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# Federalization of Corporation Law in a Time of Crisis – Which Institutions are Best Able to Improve Corporate Governance and Performance Going Forward?

*Presented by:*

*The Committee on Business and Corporate Litigation,*

*The Committee of the Federal Regulation of Securities*

## Panel Members

**The Honorable Myron T. Steele**, Chief Justice, Delaware Supreme Court, Dover, DE

**The Honorable J. Travis Laster**, Vice Chancellor, Delaware Court of Chancery, Wilmington, DE

**Professor Jill E. Fisch**, Perry Golkin Professor of Law, Co-Director, Institute for Law and Economics, University of Pennsylvania Law School, Philadelphia, PA

**Thomas J. Kim**, Chief Counsel and Associate Director, Division of Corporation Finance of the SEC, Washington, DC

**Michele E. Rose**, Latham & Watkins LLP, Washington, DC

## Moderator and Program Coordinator

**Rolin P. Bissell**, Young Conaway Stargatt & Taylor, LLP, Wilmington, DE

*Federalization of Corporation Law in a Time of Crisis – Which Institutions are Best Able to Improve Corporate Governance and Performance Going Forward?*

By Rolin P. Bissell*

## TABLE OF CONTENTS

**Page**

Introduction and Overview .......... 1

I. A Short History of Regulatory Competition in Corporation Law .......... 5

A. Phase One – The Era of State Competition (1880-1910) .......... 5

B. Phase Two – The Federal Versus State Era (1974-2006) .......... 7

1. The Rise and Fall of the Race to the Bottom Theory (1974-1985) .......... 7

2. The Early 2000s; Corporate Scandals, The Sarbanes-Oxley Act and Their Wake .......... 9

C. Phase Three – The Era of Globalization and Crisis (2003 to the Present) .......... 12

1. Growing Competition Among International Capital Markets To Attract Issuers .......... 13

2. Rise of Competition within The E.U. for Place of Incorporation .......... 15

3. The Financial Crisis .......... 18

II. Shareholder Success In Changing State Corporation Law. .......... 20

A. Majority Voting for Directors .......... 21

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* Mr. Bissell (rbissell@ycst.com) is a partner in the Corporate Litigation and Counseling Section of Young Conaway Stargatt & Taylor, LLP, Wilmington, Delaware. A draft of these CLE materials were being submitted on October 22, 2009 in advance of the November 20, 2009 program on this issue at the ABA Business Law Section Fall Meeting for inclusion in the meeting's CD-ROM materials. This is an updated version that covers additional developments between October 22, 2009 and November 17, 2009. The views expressed in these CLE materials are those of Mr. Bissell and may not reflect the views of the other panelists or Young Conaway Stargatt & Taylor LLP.

B. Proxy Access Bylaws ........ 24

C. North Dakota Publicly Traded Corporations Act. ........ 26

III. Shareholder Efforts to Enact Federal Legislation Have Been Unsuccessful ... 27

A. Proxy Access ........ 27

B. Executive Compensation and "Say on Pay" ........ 30

IV. Towards A Cooperative Federalism? ........ 36

A. The Certification Process ........ 37

B. First Certification—The AFSCME Proposal ........ 38

C. Making the Conversation Two-Way ........ 41

D. Taking Advantage of the Relative Nimbleness of the States ........ 43

Conclusion ........ 44

Appendix – Panel Biographies

**The Honorable Myron T. Steele**, Chief Justice, Delaware Supreme Court, Dover, DE

**The Honorable J. Travis Laster,** Vice Chancellor, Delaware Court of Chancery, Wilmington, DE

**Professor Jill E. Fisch,** Perry Golkin Professor of Law, Co-Director, Institute for Law and Economics, University of Pennsylvania Law School, Philadelphia, PA

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**Rolin P. Bissell**, Young, Conaway, Stargatt & Taylor, LLP, Wilmington Delaware

