as opposed to mandatory, rules in the context of corporate governance, allowing for innovation in charters).

[144] *See* Robert E. Scott & George G. Triantis, *Incomplete Contracts and the Theory of Contract Design*, 56 CASE W. RES. L. REV. 187, 190 (2005) ("To a lawyer, a contract may be incomplete in failing to describe the obligations of the parties in each possible state of the world.").

[145] For more background on the concept of incomplete contracting, see generally Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473 (1992) (discussing incomplete contracts in the context of capital structuring and financing decisions); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989) (applying a law and economics framework to the development of default rules for filling gaps in incomplete contracts, and arguing that these defaults should sometimes deviate from what the parties may have bargained for had they considered the issue ex ante); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) (discussing the contractarian case for director primacy); Karen Eggleston, Eric A. Posner & Richard Zeckhauser, *The Design and*

Robert Scott and George Triantis suggest that parties entering an incomplete contract will seek to minimize the sum of the ex ante cost of drafting and agreeing upon the contractual terms, along with the ex post cost of litigating items left unresolved by the contract.[146] Subsequent work by Triantis and Professor Albert Choi engaged the question as to how parties will design an incomplete contract in the corporate context, framing the ex ante drafting versus ex post litigation costs as a balance between vagueness and specificity of contractual terms.[147] Most recently, Scott along with Professors Ronald Gilson and Charles Sable, introduced a model in which parties in an incomplete contract prefer more specific terms when the objective at issue is more certain, and conversely prefer vagueness when uncertainty renders a court the most convenient ex post arbiter.[148]

Notwithstanding these thoughtful treatments of incomplete contracting models, the literature has left a conspicuous gap. There has been little attempt to address the role of courts and their use by parties in the context of a preexisting incomplete contract—particularly in the corporate governance context.[149] In other words, while existing models focus on the *design* of the contractual relationship, we are concerned with the role courts play in an already extant incomplete contract and how the parties will, or will not, *use* courts when they have the right to do so.[150] This Article attempts to fill this gap in the litera-

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Interpretation of Contracts: Why Complexity Matters, 95 Nw. U. L. Rev. 91 (2000) (critiquing scholarly analysis which focuses solely on the (in)completeness of contracts at the expense of discussing their complexity and discussing the resultant implications for courts deciding how to interpret contractual provisions); Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 Colum. L. Rev. 1641, 1667–72 (2003) (arguing that parties often can abide by and often intentionally write indefinite, incomplete contracts due to the prevalence of concerns about "reciprocal fairness" among the population).

146 Scott & Triantis, *supra* note 144, at 188–90 (discussing the refinement of the broad category of transaction costs into more nuanced concepts of ex ante and ex post costs).

147 Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 Yale L.J. 848, 855 (2010) ("Our objective throughout is to demonstrate the possibility that vagueness may be used strategically to resolve information obstacles to efficient contracting.").

148 Ronald J. Gilson, Charles F. Sable & Robert E. Scott, *Text and Context: Contract Interpretation as Contract Design*, 100 Cornell L. Rev. 23, 56–57 (2014).

149 Scholarship specific to corporate law has emphasized the importance of courts in enforcing the duty of loyalty. *See, e.g.*, Ronald J. Gilson & Alan Schwartz, *Corporate Control and Credible Commitment*, 43 Int'l Rev. L. & Econ. 119, 123–29 (2015) (characterizing the duty of loyalty as a partial solution to the credible-commitment problem faced by controlled companies).

150 In our theory, judicial interpretation of corporate contracts is not a future cost that the parties consider at the drafting stage, but rather a tribunal that the parties may, or may not, turn to once disputes arise. Notably, this tribunal is capable of creating default rules that may be designed either to codify or impede the parties' ability to resolve corporate disputes extrajudicially. It is important to note that while our aim in this Article is primarily to provide a theory that explains the conditions under which principals and

ture, beginning with a theory to explain when a principal and an agent might prefer to use a court for dispute resolution, and when they might, alternatively, prefer to use discretionary control rights.

B. Agent Costs, Principal Costs, and Adjudicatory Costs

Since Marco and Sarah cannot contractually enumerate all possible future decisions, they must instead decide ex ante how to allocate the value generated by the firm (cash flow rights) and the decisionmaking authority (control rights) over broad classes of decisions—this is the essence of corporate governance. Parties to an incomplete contract acknowledge that conflicts as to the allocation of control rights and cash flow rights might also arise in the future. When deciding ex ante how to resolve future disputes arising out of unspecified eventualities in an incomplete contract, parties generally have two options: (1) Assign decisionmaking authority to either the principal, agent, or some combination thereof; or, (2) assign authority to a neutral third party.[151]

Consider the first option: Parties can assign authority over some broad class of decisions to the agent, the principal, or some combination of both. For example, returning to the Marco-Sarah hypothetical, it may make sense for the parties to assign decisionmaking authority to Marco, the entrepreneur, over day-to-day business operations because he has superior expertise and information regarding the business itself. And it may make sense for Marco and Sarah to share decisionmaking authority over setting Marco's compensation because Sarah might not trust Marco to self-impose a fair level of compensa-

agents will or will not turn to judicial resolution in the context of a *preexisting* corporate contract, our theory also has the potential to inform future discussions of contract *design*. However, for purposes of clarity and concision, we leave for another day the question of how parties might apply our theory to contract design.

[151] Because our example of Marco and Sarah abstracts from reality in the interest of conveying the essence of our theory, it is important to make a clarification as to the identity of the agent. The identity of the agent changes depending on whether one is considering a widely held or a controlled firm. If a firm is widely held, the agent is the board and management, whereas if the company has a controlling shareholder, the controller herself will be the agent (in the latter case, the minority shareholders are the principal). *See* Goshen & Squire, *supra* note 33, at 785 (describing the distinctions between principals and agents). One way of understanding this difference is to consider the fact that in a widely held company, the competence and conflict costs of the board and managers will lead to agency costs in light of the limited ability of dispersed shareholders to control this behavior (for example, due to rational apathy or collective action problems); on the other hand, in a controlled company, the controller's competence and conflict costs are the cause for greatest concern vis-à-vis agency costs, because the controller is capable of forcing the company (including its board and management) to behave as the controller sees fit. *See* Goshen & Hamdani, *supra* note 33, at 581–82 (explaining the phenomenon of agency costs).

tion. The efficiency of any specific allocation of control rights between Marco and Sarah will depend on the balance of "control costs" associated with the agent's exercise of *control rights* ("agent costs") and the principal's exercise of control rights ("principal costs").[152]

There are two subcategories within the broad umbrella of control costs: competence costs and conflict costs.[153] *Competence costs* arise when the party exercising control makes an honest mistake that reduces firm value.[154] These costs drive the decision to grant Marco decisionmaking authority over day-to-day business operations, as Marco's superior expertise and access to information imply he will make fewer honest mistakes than Sarah (i.e., *agent* competence costs are lower than *principal* competence costs).[155] *Conflict costs*, on the other hand, arise when the party exercising control takes a value-reducing action out of self-interest.[156] These costs motivate the decision to split decisionmaking authority over Marco's compensation between the two parties—if Marco is a self-interested agent (i.e., there is a risk of high agent conflict costs), he may try to compensate himself at a level significantly above the fair value of his service.[157]

Consider now the second option for resolving incomplete contract disputes: The parties can assign decisionmaking authority to a neutral third party, such as a court.[158] Returning to Marco and Sarah, the parties might decide that a court should determine whether to permit the firm to enter a transaction with a different firm also owned by Marco—a "self-dealing" transaction—according to whether the court deems the transaction "fair," however determined. The only control right that Sarah, the principal, would retain is the right to petition the court to prevent a self-dealing transaction of which she disapproves—a "duty-enforcement right."[159]

Herein lies our theory's critical observation: Just as exercise of control by the principal or agent can impose control costs, so too can exercise of control by the third-party adjudicator. We call these judicially imposed control costs "adjudicatory costs." Adjudicatory costs

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152 *See* Goshen & Squire, *supra* note 33, at 770 (explaining the principal-cost theory that states that a firm's optimal governance structure will minimize total control costs—the sum of principal costs and agent costs).

153 *Id.*

154 *Id.*

155 *See id.* at 785–90 (discussing competence costs).

156 *Id.* at 791.

157 *See id.* at 785–90.

158 We assume that the parties have chosen a court as the neutral third party rather than an administrative agency or private arbitrator. The analysis, however, would be the same.

159 *See* Goshen & Squire, *supra* note 33, at 798–801 (explaining the function of duty-enforcement rights in corporate governance).

can arise in a variety of different contexts, related to both competence and conflict. Courts given responsibility to adjudicate disputes over day-to-day business decisions may lack the expertise and information about the firm's business that the agents and principal possess. If a court inefficiently blocks a value-enhancing transaction due to lack of information or lack of the expertise necessary to evaluate this information, this behavior imposes adjudicatory *competence* costs. Concerns with adjudicatory competence costs animate the business judgment rule, which requires courts to defer to disinterested, informed decisions by directors and managers.[160]

Assuming a professionalized, honest judiciary, we can expect adjudicatory *conflict* costs related to judges' conflicts of interest to be minimal. We must extend our theory away from the stylized single-manager/single-investor firm to understand how adjudicatory *conflict* costs impact the parties' preference of whether to enlist a court. Instead of a single principal, assume a firm with thousands of principal investors, each of whom owns a very small portion of the firm's equity and holds a diversified portfolio of investments. As before, the parties may delegate to a court authority to review challenged conflicted transactions. But because the principals each hold a very small stake in the firm, they each lack the incentives necessary to vigorously prosecute the lawsuits.[161] The principals, therefore, have an incentive to delegate authority to the court to award fees to their counsel, hoping that entrepreneurial "private attorneys general," motivated by the promise of such fees, will drive the litigation.[162] However, these attorneys' incentives may depart from those of their clients[163]—particularly

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160 *See* Aronson v. Lewis, 473 A.2d 805, 811–13 (Del. 1984) (explaining the function of the business judgment rule in the context of derivative actions); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) ("A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose.").

161 This is an instantiation of the fundamental "separation of ownership and control" problem analyzed by Berle and Means nearly a century ago. *See generally* BERLE & MEANS, *supra* note 40.

162 Judge Jerome Frank coined the term "private [a]ttorney [g]eneral[ ]" to refer to one who brings an action to "vindicate the public interest." Associated Indus. of N.Y. State, Inc. v. Ickes, 134 F.2d 694, 704, 705 (2d Cir. 1943), *vacated on other grounds*, 320 U.S. 707 (1943).

163 *See, e.g.*, U.S. CHAMBER INST. FOR LEGAL REFORM, THE TRIAL LAWYERS' NEW MERGER TAX: CORPORATE MERGERS AND THE MEGA MILLION-DOLLAR LITIGATION TOLL ON OUR ECONOMY (October 2012), https://dandodiscourse.lexblogplatform.com/wp-content/uploads/sites/162/2012/10/U.S.-Chamber-Institute-Paper.pdf (discussing the purportedly inefficient, and conflict-based, tendency of plaintiffs' lawyers to challenge via lawsuit the overwhelming majority of attempted mergers); *see also supra* notes 138–41 (describing several ways in which the Delaware courts have doctrinally sought to curtail this abusive practice).

if courts sometimes mistakenly award attorneys' fees for frivolous litigation.[164] 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. In other words, "adjudicatory costs" are costs borne out of the litigation process at large, not only those costs generated by judges. Table 1 catalogs various types of conflict and competence costs.

TABLE 1. CONTROL COSTS

	Competence Costs	Conflict Costs
Principal	Inadequate information and expertise Low intellectual endowment Low emotional endowment Cognitive biases Coordination problems	Collective action problems Rational apathy Holdouts Different investment horizons Different investment goals Conflicts due to competing external interests
Agent	Inadequate information and expertise Low intellectual endowment Low emotional endowment Cognitive biases	Shirking (reduced effort) Diverting (self-dealing and inefficient, but self-promoting, decisions)
Adjudicatory	Inadequate information and expertise Low intellectual endowment Low emotional endowment Cognitive biases Crowded dockets	Plaintiffs' Bar: Fee-generating conflicts Courts: Reputational pressures on judges Effects of the judges' appointment process

[164] Substantial literature covers the agency costs associated with this model of litigation. *See, e.g.*, 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) (explaining that there are high agency costs associated with derivate and class actions that depend on a variety of factors). Under our framework, these costs are species of adjudicatory conflict costs, which in turn fall under the larger umbrella of control costs.

Recognizing that principals, agents, and courts all impose control costs clarifies why parties under certain circumstances may wish to delegate decisionmaking authority to courts rather than reserving this authority for themselves and vice versa. Assume a principal with high competence costs (such as a principal with little knowledge of the firm's business) and an agent with low competence costs (such as an expert) but high potential conflict costs. Assume further the parties anticipate that the agent may engage in self-dealing and therefore wish to prevent harmful conflicted transactions. Consider, as previewed above, two possible governance options: The first option is to give the principal a right to veto any transaction that involves the agent's self-dealing. The second option is to give the principal a right to petition a court to challenge such transactions.

Regarding the first option, the principal—due to her inadequate competence—may be prone to mistakenly applying the veto right, either blocking beneficial transactions or approving harmful transactions. This erroneous application of the veto right would introduce principal competence costs. If the court itself has a comparable level of competence costs (such as with a nonexpert court), replacing the competence costs of the principal with the competence costs of the court—the second option noted above—may not reduce total control costs. However, if the court has *low* competence costs (such as an expert court), this court is likely to make fewer mistakes than the principal when choosing which transactions to block, and thus is able to decrease total control costs, rendering the court the better option than the veto right.

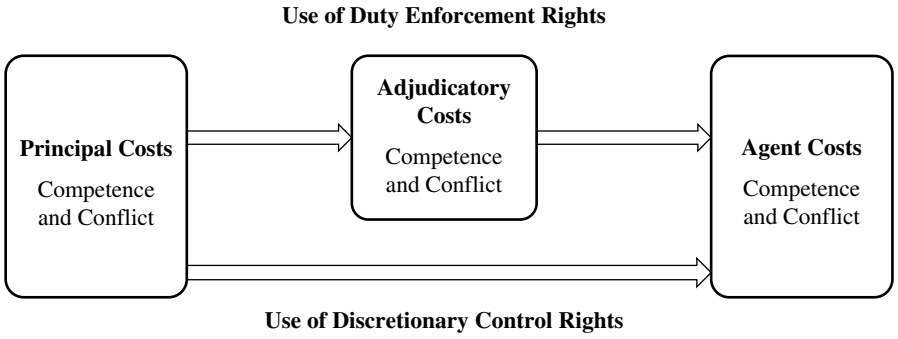
The reverse is also true. Assume a principal with low competence costs (an expert investor) and a court with high competence costs (a nonexpert court). Here, the principal is likely to make fewer mistakes than the court, making the veto right the more efficient option. If both the principal and court have low competence costs (both the principal and the court are experts), then conflict costs associated with the adjudication process may tilt the scale toward using the veto right. Finally, if both the court and principal have high competence costs, then the principal must decide whether to forego the agency relationship altogether.[165]

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[165] The unfortunate implication of this conclusion is that countries without courts below some threshold level of adjudicatory costs are unlikely to have capital markets at all. *See* Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 6 (2000) ("At the extreme of no investor protection, the insiders can steal a firm's profits perfectly efficiently. Without a strong reputation, no rational outsider would finance such a firm.").