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## Introduction and Overview

The federalization debate of the last 35 years has two aspects. The first aspect of the debate has typically revolved around what should be the respective roles of the federal government, chiefly the Securities and Exchange Commission ("SEC"), and state corporation law in corporate governance. Global competition between capital markets is transforming this aspect of the debate dramatically. There has been increasing international competition for incorporations and listings on securities exchanges. Thus, the globalization of finance and the free flow of capital across national borders has chipped away at a key assumption that has informed the pro-federalization side of the debate—that a federalized, nationwide approach would end regulatory competition and set the optimal level of corporate regulation. Because the U.S. securities markets (and the companies that seek capital through them) are not a closed system, the U.S. must compete with the regulatory schemes of other nations, or lose business to foreign exchanges for listings and foreign venues for incorporation. Indeed, there is substantial, but not conclusive, evidence that the federalization caused by the enactment of the Sarbanes-Oxley Act in 2002 hurt the competitiveness of U.S. capital markets. Moreover, prior to the onset of the financial crisis, foreign exchanges and foreign venues for incorporation were liberalizing their regulatory regimes to attract incorporations and listings. In particular, the E.U. countries seemed to be on a

path to liberalize rules governing place of listing and incorporation to foster greater regulatory competition among its member nations.

The second aspect of the federalization debate concerns which policies are worth pursuing to improve corporate governance and performance. Over the last decade, these debates have typically revolved around issues relating to the allocation of power between shareholders and boards of directors to manage corporations. The perennial battles about whether stockholders have greater proxy access or a greater role in reviewing executive compensation decisions are examples of this aspect of the federalization debate. In these debates, the federal government is often cast as the champion of shareholder power and Delaware the bulwark of board power. As shown below, this dichotomy is simplistic. Shareholder activism has enjoyed success in driving changes to state corporation law (for example, enabling majority voting and proxy access bylaws) and has had relatively little success driving change at the federal level where more dramatic change is frequently discussed, but seemingly never enacted. This emerging pattern also undermines an explicit premise of the "race to the bottom" critique of state corporation law – that to attract incorporations, states need only to cater to management's desires and may do so at the expense of shareholder welfare. Evidence that states do account for shareholder interest in formulating their corporation laws is consistent with the theory (and empirical evidence) that regulatory competition causes a "race to the top."

The rise of the institutional shareholder and globalization are both trends that show no signs of abating. As a result of these two trends, the debate about regulatory competition needs to shift from its 35 year old locus of "federal versus state." Instead, there should be a more robust and encompassing discussion of how the federal securities regulation and state incorporation law work together to provide the optimal set of institutions to make the U.S. attractive to capital vis-a-vis competing foreign markets and to promote shareholder welfare. Moreover, in achieving the optimal blend of state law and federal regulation, it would be wise to consider the comparative nimbleness with which Delaware has been able to adapt in response to emerging corporate governance issues when compared to the abortive steps the federal government has taken in these areas. Unquestionably, some problems demand a uniform, nationwide response that only the federal government can provide. But achieving national consensus and action on a uniform approach has proven to be elusive—both because of disagreement about what is the best approach and differing interests in seeing any particular approach adopted, especially nationwide. State corporation law retains an important and perhaps irreplaceable function in meeting international competition because it can adapt quickly and more easily permits experimentation.

These CLE materials review the key drivers of the current federalization debate and have four parts. Part I reviews the history and assumptions of regulatory competition in the corporate governance arena during its three phases— (1) the era of

state competition for corporate charters (1880 through 1910); (2) the federal versus state era (1974 through 2006); and (3) the era of global competition (2003 to present). Part II reviews how shareholder activism is driving changes in state corporation law, largely through shareholder attempts to have a greater say in the election of directors. The largely successful initiative to replace plurality voting with majority voting, the recent amendments to the Delaware General Corporation law to allow for proxy access bylaws, and the successful enactment of the purportedly shareholder-centric North Dakota Publicly Traded Corporation Act are examples of successful advocacy efforts. Part III reviews the multi-year shareholder activism at the federal level, such as the as-yet-unsuccessful campaigns to gain shareholder access to the corporate proxy and achieve greater regulation of executive compensation. Part IV discusses increased cooperation between the SEC and the Delaware courts to provide greater coordination between federal securities regulation and state corporation law and concludes that the real challenge for the U.S. is providing the optimal mix of state law and federal regulation to attract capital and promote shareholder welfare.