Figure 1 broadly illustrates the interplay between principal, agent, and adjudicatory costs. The principal can hold the agent accountable either via the principal's own efforts (through the use of discretionary control rights such as shareholder voting) or with the aid of a court (through the use of duty-enforcement rights such as the right to sue for breach of directors' fiduciary duties). The use of discretionary control rights will give rise to principal costs and agent costs, while the use of duty-enforcement rights will also add adjudicatory costs into the mix.

FIGURE 1: PRINCIPAL COSTS, AGENT COSTS, AND ADJUDICATORY COSTS



Generally stated, when parties determine that total control costs will likely decrease with the addition of adjudicatory control costs—that is, *principal costs + agent costs* are higher than *principal costs + agent costs + adjudicatory costs*—conventional economic assumptions suggest that parties will assign more decisionmaking authority to the court.[166] The opposite holds true as well. When parties determine that adding adjudicatory control costs will likely increase total control costs—that is, *principal costs + agent costs + adjudicatory costs* are higher than *principal costs + agent costs*—our theory predicts that the parties will assign more decisionmaking authority to the principal, the agent, or both, without involving the court.

1. Total Control Costs by Decision Type

Having introduced a framework in which parties to a corporate contract will seek to minimize the sum of principal costs, agent costs, *and* adjudicatory costs, we turn now to an important subsidiary question: What factors contribute to the size and balance of principal, agent, and adjudicatory costs? In this subsection, we discuss one such

[166] *See supra* text accompanying notes 33–34 (discussing this phenomenon).

factor: *decision type*. Specifically, we argue that the magnitude of total control costs in a given situation will vary based on the type of decision that a court might be enlisted to adjudicate. We consider two broad decision types: First, judicial decisions intended to reduce the competence costs of either the principal or the agent; and second, judicial decisions intended to reduce the conflict costs of either the principal or the agent.

Competence Costs. Generally, courts are not enlisted to try to reduce the competence costs of either principals or agents. The adjudicatory process is inherently inadequate to pass meaningful judgment on the competence of corporate actors and very likely to increase total control costs if granted such power. Consider a paradigmatic case involving the competence of corporate actors: selection of a company's board of directors. Delegating authority to the courts to consider whether individuals ought to sit on the company's board would likely be quite costly. Judges do not have the competence to select directors, nor do judges employ anything resembling a human resources department to help discern the abilities of director nominees. Therefore, involving judges in the evaluation of director nominees would likely impose high adjudicatory competence costs. Additionally, judges do not bear the consequences of their decision, and there is no mechanism to hold judges accountable for their mistakes in appointing the wrong directors. To make matters worse, delegating control to courts over the nomination of directors may also introduce the distorted incentives of the plaintiffs' bar. Insofar as the plaintiffs' bar may wish to pursue unnecessary litigation, involving the judicial process in the evaluation of director nominees is therefore likely also to impose adjudicatory conflict costs.

In contrast, shareholders have incentives to correctly appoint directors. If principal competence costs are relatively low (such as with institutional investors), we expect shareholders to be capable of competently selecting individuals to sit on the company's board. Even if shareholder principal costs are high (such as with retail investors), this will still not justify using courts to nominate directors. In such a case, and despite the obvious conflict, it will be better to allow the agent (i.e., management or the existing directors) to nominate directors because the agent is more competent than the courts and is subject to accountability mechanisms such as a compensation package and hostile takeovers.

In light of the foregoing risk of high adjudicatory costs, our theory predicts that courts will generally be limited by the parties to a minor role in director elections and other decisions involving the competence of principals and agents, tasked only with refereeing proce-

dural issues rather than ruling on the candidates' substantive merit. Indeed, this is precisely what the law reflects.[167]

Conflict Costs. Courts have traditionally been far more involved in decisions intended to reduce the conflict costs of either the principal or the agent. Corporate conflict costs typically emerge from disputes over either the allocation of cash-flow rights or control rights between the principal and the agent. Consider a conventional cash-flow conflict: a "squeeze-out" merger in which a controlling shareholder seeks to buy out minority shareholders to obtain full control of the company. In squeeze-outs, the controlling shareholder's financial interest is clearly implicated, suggesting that leaving the decision with the board (perhaps under the influence of the controlling shareholder) might be unwise insofar as it risks agent conflict costs. The parties may thus wish to enlist the courts, which can scrutinize the board's decisionmaking process in accepting the terms and price of the squeeze-out.

The exact role of courts in supervising such a conflict will depend on the magnitude of principal costs relative to that of the court in any given situation. Unlike Delaware courts, not all courts are able to offer a sound opinion on valuation, thus imposing adjudicatory competence costs.[168] Moreover, the rent-seeking tendencies of the plaintiffs' bar are likely to impose adjudicatory conflict costs via a desire to litigate squeeze-out transactions at a frequency that may be higher than what is efficient.

Assuming, however, that courts are professional (as they are in Delaware), the relative sizes of principal costs and adjudicatory costs will likely be the primary determinant of the role such a court might have. For example, consider a proposed squeeze-out in a firm held primarily by retail investors. In such a case, retail investors may impose relatively high principal costs in the form of competence costs, due to lack of information and expertise regarding the pricing of the deal, and conflict costs, insofar as some shareholders might frustrate an efficient transaction by demanding an unreasonably high price (a

[167] In Delaware, courts scrutinize board actions related to elections under the *Blasius* standard, whereby the board must demonstrate a "compelling justification" for "acts done for the primary purpose of impeding the exercise of stockholder voting power," a quintessential procedural restriction. Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988). We consider ordinary business decisions among the paradigmatic cases in which our theory predicts courts' role to be limited. *See, e.g.*, Aronson v. Lewis, 473 A.2d 805 (Del. 1984) (discussing the business judgment rule).

[168] *See supra* notes 3–4 (describing the uniqueness of the Delaware courts' expertise in these matters).

holdout problem).[169] Therefore, in this situation, the court might be enlisted to perform a substantive role, evaluating the fairness of the squeeze-out. If we imagine the same squeeze-out, but with institutional investors instead of retail investors, things become very different. Institutional investors may impose relatively low principal costs, due to greater expertise in valuation and a lower likelihood of unreasonably holding out. In such a case, the court might be enlisted to perform a more procedural role, refereeing the integrity of the vote of disinterested shareholders.

2. Principal Competence and Ownership Composition

As we have explained, principal competence affects the optimal option between using courts or discretionary control rights to resolve corporate disputes. Because investor sophistication is a proxy for investor competence, we suggest that the sophistication of a firm's investor base helps to predict whether it is efficient to allocate conflict-resolution authority to a court or, alternatively, keep authority with investors for purposes of extrajudicial dispute resolution. Specifically, our theory predicts that investor sophistication should influence the degree to which market participants employ courts to resolve corporate disputes.

To illustrate the significance of investor characteristics in determining whether the use of a court is optimal, it is helpful to consider firms of varying hypothetical investor bases. Consider first our now-familiar example of Marco, the entrepreneur of a technology company, and Sarah, the investor. Assume that Sarah's venture capital firm has considerable experience in the technology industry and also that Sarah's firm owns a sizeable stake in Marco's company. Assume further that the remaining equity shareholders of Marco's company are similarly experienced and sophisticated, generating relatively few principal competence costs. If we assume finally that each investor, like Sarah, owns a significant stake of the company, we can also generally expect relatively low principal conflict costs, as Sarah et al. have a clear financial incentive to ensure the success of Marco's company.[170] Given Marco's company's minimal exposure to principal costs, our

[169] For full analysis of the tradeoffs between requiring minority shareholder approval and judicial supervision, see Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CALIF. L. REV. 393 (2003) (analyzing the efficiency of the methods by which corporate law addresses the self-dealing problem).