# I. A Short History of Regulatory Competition in Corporation Law

## A. Phase One – The Era of State Competition (1880-1910)

Regulatory competition between states to be the home of corporate charters has a 130 year history.[1] The history of New Jersey's rise and fall as the "mother of trusts" remains interesting today because it shows both how a legal regime can become the dominant incumbent and then later lose that position. Indeed, the parallels between New Jersey's competitive position vis-à-vis other states as a place for incorporation in the late 19th Century and the United States' competitive position vis-à-vis other capital markets today seem apt, and perhaps cautionary.

In 1875, New Jersey abolished special charters and expanded its general incorporation law to make it more attractive for citizens of other states to form New Jersey corporations.[2] New Jersey quickly gained the reputation as a "corporation friendly state," and became the leading state for the incorporation of firms doing business outside of a single state.[3] Through various amendments to its corporation laws New Jersey reinforced and extended that position through out the late 1880s and early 1890s, culminating in 1896 when New Jersey recodified its corporation law to

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[1] For a meticulously researched, thought-provoking and eminently readable history of the competition for corporate charters in the late 19th and early 20th centuries, *See* Charles M. Yablon, *The Historical Race Competition for Corporate Charters and a Rise and Decline of New Jersey: 1880-1910*, 32 THE JOURNAL OF CORPORATION LAW No. 2 (Winter 2007) which describes New Jersey's rise and fall as the dominant state of incorporation.

[2] *Id.* at 334.

[3] *Id.* at 326.

create what is often considered the first modern corporation law statute.[4] The signal feature of the 1896 recodification was not primarily in granting new or expanded powers to New Jersey corporations, but "the creation of a clear, simple and unified conception of corporate law as a body of enabling rules that provided a wide scope for private contracting among individuals."[5] New Jersey's achievement in 1896 was copied or otherwise emulated by other states such as Maine, Massachusetts, Connecticut, New York, West Virginia, and Delaware in 1899 through 1902.[6] At first, these imitators, even the more permissive and less expensive ones, did not have much impact on New Jersey's position. New Jersey's political and legal culture was thought to be a known quantity and thus considered more politically reliable than "the mercurial New York, or the relatively unknown legal and legislative regime of Delaware."[7]

The decline and fall of New Jersey as the choice state for incorporation is usually credited to the passage of the so-called "seven sisters" provisions to its corporation and trust laws at the insistence of Governor Woodrow Wilson.[8] The

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[4] *Id.* at 326-27.

[5] *Id.* at 349-50.

[6] *Id.* at 354.

[7] *Id.* at 357.

[8] *Id.* at 326 (quoting William L. Carey, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974) but suggesting that Carey's account "is mostly wrong.").

"seven sisters" provisions did not have an impact on most New Jersey corporations, and so following the enactment of the "seven sisters" provisions, there were a few immediate migrations to Delaware, General Motors and DuPont being the major exceptions.[9] But the "seven sisters" provisions did change promoters' views about the political and legal climate of New Jersey. Although New Jersey's decline as the predominant state of incorporation was not recognized until long after 1913, over the decades New Jersey was overtaken by Delaware.