[170] One can, of course, imagine situations in which principal conflict costs would be high. For example, if the venture capitalists (VCs) also own stakes in the company's competitors, we might expect them to agitate for corporate action that would help their other portfolio companies but reduce the firm's value.

theory predicts that the parties will prefer for the principals and agents to retain significant dispute-resolution authority and only rarely seek judicial oversight.[171] This comports with what we observe in reality, as VCs—who comprise only a small portion of investors in U.S. public companies—often negotiate for control rights at a high level of specificity, reserving considerable discretionary control rights.[172]

Now consider the other end of the investor spectrum: Instead of Marco's company, consider a dispersed-ownership firm whose equity is owned almost entirely by small, diversified retail investors who know little about managing a large company. This lack of know-how and small financial stake will likely generate high principal competence costs and principal conflict costs, respectively.[173] In such a situation, one might expect parties to make more frequent use of judicial dispute resolution, relying on courts to reduce conflict costs.

As a final example, consider a hypothetical intermediate firm: Imagine a firm owned primarily by large institutional investors with (1) some level of sophistication greater than that of retail investors but less than the industry-expert VCs discussed above; and (2) financial stakes in the firm greater than small retail investors but less than highly-invested VCs, say at a rate somewhere between one and ten percent of the firm's total equity. In this hypothetical firm, we expect that the institutional investors' moderate sophistication will lead to principal competence costs lower than those associated with retail investors, but higher than those associated with VCs. We should fur-

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171 The coherence of this theory is also supported by the Scott and Triantis formulation. Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814 (2006) (examining the efficiency of the contracting process at the front and back end, with a focus on litigation as the back-end stage).

172 In other words, the parties opt for a complete contract rather than an incomplete one. *See id.* at 814 ("When the parties agree to precise terms (or rules), they invest more at the front end to specify proxies in their contract, thereby leaving a smaller task for the enforcing court."). One might also think of this problem in terms of rules versus standards. *See generally* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 557 (1992) (offering an "economic analysis of the extent to which legal commands should be promulgated as rules or standards"). VCs and other sophisticated parties can convert nebulous standards into more precise rules that provide a more optimal arrangement for their specific circumstances.

173 There is a large literature discussing the ways in which small ownership stakes lead to distorted incentives for investors, specifically noting that the minimal financial incentive to monitor company management leads both to so-called "free-rider" and "rational apathy" problems. *See, e.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 526–29 (1990) (describing shareholder passivity and surveying recent scholarship that recognizes the increased role of institutional shareholders in proxy contests). For discussion of shareholders' collective action problems, see Hannes, *supra* note 106, at 172–73. For discussion of shareholders' rational apathy, see Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1575–77 (1989).

ther expect that the institutional investors' moderate ownership stakes will lead to principal conflict costs lower than those generated by retail investors but higher than those generated by VCs. In such a scenario of moderate principal competence costs and moderate principal conflict costs, our theory predicts that the parties will enlist courts for dispute resolution more than in our first example of the VC-owned firm but less than in our second example of the retail-investor-owned firm.

In the next Part, we apply our theory to the typical modern U.S. corporation, with attention to the corresponding declined role of the Delaware courts.

III
Applications and Implications for Delaware

Part I described the death of corporate law, illustrated by the waning role of the Delaware courts and the increasing tendency for market participants to resolve conflicts outside of courts. Part II introduced a theory that explains how principal costs affect shareholders' preference between using discretionary control rights and courts. Our theory demonstrated that the optimal role of courts depends on the balance of principal costs, agent costs, and adjudicatory costs associated with the allocation of a given control right. This Part applies our theory to explain the declined role of Delaware courts in resolving corporate disputes (III.A) and to provide predictions for the future of Delaware as the leading state of incorporation (III.B).

A. Applying the Theory to the Declined Role of Delaware Courts

To explain the changed role of Delaware courts we need to analyze the current balance of control costs to identify which player's costs—the principal, the agent, or the courts—have led to the declined role of Delaware courts.

Courts. We begin with the observation that the Delaware courts' competence and conflict costs appear to have remained relatively unchanged over the last several decades.[174] The Court of Chancery, Delaware's specialized business-entity court, has changed little in composition and competence, and its judges are selected via the same

[174] *See* Randy J. Holland, *Delaware's Business Courts: Litigation Leadership*, 34 J. Corp. L. 771, 777 (2009) (indicating no significant change in the method of judicial appointment or the size and composition of the Delaware courts since the 1980s); *see also* Maurice A. Hartnett, III, *The History of the Delaware Court of Chancery*, 48 Bus. Law. 367, 367 (1992) (providing a history of the Delaware Court of Chancery); William T. Quillen & Michael Hanrahan, *A Short History of the Court of Chancery*, Del. Cts., http://courts.delaware.gov/chancery/history.aspx (last visited Oct. 19, 2018) (same).

process.[175] In short, adjudicatory control costs have likely remained largely unchanged. Our theory, therefore, suggests that Delaware's shift in power from courts to market actors must trace to a change in either agent or principal costs.

Agents. There is little reason to believe that inherent agent costs (i.e., costs imposed by managers' exercise of control) have significantly changed over the last few decades. As to competence costs, overall there does not appear to have been a pivotal shift in managerial competence. Perhaps more importantly, as courts are tasked largely with monitoring management conflicts rather than competence,[176] a change in the latter seems unlikely to catalyze a changed role for the court.

Regarding conflict costs, we have found no evidence that, on average, management has undergone a noteworthy shift in conflicted behavior. To be sure, board oversight practices have evolved to encourage directors to more closely scrutinize firms' senior executives,[177] but, similar to other trends we described in Part I, this change is also driven by shareholders' increased use of discretionary control rights. Theoretically, changes in executive compensation techniques might affect management conflict costs over time. That being said, there are competing theories as to whether executive compensation is structured to reduce agency costs or is itself a manifestation of agency costs.[178] Since 2000, there have been changes in the size (amount of compensation has decreased) and composition (compensation has shifted from options-based to restricted stock-based) of board compensation, but the empirical findings as to the effects on firm performance and risk-taking are inconclusive.[179]

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175 *See* Holland, *supra* note 174, at 776–77.

176 *See supra* note 44 and accompanying text.

177 *See, e.g.*, TIM J. LEECH, THE CONFERENCE BD., BOARD OVERSIGHT OF LONG-TERM VALUE CREATION AND PRESERVATION: WHAT NEEDS TO CHANGE? 1 (2017), https://www.conference-board.org/publications/publicationdetail.cfm?publicationid=7557 ("Stakeholders increasingly expect boards of directors to do more to oversee the organizations they direct."); F. William McNabb III, *Getting to Know You: The Case for Significant Shareholder Engagement*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 24, 2015), https://corpgov.law.harvard.edu/2015/06/24/getting-to-know-you-the-case-for-significant-shareholder-engagement (explaining that Vanguard, the largest mutual fund firm globally, understands corporate governance from the perspective of "want[ing] to provide oversight and input to the board of directors . . . [and] count[ing] on boards to oversee management").

178 *See* Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71, 72 (2003) (describing the two approaches of studying executive compensation, namely the "optimal contract approach" and "managerial power approach").

179 *See* Kevin J. Murphy, *Executive Compensation: Where We Are, and How We Got There*, *in* 2 HANDBOOK OF THE ECONOMICS OF FINANCE 211 (George M. Constantinides,

Similarly, the widespread use of "golden parachutes"—a part of executive compensation offering a substantial payment to management upon a sale of control—should theoretically incentivize managers to sell the corporation and alleviate the problem of management entrenchment.[180] However, in practice, a substantial part of hedge fund activism is about facilitating merger and acquisition activity.[181] This reality implies that management conflict has not declined substantially on this front as well. What has changed is the method to cope with management conflict.

Principals. This leaves one remaining possible culprit for the courts' changed role: a change in principal costs. If principal costs at widely held firms have declined over the past several decades, then our theory suggests that the reduced costs associated with investor control have led to a shift in authority from courts to shareholders—a result that comports with the narrative presented in Part I and the theory expounded in Part II. Indeed, the decline in the role of the Delaware courts has coincided with a shift in the ownership structure of U.S. equity markets; retail investors have vacated their place to large, sophisticated institutional investors.[182]

A few figures help to shed light on the magnitude of this change: In 1965, American mutual funds, pension funds, and insurance companies held shares of U.S. corporations worth a total of $36 billion, $43 billion, and $21 billion, respectively.[183] The holdings of these three

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Milton Harris & Rene M. Stulz eds., 2013) (documenting the present state of executive compensation and how it has evolved over the past century); Alex Edmans, Xavier Gabaix & Dirk Jenter, *Executive Compensation: A Survey of Theory and Evidence* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 23596, 2017), http://www.nber.org/papers/w23596 (surveying "the theoretical and empirical literature on executive compensation"). Given the conflicting and inconclusive evidence, we consider any broad claim on the relationship between executive compensation and management conflict to be speculative at this time.

[180] Empirically, however, the effects of golden parachutes on management incentives are inconclusive. *See, e.g.*, Lucian Bebchuk, Alma Cohen & Charles C.Y. Wang, *Golden Parachutes and the Wealth of Shareholders*, 25 J. CORP. FIN. 140 (2014) (showing the conflicting effects that golden parachutes have on management incentives).

[181] *See* J.P. MORGAN, *supra* note 118, at 4 ("More than 500 M&A-related campaign demands were made by activists globally during the 2016 and 2017 proxy seasons, representing approximately 75% of total value demands for that period.").

[182] *See* Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 897 (2007) ("In 1965, institutional investors held 16% of U.S. equities; by 2001, institutional investors held 61%.").

[183] *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: HISTORICAL ANNUAL TABLES 1965–1974, at 95 tbl.L.213 (2014) [hereinafter FEDERAL RESERVE TABLES 1965–1974], http://www.federalreserve.gov/releases/z1/20140306/annuals/a1965-1974.pdf (showing that the entire equity market of all U.S. public shares was worth less than $750 billion at the time). Shares of U.S. corporations not held by institutional investors were held directly by the public or by large shareholders, including controlling shareholders. *See* John C. Coates IV, *Measuring the Domain of*

groups amounted to a relatively small fraction of the stock market: 5% for mutual funds, 6% for pension funds, and 3% for insurance companies.[184] By 1980 the portion of the equity market held by these three groups had grown, and the division between them had changed: 3.1% for mutual funds, 17.4% for pension funds, and 5.1% for insurance companies.[185] At the time, the market capitalization of listed domestic companies was $1.36 trillion,[186] and institutional investors held $436.2 billion in equity altogether.[187]

These figures have since continued to grow rapidly.[188] In 2016, mutual funds, pension funds, and insurance companies held shares worth $9.1 trillion, $2.3 trillion, and $811 billion of U.S. corporation shares, respectively.[189] Even with the tremendous growth of the equity market itself, with an aggregate market capitalization of over $25 trillion for all public companies in 2016,[190] these three groups of institutional investors collectively hold over 50% of the market.[191]

Mediating Hierarchy: How Contestable Are U.S. Public Corporations?, 24 J. CORP. L. 837, 848 (1999) (discussing ownership patterns of U.S. corporations and noting the presence of controlling shareholders in an appreciable segment of the economy).

184 FEDERAL RESERVE TABLES 1965–1974, *supra* note 183, at 95 tbl.L.213.

185 James M. Poterba & Andrew A. Samwick, *Stock Ownership Patterns, Stock Market Fluctuations, and Consumption*, *in* 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 295, 313 tbl.5 (William C. Brainard & George L. Perry eds., 1995) (describing the changing pattern of stock ownership during the previous three decades and the association between share price movements and consumption).

186 *Market Capitalization of Listed Domestic Companies (Current US$)*, WORLD BANK: DATA, http://data.worldbank.org/indicator/CM.MKT.LCAP.CD?locations=us (last visited Oct. 19, 2018) (listing the market capitalization of listed domestic companies for multiple countries over variable spans of time).

187 *See* Edward Rock, *Institutional Investors in Corporate Governance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE, *supra* note 8, at 1, 3 (examining the "role of institutional investors in corporate governance and whether regulation is likely to encourage them to become active stewards").

188 *See* Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Institutional Investors: Power and Responsibility, Speech at Georgia State University (Apr. 19, 2013), https://www.sec.gov/news/speech/2013-spch041913laahtm (summarizing data to demonstrate the growth of institutional investors).

189 *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: SECOND QUARTER 2018, at 130 tbl.L.223 (2018), https://www.federalreserve.gov/releases/z1/20180920/z1.pdf (listing the amount of U.S. equities various actors hold).

190 *See* Bespoke Investment Group, *U.S. Stock Market Tops $25 Trillion - Up $1.9 Trillion Since Election*, SEEKING ALPHA (Jan. 27, 2017, 1:49 AM), https://seekingalpha.com/article/4040012-u-s-stock-market-tops-25-trillion-1_9-trillion-since-election (detailing the total stock market capitalization for stocks in the Russell 2000 since 2002). As of September 2018, the total market capitalization of the S&P 500 companies was $25.8 trillion. *S&P 500 Historical Total Market Cap & Float Adjusted Cap*, SIBLIS RES., http://siblisresearch.com/data/total-market-cap-sp-500 (last visited Oct. 21, 2018).

191 *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: HISTORICAL ANNUAL TABLES 2005–2015, at 123 tbl.L.223 (2016), https://www.federalreserve.gov/releases/z1/current/annuals/a2005-2015.pdf.

Within this group of institutional investors, a few money managers wield especially significant influence.[192] For instance, in the commercial sector, BlackRock Funds holds approximately $6.3 trillion in assets under management,[193] Vanguard Group holds $5.1 trillion,[194] State Street Global Advisors holds $2.7 trillion,[195] Fidelity Investments holds $2.1 trillion,[196] and Prudential Financial holds $1.4 trillion.[197] The largest public pension funds are also, by any measure, enormous.[198] Teachers Insurance and Annuity Association has over $1 trillion in assets under management,[199] and the California Public Employees' Retirement System's investment fund is valued at over $347 billion.[200]

Institutional investors in the aggregate thus exert notable influence on corporate governance.[201] In most firms, institutional investors collectively hold a dominant position.[202] Their presence, considered in terms of ownership concentration, is even more pronounced in the largest corporations, with institutional shareholders owning on

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192 *See* Stephen Choi, Jill Fisch & Marcel Kahan, *Who Calls the Shots? How Mutual Funds Vote on Director Elections*, 3 HARV. BUS. L. REV. 35, 55 (2013) (stating that three specific mutual funds dominate other mutual funds in terms of the size of assets under management).

193 *About Us*, BLACKROCK, https://www.blackrock.com/au/individual/about-blackrock (last visited Feb. 5, 2019).

194 *Fast Facts About Vanguard*, VANGUARD, https://about.vanguard.com/who-we-are/fast-facts (last visited Oct. 21, 2018).

195 ST. STREET GLOBAL ADVISORS, https://www.ssga.com/na/us/institutional-investor/en/home.html (last visited Oct. 21, 2018).

196 *Fidelity by the Numbers: Corporate Statistics*, FIDELITY, https://www.fidelity.com/about-fidelity/fidelity-by-numbers/corporate-statistics (last visited Oct. 21, 2018).

197 *Prudential Financial Fact Sheet*, PRUDENTIAL, http://www.news.prudential.com/press_file.cfm?presskit_id=68 (last visited Oct. 21, 2018).

198 *See* Alan R. Palmiter, *Staying Public: Institutional Investors in U.S. Capital Markets*, 3 BROOK. J. CORP. FIN. & COM. L. 245, 266–67 (2009) (describing public pension funds).

199 *Who We Are*, TIAA, https://www.tiaa.org/public/plansponsors/who-we-are (last visited Nov. 2, 2018).