## B. Phase Two – The Federal Versus State Era (1974-2006)

### 1. The Rise and Fall of the Race to the Bottom Theory (1974-1985)

Delaware slowly built its predominant position as a state of incorporation without much comment or note. Then in 1974, in language more provocative than descriptive, professor William L. Cary declared that Delaware was a "pygmy" state and leading a "race to the bottom" among the fifty states to see which state could offer corporate laws most favorable to management and at the expense of shareholders.[10] Cary argued that many corporate law and governance issues traditionally left to the states needed a uniform, nationwide "federalized" solution through the enactment of a preemptive federal corporation law statute that would apply nationwide.

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[9] *Id.* at 325 note 10.

[10] William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L. J. 663, 701 (1974).

In the late seventies and eighties, practitioners and academics discredited Cary's "race to the bottom" thesis and its underpinnings.[11] Congress and the United States Supreme Court also remained unpersuaded. Both consistently refused to federalize state corporate law.[12] In fact, over time, a body of empirical evidence developed that not only was there no "race to the bottom," but rather competition between states caused a "race to the top."[13] By the eighties Cary's theory seemed moribund.[14]

The failure of pro-federalization forces to displace the traditional division between federal and state roles in corporate governance with a national, uniform,

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11 S. Samuel Arsht, *Reply to Professor Cary* 31 BUS. LAW 1113 (1976) (a Delaware practitioner's critique of Cary's scholarship and understanding of Delaware precedents); Ralph K. Winter, Jr., *Shareholder Protection and the Theory of the Corporation* 6 J. LEGAL STD. 251 (1977); Charles M. Yablon, *The Historical Race Competition for Corporate Charters and a Rise and Decline of New Jersey: 1880-1910*, 32 THE JOURNAL OF CORPORATION LAW No. 2 (Winter 2007) (noting several of Cary's historical inaccuracies and how those inaccuracies have been "repeated by generations of law professors to their Corporations classes").

12 *See e.g., CTS Corporation v. Dynamics Corp.,* 481 U.S. 69 (1987); *Santa Fe Indus. v. Green*, 430 U.S. 462, 472-73 (1977).

13 Ralph K. Winter, Jr., *The "Race for the Top" Revisited: A Comment on Eisenberg,* 89 COLUM. L. REV. 1526 (1989); Frank H. Easterbrook & Daniel R. Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991); Roberta Romano, THE GENIUS OF AMERICAN CORPORATE LAW (1993).

14 Daniel Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. L. 1437, 1454 (1985) ("Cary's position has been discredited; indeed, in recent years it has been discussed only as an illustration of how it is possible to reach the wrong conclusions if one lacks a basic understanding of the economic structure of the corporation and of corporate law.") (citing authorities).

federal regime reflects, in large part, their failure to establish their case that regulatory competition in corporation law had the ill effects they claimed. In addition, the pro-federalization forces struggled against an unwillingness to disturb the traditional (and constitutional) roles the federal government and state governments had staked out. Despite the lack of enthusiasm for the project, the federalization of corporation law retained its adherents and from time to time proposals were made that would give corporation law and corporate governance a more federalized tilt.

### 2. The Early 2000s; Corporate Scandals, The Sarbanes-Oxley Act and Their Wake

A renewed push for federalization of corporation law began in 2002 and followed the highly publicized wave of securities law violations and criminal behavior by corporate officers and directors of companies such as Enron, WorldCom, Adelphia, and Tyco. The scandals gave federal preemption of state corporate law new political life, if not data that would suggest that it was societally desirable.[15] The Sarbanes–Oxley Act of 2002 ("SOX") made incursions into traditional areas of state corporate law such as the composition of audit committees, and there was concern

[15] David A. Kotler and Rick Swedloff, *Sarbanes-Oxley's Impact On State Corporate Governance*, WLF LEGAL OPINION LETTER, Vol. 13 No. 16 July 25, 2003; Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, Research Paper No. 03-7 (2003) (downloaded from http://ssrn.com/abstract=389403); W. Chandler and L. Strine, *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U OF PA L REV 953, 955 (2003) (Messrs. Chandler and Strine are respectively, the Chancellor and a Vice Chancellor of the Delaware Court of Chancery).