200 *CalPERS Investment Fund Values*, CALPERS, https://www.calpers.ca.gov/page/investments/asset-classes/trust-level-portfolio-management/investment-fund-values (last visited Oct. 21, 2018). It is noteworthy that there were similar developments in the United Kingdom. *See* OFFICE FOR NAT'L STATISTICS, STATISTICAL BULLETIN: SHARE OWNERSHIP SURVEY 2008, at 4 tbl.A, 5 tbl.B (Jan. 27, 2010), https://www.ons.gov.uk/ons/rel/pnfc1/share-ownership---share-register-survey-report/2008/share-ownership---share-register-survey-report--share-ownership.pdf (suggesting that there is a growing presence of institutional investors); *see also* BRIAN R. CHEFFINS, CORPORATE OWNERSHIP AND CONTROL: BRITISH BUSINESS TRANSFORMED 344–46 (2008) (describing the rise of institutional share ownership in the United Kingdom).

201 *See* Edward S. Adams, *Bridging the Gap Between Ownership and Control*, 34 J. CORP. L. 409, 425 (2009) ("[I]nstitutional investors tend to acquire a significant portion of stock in a corporation to gain a measure of control in the corporation.").

202 *See id.*; Aguilar, *supra* note 188 ("Simply stated, institutional investors are dominant market players . . . .").

average over 70% of the stock in such firms.[203] Even *among* institutional investors, the market is highly concentrated. The largest twenty-five institutions hold more than 30% of all U.S. corporate shares,[204] and the largest ten managers managed 26.5% of all assets.[205]

Moreover, the three biggest asset management institutions, BlackRock, Vanguard, and State Street, when considered in combination, are the "single" largest shareholder, with mean ownership over 17%, in many U.S. listed companies (1662 out of approximately 3900 firms in 2015), and particularly among the S&P 500 (438 out of 500 firms).[206]

It should, therefore, come as no surprise that, given these sizable stakes and related market concentration, institutional shareholders have become capable of influencing the behavior of their portfolio companies. Not only are these institutional investors more sophisticated than the retail investors of years past, but their ownership blocks are far larger, reducing coordination costs and providing greater monitoring incentives.[207] Several major asset managers have

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[203] *See* MATTEO TONELLO & STEPHAN RABIMOV, THE CONFERENCE BD., THE 2010 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPOSITION 27 (2010), http://shareholderforum.com/e-mtg/Library/20101111_ConferenceBoard.pdf (showing that in 2009, ownership concentration of institutional investors in the top 1000 U.S. corporations by market value was 73%). For instance, institutional investors currently hold 61.3% of Apple. *Apple Inc. (AAPL): Major Holders*, YAHOO! FIN., https://finance.yahoo.com/q/mh?s=AAPL+Major+Holders (last visited Oct. 21, 2018). In another telling example, institutional investors currently hold 74.6% of Microsoft. *See Microsoft Corporation (MSFT): Major Holders*, YAHOO! FIN., https://finance.yahoo.com/quote/MSFT/holders?p=MSFT&.tsrc=fin-srch (last visited Oct. 23, 2018).

[204] *See* Marcel Kahan & Edward B. Rock, *Anti-Activist Poison Pills* 20 (N.Y. Univ. Sch. of Law, Law & Econ. Research Paper Series, Working Paper No. 17-08, 2017), https://ssrn.com/abstract=2928883.

[205] As of December 2016. Itzhak Ben-David et al., *The Granular Nature of Large Institutional Investors* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 22247, 2017), http://www.nber.org/papers/w22247.pdf.

[206] Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 311–13 (2017).

[207] Indeed, not doing so may violate their fiduciary duties under federal law. *See* Proxy Voting, 17 C.F.R. § 275.206(4)-6 (2018) (prohibiting the "exercise [of] voting authority with respect to client securities" by investment advisers without implementation of "written policies and procedures that are reasonably designed to ensure that [the adviser] vote[s] client securities in the best interest of clients"); Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Policies or Guidelines, 29 C.F.R. § 2509.2016-01(1) (2018) (fiduciary duties under the Employee Retirement Income Security Act of 1974 "require the responsible fiduciary to vote proxies on issues that may affect the value of the plan's investment").

specialized in-house corporate governance offices dedicated precisely to this monitoring role.[208]

To the extent that institutional investors are hesitant to take an active role in agitating for corporate change, other investors—such as activist hedge funds—now step in to fill the void.[209] These changes have created costs of their own,[210] but, on balance, it seems that principal costs are lower now than they were several decades ago. Thus, the relative costliness of adjudication suggests under our theory that shifting control from courts to shareholders would be preferred—consistent with the evidence presented in Part I. Put simply, shareholders seem to have become sufficiently sophisticated and incentivized to fend for themselves, reducing the need for judicial assistance.

B. Delaware's Future in Corporate Law and Governance

This Section turns to the implications and predictions for the future. Section III.B.1 considers the role of courts in an age of sophisticated shareholders and argues that changes in the composition of U.S. shareholders imply, under our theory, a more limited role for courts and litigation more generally. Section III.B.2 then narrows the scope, discussing the future role of the State of Delaware. We predict that changes to the aggregate character of public shareholders will lead to a more limited role for the state, but also that these changes are unlikely to cause a mass exodus of public corporations to other jurisdictions. To ensure its continued dominance and participatory role in the corporate law space, however, Delaware must adapt to the decreased need for court-centered dispute resolution.

1. The Role of Courts in an Age of Sophisticated Shareholders

Under our theory, parties seek to minimize the sum of principal, agent, and *adjudicatory* costs. Therefore, an increase in principal sophistication (reducing principal competence costs) suggests that parties will have less of a need for judicial dispute resolution, as the latter

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[208] *See, e.g.*, *Investment Stewardship*, BLACKROCK, https://www.blackrock.com/corporate/en-gb/about-us/investment-stewardship (last visited Oct. 21, 2018) (describing how the BlackRock Investment Stewardship team engages with companies and disseminates information to "[p]rotect and enhance the value of clients' assets").

[209] *See* Gilson & Gordon, *supra* note 24, at 895–96 ("Activist investors specialize in monitoring portfolio company strategy and formulating alternatives when appropriate for presentation to the institutional investors; in turn, institutional investors specialize in portfolio management and in evaluating proposals presented by activist investors.").

[210] *See generally* Rose, *supra* note 182, at 906 (outlining concerns about governance standards with "limited or no evidentiary support" and rigid models inhibiting potentially beneficial experimentation).

risks introducing unnecessary adjudicatory costs.[211] Instead, market participants are likely to utilize discretionary control rights to achieve their objectives.[212]

Indeed, we have already observed several salient instantiations of this trend, whereby market participants stay away from courts, electing instead to use discretionary control rights to resolve various corporate disputes.[213] The presence of repeat-player, sophisticated shareholders militates toward a corporate law environment in which courts play a relatively procedural role, with substantive decision-making authority retained by principals, agents, or some combination thereof.

As the role of courts has become more procedural, we can observe a shift of the locus of power from public decisionmakers, such as courts, to private decisionmakers, such as proxy advisers and large institutional investors. This shift away from substantive judicial adjudication toward the exercise of discretionary control rights has resulted in boards being more constrained by the likely responses of large institutional shareholders and proxy advisers than by the anticipated legality of their actions under Delaware law.[214] When institutional investors wield the necessary ownership to make a "withhold vote" a threat, sometimes coupled with "majority vote" and "proxy access" mechanisms,[215] it is entirely sensible for board members to reorient their focus toward the approval of institutional investors and other private decisionmakers rather than of the judiciary.[216] This

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211 *See supra* Section II.B (outlining our theory and the aim of parties to minimize the sum of principal, agent, and adjudicatory costs).

212 *See supra* Section I.B.1 (providing several examples of this private ordering).