that SOX was the tip of the federalization iceberg.[16] In 2004, the SEC's proposal to give shareholders the power to nominate directors, a power typically reserved to a board's nominating committee, represented a potentially substantial federal incursion into corporate governance. At the 2004 ABA Annual Meeting, Chief Justice Myron T. Steele of the Delaware Supreme Court noted: "I worry about the chilling effect that federal encroachment will have on our flexible market approach.... The bottom line in my view is that competitive federalism is under attack."[17]

Despite these concerns, SOX was not a harbinger of a major realignment of federal and state roles in corporate governance. For the most part (or at least, so far), federal regulation has concerned itself with issues that affect disclosure and the function of the financial markets and left the internal affairs of corporations to the states to regulate. Significantly there has been no wide-scale migration of cases

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[16] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (the various provisions of the act are codified in various sections of 15 U.S.C.).

[17] *BNA's Corporate Counsel Weekly*, Vol. 19, No. 32 at 250 (August 18, 2004). In the same vein and also during the 2004 ABA Annual Meeting, E. Norman Veasey, immediate past Chief Justice of the Delaware Supreme Court, commented on the undesirability of federal encroachment. E. Norman Veasey, "Musing from the Center of the Corporate Universe," Section of Business Law Luncheon, America Bar Association Annual Meeting, August 9, 2004 (downloaded from www.abanet.org\bus\law\newsletter\0027\materials\speech.pdf); *see also*, Leo E. Strine, *The Delaware Way, How We Do Corporate Law and New Challenges for Free Market Economies*, Washington Legal Foundation, WORKING PAPER No. 133 at 20-25 (Sept. 2005) (noting the need for federal regulatory authorities to "stay in their lane"); E. Veasey, S. Pompian, C. Di Guglielmo, *Federalism vs. Federalization: Preserving the Division of Responsibility in Corporation Law,* December 28, 2005 in WHAT ALL BUSINESS LAWYERS & LITIGATORS MUST KNOW ABOUT DELAWARE LAW DEVELOPMENTS 2006, Practicing Law Institute, Course Handbook Series, B-1543 (May 2006) (Mr. Veasey is a former Chief Justice of the Delaware Supreme Court).

involving the internal affairs of corporations from state to federal court following the enactment of SOX.

Nor did the scandals bring a major shift in the direction of state corporation law. In light of corporate governance failures the scandals exposed, there was concern that states, fearing federal preemption, would shift from the traditional approach of broadly enabling incorporation statutes in favor of more prescriptive and confining statutory approaches. On the seven-year anniversary of the enactment of SOX, there has been no major overhaul of state incorporation statutes.

In this regard, the business judgment rule seemed as though it was under attack. The business judgment rule's broad deferential respect of management decisions was seen by some as insufficient to provide oversight of corporations and, perhaps, contributed to the laxity in corporate governance practices, particularly in the areas of executive compensation and risk management. Making directors face increased exposure for liability from derivative shareholder suits might serve as a means of tightening up corporate governance. Or so the argument went. As it turned out, the business judgment rule survived these critiques without a scratch.

Two 2006 decisions by the Delaware Supreme Court, *Disney*[18] and *Stone v. Ritter*,[19] broadly affirmed that the business judgment rule will protect independent directors of Delaware corporations from liability for decisions taken in good faith. In

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[18] *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006).

[19] *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

addition, the decisions clarify that to show that a director has failed to act in good faith "requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (i.e., gross negligence)" and seemingly requires demonstration of an intent to do wrong.[20] In so holding, the Delaware Supreme Court reasserted the broad discretion directors of a Delaware corporation enjoy in their oversight of a corporation's affairs. *Disney* and *Stone* strongly suggest that there was no post-Enron shift in director liability under Delaware law.