213 *See supra* Section I.B.1 (highlighting examples of the trend away from the courts and towards discretionary control rights).

214 *See, e.g.*, Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 688 (2005) ("[P]owerful CEOs come on bended knee to Rockville, Maryland, where [Institutional Shareholder Services] resides, to persuade the managers of ISS of the merits of their views about issues like proposed mergers, executive compensation, and poison pills."); *supra* Section I.B.1 (noting that, despite open questions about their legality, golden leash poison pills have largely been abandoned by management out of fear of retribution by institutional owners).

215 *See supra* note 102 (describing shareholder success at getting "majority vote" and "proxy-access" mechanisms implemented in bylaws).

216 In addition to the cases mentioned in Part I, consider also other scattered, but increasingly conspicuous, instances of institutional investors disciplining directors without judicial assistance. A recent paper examined whether "institutional investors follow directors to new firms with their equity investments" and answered with "an emphatic yes." *See* Jay Dahya & Richard Herron, Do Investors Follow Directors? 32 (Nov. 21, 2017) (unpublished manuscript), https://ssrn.com/abstract=2943540. In other words, corporate directors must operate under the assumption that major investors will reward directors for good performance (and correspondingly withhold this reward for bad performance) even

increased influence of private decisionmakers may portend a transformation of American corporate dispute resolution from court-centered to control-centered dispute resolution. In turn, this dynamic may assign corporate law only a secondary role.

2. *Delaware's Future Challenges*

In this section, we turn from the macro-level observation to the microcosmic implications for the State of Delaware. Many scholars have attributed Delaware's dominance in the field of corporate law at least in part to its judicial system.[217] Professor Roberta Romano, in describing Delaware's dominance, cites Delaware's "substantial body" of precedent, its "judicial expertise," the predictability of its judicial decisions, and the likelihood that "any specific corporate law issue will be, or has been, adjudicated" by its courts.[218] Professor Michael Klausner likewise identifies the "network benefits" associated with Delaware judicial precedents as a key factor contributing to Delaware's success in attracting corporate charters.[219] According to Klausner, firms incorporate in Delaware in part to realize the benefits of positive "network externalities" produced by Delaware deci-

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after directors have moved on to a different firm. Similarly, Dimension Fund Advisors, the eighth-largest mutual fund in the United States, recently threatened to vote against directors who approved frowned-upon (by Dimension Fund Advisors, that is) governance mechanisms without the approval of shareholders, not only at the specific company that implemented the mechanism but at all boards upon which a given director sits. *See* Toonkel, *supra* note 38.

217 *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. Bainbridge et al. eds., 2018) ("[T]he most important reason for the Delaware dominance in incorporations is judicially based."); Leo Herzel & Laura D. Richman, *Delaware's Prominence 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) (describing Delaware's judicial proficiency, rich body of precedents, and specialized bar as different manifestations of scale economies); Mark J. Roe, *Takeover Politics*, *in* THE DEAL DECADE: WHAT TAKEOVERS AND LEVERAGED BUYOUTS MEAN FOR CORPORATE GOVERNANCE 321, 351 (Margaret M. Blair ed., 1993) (arguing that the value of legal standardization helps Delaware retain its lead).

218 Romano, *Law as a Product*, *supra* note 3, at 277; *see also* Romano, *State Competition*, *supra* note 3, at 722 (describing "a comprehensive body of case law" and "judicial expertise" as Delaware assets).

219 *See* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 776, 842–47 (1995) ("[T]o the extent that future judicial interpretations are beneficial, they are network benefits associated with particular corporate contract terms."). For a more skeptical view of the Delaware courts, see Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 459 (2001) ("[T]here are signs of growing discomfort with the more extreme forms of unpredictable ex post decisionmaking that have sometimes been characteristic of, say, the Delaware courts.").

sions.[220] These theories are premised on the assumption that Delaware courts play an active and substantive role in corporate governance.

If Delaware's judicial system is indeed responsible for the state's success in attracting corporate charters, then a decline in the courts' opportunity to resolve corporate disputes may imply that market centrism risks Delaware ceding its prominent position. This risk would be particularly acute to the extent that the judicial system's importance stems from its substantive role in adjudicating corporate disputes. If the courts' judicial expertise in resolving these highly technical disputes is critical, then a shift away from adjudication toward discretionary control rights would seem to provide less reason for firms to incorporate—or stay incorporated—in Delaware. Similarly, if Delaware's success hinges on the network benefits associated with the interpretation of its precedents,[221] the diminished importance of these precedents would imply fewer reasons for firms to turn to Delaware.

However, there are at least two reasons to suspect that the increase of market participants employing discretionary control rights will *not* lead to Delaware entirely relinquishing its dominance as a corporate governance forum. First, even if the substantive role of the Delaware courts is diminished, Delaware's courts are still very much operationally effective.[222] The Chancery Court renders expert decisions quickly and efficiently, without juries, and based mostly on written testimonies.[223] There is little reason to expect other states to surpass Delaware in this regard—even as the Delaware courts' substantive role declines, other states would have to incur substantial costs to match, let alone overcome, the positive network externalities associated with Delaware's operational efficacy.

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220 Klausner, *supra* note 219, at 842–47.

221 *See supra* note 219 and accompanying text (describing the theory that companies incorporating in Delaware benefit from network effects).

222 The advantages of the Delaware courts in this respect are well recognized. *See* Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 918 (1990) ("[T]he small, expert, and nondiverse Delaware judiciary reduces agency costs in two ways. First, Delaware has only one trial court with jurisdiction to hear corporate cases, the Court of Chancery (in which no jury trials occur). . . . Second . . . the judges in Delaware are expert in corporate law."); Kenju Watanabe, *Control Transaction Governance: Collective Action and Asymmetric Information Problems and Ex Post Policing*, 36 NW. J. INT'L L. & BUS. 45, 102 (2016) ("As a court of equity, the Chancery Court has no juries. This assures that the court resolves factual issues quickly, even in situations in which trials need to be held, and without the risk of making errors that may result from having a lay jury."); *see also* Savitt, *supra* note 4 (describing the "uncommon" efficiency of the Delaware Court of Chancery).

223 *See* Watanabe, *supra* note 222, at 102 (noting the lack of juries in the Chancery Court and the efficient process for appeals).

Second, there are at least some transaction costs associated with reincorporation, although scholars have debated their precise magnitude.[224] So long as Delaware refrains from imposing inefficient adjudicatory costs that exceed the transaction costs of reincorporation, Delaware appears poised to retain its historical prominence. An inefficient, litigation-friendly regime, however, will increase adjudicatory costs and threaten the state's position as the leading state of incorporation.[225] Thus, Delaware courts must align themselves with shareholders as a whole, and not with nominal shareholder plaintiffs and their lawyers.[226]

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[224] *Compare* Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 586–88 (1990) (claiming transaction costs associated with reincorporation are trivial), *with* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 34–35, 34 n.11 (1993) ("Besides understating some of the large one-time reincorporation costs . . . Black excludes from his calculation the increased costs that firms bear over their lifetime from a move, such as increased listing, tax, and attorney's fees."), *and* Romano, *Law as a Product*, *supra* note 3, at 246–48 ("The cost [of reincorporation] estimates varied quite a bit, ranging from a few thousand to well over a million dollars . . . . There is also an array of more indirect expenses . . . ."). In addition to the direct costs of reincorporation, path dependence is an additional cost that might limit incorporation and reincorporation in other states. *See* A. Gilchrist Sparks III & Daniel D. Matthews, *Delaware's Continued Resilience: The Next Hundred Years*, *in* CAN DELAWARE BE DETHRONED?, *supra* note 217, at 238, 258 ("Inertia, including the familiarity of lawyers and investors across the country with Delaware law, further reinforces Delaware's dominance and is not something that can be readily reproduced.").