### C. Phase Three – The Era of Globalization and Crisis (2003 to the Present)

With globalization of the 1990s and the first decade of this century, the competition between corporate governance regimes has become less and less an intramural game played within the borders of the U.S. Put simply, the United States' financial markets are no longer the only or best game in town and many issuers availed to themselves to European and Asian financial markets. This greater choice in places to raise capital also coincided with a liberalization of corporation law in other jurisdictions giving companies a greater choice of where to incorporate. The potential competition from abroad has put very real constraints on the type and amount of corporate governance regulation either the federal government or states can impose because of the risk of capital flight to more flexible and friendly venues.

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[20] *Stone,* at 368-69 (citing *Disney*, 906 A.2d at 66).

### 1. Growing Competition Among International Capital Markets To Attract Issuers

U.S. capital markets have faced increasing competition from foreign capital markets. Part of this is the natural growth and improvement of foreign-based exchanges, but the U.S. regulatory climate following SOX has been a target for some of the competitive erosion. On November 20, 2006, the Committee on Capital Markets Regulation issued its Interim Report, the first of a series of reports concerning the competitiveness of U.S. capital markets. The Interim Report found:

> The trend in so-called "global" IPOs, *i.e.*, IPOs done outside a company's home country, provides evidence of a decline in the U.S. competitive position. As measured by value of IPOs, the U.S. share declined from 50 percent in 2000 to 5 percent in 2005. Measured by number of IPOs, the decline is from 37 percent in 2000 to 10 percent in 2005.[21]

The Interim Report added:

> In 2005, foreign companies raised 10 times as much equity in the private U.S. markets as in the public markets ($53.2 billion vs. $4.7 billion). Further, of the global IPOs that raised money in non-U.S. markets, 57 percent of these companies (94 percent of the capital raised) chose to raise additional capital in the U.S. private markets.[22]

On December 4, 2007, the Committee on Capital Markets Regulation issued a follow-on report entitled, "*The Competitive Position of the U.S. Public Equity Market.*"[23]

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[21] Interim Report, Executive Summary at x.

[22] Interim Report, Executive Summary at x.

[23] The Report is available at http://www.capmktsreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf.

Like the Interim Report, the December 2007 Report expressed the conclusion "that the competitive position of the U.S. public equity market was seriously eroding."[24]

The Interim Report linked this decline in competitive position to regulatory issues including the requirements of SOX.[25] More fundamentally, Interim Report noted:

> Said a bit differently, for much of the 60 years since the end of World War II, firms raising capital did not so much choose to come to the United States, they came *naturally*. Today, the forces at work are increasingly different. Firms must *choose* to come to the United States to raise capital: they do not have to come. U.S. financial markets need to attract business that has a choice, and therefore how our markets are regulated by rules and laws really does matter today.[26]

(emphasis added). The December 2007 Report makes this linkage as well.

The Committee on Capital Markets Regulation's findings have implications for the federalization debate and regulatory competition within the U.S. First, how the U.S. allocates the responsibility between federal and state regulation of corporate governance is no longer a U.S.-only affair. How each of the two schemes of regulation are packaged together impacts the competitive position of U.S. capital

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24 *Id.* at v.

25 *See also*, Myron T. Steele, *Sarbanes-Oxley: The Delaware Perspective* at 5, remarks of Chief Justice of the Delaware Supreme Court Myron T. Steele as the keynote luncheon speech at the symposium entitled, *Corporate Governance Five Years After Sarbanes-Oxley: Is There Real Change?*, which was held at New York Law School on April 13, 2007 (on file with author).

26 *Id.*

markets vis-à-vis the capital markets of other nations. Accordingly, the penalty for over-regulation, under-regulation, or mis-regulation is higher. Second, with increased competition coming from abroad, the U.S.'s need for institutional flexibility to meet a competitive threat is arguably greater. As discussed below, there is some evidence that, prior to the financial crisis, E.U. nations were adopting more flexible frameworks to attract incorporation and listings.

### 2. Rise of Competition within The E.U. for Place of Incorporation

In the last decade, the E.U. countries have been experimenting increasingly with greater flexibility on place of incorporation and place of issuance of securities.

In the U.S., most of the companies that incorporate in Delaware have their headquarters or the main hub of their operations in another state. Put differently, a corporation can pick the state of incorporation (and therefore the corporate laws) of any state it pleases. Until the late 1990s, E.U. companies incorporated in the country that was the main seat of their operations.[27] This reflected historical requirements in most continental E.U. member states that a corporation be incorporated in the real seat of its business for it to have recognizable legal status.

[27] M. Becht, C. Mayer, and H.F. Wagner, *Where Do Firms Incorporate? Deregulation and Cost of Entry*, ECGI Working Paper Series in Law, Working Paper No. 70/2006 at 1 (August 2007).

This historical limitation has been largely abolished. Beginning in 1999 with its decision in *Centros*[28] and culminating with its decision in *Inspire Art*[29] in 2003, the European Court of Justice established that there will be free choice of location of incorporation within the E.U. These rulings have resulted in competition between the member states of the E.U. for incorporations.[30] So far, the U.K. has been the beneficiary. "Between 2003 and 2006, over 67,000 new private limited companies were established in the U.K. from other E.U. member states."[31] Most of this flow of companies has come from Germany, France, the Netherlands, and Norway.[32] Most of these migratory incorporations are new incorporations, and very few are reincorporations of existing firms.[33]

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[28] *Centros Ltd. v. Erhvervs-og Selskabsstyrelsen*, ECJ Case C-212/97, decision of March 3, 1999.

[29] *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd.*, ECJ Case C-167/01, decision of September 30, 2003.

[30] C. Kirchner, Richard W. Painter, and Wulf A. Kaal, *Regulatory Competition in EU Corporate Law After Inspire Art: Unbundling Delaware's Product for Europe*, U. Illinois Law & Economics Research Paper No. LE04-001 ("The European debate after *Inspire Art* will in some part be modeled after the U.S. debate over the "Delaware effect" on American corporate law for well over the past seventy years.")

[31] M. Becht, C. Mayer, and H.F. Wagner, *Where Do Firms Incorporate? Deregulation and Cost of Entry* at 2.

[32] *Id.*

[33] *Id.*

Significantly, the free migration of incorporations is leading to regulatory competition between E.U. member states for incorporation business. France, Spain, Germany, and the Netherlands have eliminated or lowered minimum capital requirements.[34] France and Spain have sought to make domestic incorporation less expensive.[35]

The freedom to choose place of incorporation has a second effect in the E.U.—it gives the incorporator some flexibility to choose which of the E.U. member states' securities laws will apply to it. In the U.S., no matter which state a corporation chooses as its state of incorporation, the same federal securities law will govern it. By contrast, there is no E.U.-wide securities law supervised and enforced by a single supra-national E.U.-wide authority.[36] Although there have been numerous steps toward E.U.-wide harmonization, "securities regulation is still chiefly a matter of national law in the E.U."[37] Thus, by choosing place of incorporation, a company may influence which of the E.U. member states' securities laws will govern it.[38]

There is much debate about whether the E.U. member states should pursue greater harmonization and uniformity in their securities laws or greater regulatory

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[34] *Id.* at 4.

[35] *Id.*

[36] L. Enriques and T. Troger, *Issuer Choice in Europe*, ECGI Working Paper Series, Law Working Paper No. 90/2007 at 14 (October 2007).

[37] *Id.*

[38] *Id.* at 16.

competition with the hope that a "European Delaware" will emerge.[39] It is beyond the scope of this paper or panel to predict which way the E.U. should go or will go. The key point is that not only is the U.S. facing increasing competition from abroad in the capital markets, but also the current trend in the E.U. is conducive to increased flexibility in arrangements and increased regulatory competition between E.U. member states. These trends potentially give the E.U. member states more flexibility and a sharpened competitive edge in ongoing competition with the U.S. and other locales to be the center of capital markets.