[225] As other scholars have observed, amendments to the Delaware General Corporation Law are effectively controlled by the Section of Corporation Law of the Delaware State Bar Association, which tends to be led by local defense firms with more interest in preserving incorporations in-state than in a large volume of litigation. *See* Bo Becker, Daniel Bergstresser & Guhan Subramanian, *Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable's Challenge*, 56 J.L. & ECON. 127, 137 (2013) ("[I]t is well known that the Corporate Law Section of the Delaware Bar Association, not the Delaware legislature, creates Delaware corporate law."); Faith Stevelman, *Regulatory Competition, Choice of Forum, and Delaware's Stake in Corporate Law*, 34 DEL. J. CORP. L. 57, 70 (2009) (highlighting the influence of the Delaware State Bar Association). As of December 2018, the Section of Corporation Law was led by partners at four prominent defense firms: Connolly Gallagher LLP; Morris James LLP; Morris, Nichols, Arsht & Tunnell LLP; and Skadden, Arps, Slate, Meagher & Flom LLP. *About the Section of Corporation Law*, DEL. ST. BAR ASS'N, https://www.dsba.org/sections-committees/sections-of-the-bar/corporation-law (last visited Dec. 27, 2018).

[226] The Delaware plaintiffs' bar has little incentive to limit adjudicatory costs. Whereas the franchise taxes Delaware levies on its corporations incentivize state lawmakers, including courts, to create value-enhancing law, the plaintiffs' bar has a very different and very powerful goal: maximizing attorneys' fees. Because attorneys' fees can be earned only to the extent that courts hold decisionmaking authority, one would expect a rational, self-interested plaintiffs' bar to seek to maximize this judicial authority—even if the balance of principal, agent, and adjudicatory costs implies that the use of courts in a given situation is suboptimal. As long as enterprising plaintiffs' attorneys can find nominal shareholder plaintiffs—which history suggests is not particularly difficult—and the promise of fees remains, these attorneys will likely continue bringing litigation even when shareholders in the aggregate would be better off without it. For a clear view of this type of

Thus far, Delaware seems to be resisting the urge of the plaintiffs' bar to increase the quantity of corporate litigation.[227] As we have observed, Delaware courts have begun to empower shareholders to use discretionary control rights over cash flow rights conflicts, which require the procedural involvement of courts, rather than duty-enforcement rights, which require substantive judicial involvement.[228] The Delaware courts have (1) accorded greater weight to shareholder approval of a merger vis-à-vis post-transaction lawsuits;[229] (2) limited the exposure of independent directors approving conflicted transactions;[230] (3) applied the business judgment rule to controlling shareholder self-dealing transactions when approved by both independent committee and disinterested shareholders;[231] (4) restricted the use of the statutory appraisal right by assigning substantial weight to the merger price;[232] and (5) curtailed disclosure-only settlements.[233] Delaware has approved the use of forum selection clauses in both corporate charters and bylaws, helping corporations to prevent the plaintiffs' bar from migrating to more litigation-friendly forums.[234]

"entrepreneurial" litigation, see JOHN C. COFFEE, JR., ENTREPRENEURIAL LITIGATION: ITS RISE, FALL, AND FUTURE (2015). *See also* Fisch et al., *supra* note 141, at 572 ("The structure of disclosure-only settlements is likely about something else—justification of a fee award to plaintiffs' counsel.").

227 *See* Matt Chiappardi, *Del. Plaintiffs Bar Rattled by Seismic Shift in Merger Law*, LAW360 (Feb. 10, 2017), https://www.law360.com/articles/891000/del-plaintiffs-bar-rattled-by-seismic-shift-in-merger-law ("The Delaware Supreme Court's ruling . . . is the latest in a series of decisions that some on the plaintiffs [sic] bar say represent a seismic shift in bedrock M&A law that will close the door on shareholder claims.").

228 *See supra* note 159 and accompanying text (discussing duty-enforcement rights).

229 *See supra* Section I.B.2 (surveying cases demonstrating increased judicial deference to shareholder approval).

230 *See* Leal v. Meeks (*In re* Cornerstone Therapeutics Inc., Stockholder Litig.), 115 A.3d 1173, 1182–83 (Del. 2015). *In re Cornerstone* has left market participants responsible for disciplining independent directors who approve conflict transactions. *See supra* notes 123–24 and accompanying text (describing the practical effects of exempting directors from discipline by the courts).

231 *See* Kahn v. M & F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014) (holding that business judgment is the standard of review for "mergers between a controlling stockholder and its corporate subsidiary" where the merger is premised on approval of both a truly independent committee and the "uncoerced, informed vote of a majority of the minority stockholders").

232 *See supra* note 135 (collecting cases illustrating this trend).

233 In *In re* Trulia, Inc. Stockholder Litig., 129 A.3d 884, 898 (Del. Ch. 2016), the Delaware Chancery made clear that it intends to scrutinize disclosure-only settlements much more carefully going forward. *See also* Walsh & Sims, *supra* note 136, at 1–2 (explaining the history leading up to *In re Trulia* and speculating on possible consequences of the decision).

234 *See Delaware Legislature Approves DGCL Amendments Endorsing Delaware Forum Selection Clauses and Prohibiting Fee-Shifting Provisions*, SIDLEY AUSTIN LLP (June 15, 2015), https://www.sidley.com/en/insights/newsupdates/2015/06/delaware-legislature-approves-dgcl-amendments (summarizing approved amendments as "(i) authoriz[ing]

Here again, it bears mentioning: While Delaware courts have actively and correctly developed doctrine that facilitates private ordering and reduces Delaware's role as corporate arbiter, this retreat was not solely the product of judicial volition but rather the product of market necessity. In order to preserve its dominance as the leading state of incorporation, Delaware had to pull back from its former substantive role in accordance with the idea that has animated this Article: The more competent shareholders become, the less important corporate law will be.

Conclusion

This Article has argued that the compositional transformation of U.S. equity markets has led to the death of corporate law, as the regulation of U.S. publicly traded corporations has shifted from courts to markets. Consequently, Delaware, the leading state of incorporation, and its courts have declined in importance. In order to explain the declined role of Delaware and corporate law more broadly, we introduced a novel theory demonstrating that the difference between the principal's and the court's competence is the critical factor when seeking to determine whether parties will prefer judicial intervention or private dispute resolution. When the principal has relatively low competence, parties are more likely to rely on a court to resolve future disputes; the more competent the principal, the less efficient it becomes to enlist courts as opposed to utilizing extra-judicial conflict resolution techniques.

Our triangulation of control costs—principal, agent, and adjudicatory—allows not only for an explanation as to the broader decline of corporate law, but also for a postmortem analysis of the declined role of Delaware in particular. In stark contrast to its long-held prominence, in many key decisions today the Delaware courts are no longer able to dictate the substantive final terms of corporate conflict resolution. Instead, increasingly sophisticated market participants have elected to sidestep the court in part or whole, relying on extrajudicial, party-centric activity to resolve corporate conflicts. The Delaware courts have generally accommodated this shift away from judicial resolution. However, our analysis demonstrates that market forces, *not* Delaware courts, have catalyzed this new balance of corporate con-

forum selection clauses in the charters or bylaws of Delaware corporations . . . (ii) prohibit[ing] clauses designating only courts outside of Delaware as the exclusive forum for internal corporate claims and (iii) invalidat[ing] fee-shifting provisions in the charters or bylaws"). For a look at the empirical effects of forum selection clauses, see Matthew D. Cain et al., Essay, *The Shifting Tides of Merger Litigation*, 71 Vand. L. Rev. 603, 619–30 (2018).

trol. Today's institutional shareholders perceive themselves as sophisticated market participants capable of achieving governance aims via activism without judicial assistance and as a result, prefer not to incur adjudicatory costs when avoidable. The Delaware courts are therefore increasingly edged into the role of procedural supervisors, or forced to observe governance tussles from the sidelines.

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