### 3. The Financial Crisis

With the onset of the financial crisis in 2008, IPO activity ground to a halt and it is difficult to assess whether the issues identified by the Committee on Capital Markets Regulation reflect a short-term historical aberration or are part of a long-term trend. In addition, although there are signs of a regulatory retrenchment in Europe in wake of the financial crisis, the strength and staying power of that trend is unclear.

For example, on September 3, 2009, French President Nicolas Sarkozy, German Chance llor Angela Merkel and United Kingdom Prime Minister Gordon Brown, sent a letter to Swedish Prime Minister Frederik Reinfeldt, in his capacity as European Union President.[40] The letter requested E.U. support for a plan to create

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[39] *Id.* at 54-58 (suggesting that the UK or Luxembourg might emerge as the "European Delaware").

[40] *Verbatim Text Of Sarkozy, Merkel, Brown Letter On G20*, WALL ST. J., Sep 3. 2009, http://online.wsj.com/article/BT-CO-20090903-705967.html.

binding rules regarding compensation and governance at the G20 summit in Pittsburgh in late September 2009. The Sarkozy-Merkel-Brown plan proposed restrictions on certain forms of compensation, specifically bonuses or variable compensation. At the G20 summit, Sarkozy and Merkel pressed for pay caps, but the idea was resisted by the U.S. and the U.K.. The final leaders communiqué issued at the close of the G20 summit contained guidelines whose language was broader and vaguer than what the September 3 proposal sought.[41] Following the G20 summit, France is reported to have criticized the speed with which the U.S. and U.K. have moved to implement the guidelines[42] It does not seem overly cynical to suggest that an interest in maintaining their attractiveness as centers for financial markets informs the U.S. and U.K.'s more tepid approach to adopting strict pay caps.

Similarly, this past fall Switzerland considered enacting tough pay caps on executive compensation. But on November 11, 2009, the Swiss adopted "watered-down" executive compensation limits.[43] The retreat from more restrictive executive compensation limits has been regarded as a victory for the Swiss banking industry. When push comes to shove, many nations appear to be unwilling to sacrifice their

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[41] The Leaders Statement-Pittsburgh Summit, Sep. 24-25, 2009, http://www.pittsburghsummit.gov/mediacenter/129639.htm.

[42] Alexandre Deslongchamps and Simon Kennedy, *Canada's Flaherty Says G-20 Has 'Disparate Views' on Bank Rules*, Nov. 4, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=akOTD1TvoXIY.

[43] David Jolly, *Switzerland Limits Bank Compensation, but Not Too Harshly*, Nov. 11, 2009, http://www.nytimes.com/2009/11/12/business/global/12pay.html.

international competitive position for executive compensation limits that are politically popular but of untested value.

As a result, it seems unquestionable that what other jurisdictions do with their corporate governance regimes will continue to have an impact on what the U.S. federal government and the states can do without incurring the risk of capital and corporate flight. As New Jersey learned long after 1913, even a powerful incumbency advantage can be undone by unwise policy and that the beginning and the causes of a long decline may be imperceptible until long after they have occurred. With this in mind, this paper next examines how successful the states and the federal government have been in adapting to emerging corporate governance issues.

## II. Shareholder Success In Changing State Corporation Law

Over the past five years, activist institutional investors have made a sustained push for greater control over the governance of the corporations in which they invest. Some of these initiatives (such as majority voting and the enablement of proxy access bylaws) have been sought through the states. Other changes have been sought through lobbying the federal government, such as the recent battles for proxy access and executive compensation guidelines. Paradoxically, institutional investors have received more resistance (but arguably more success) at the state level in form of enacted legislation, and more lip service (but less success) at the federal level in the form of unpassed bills and unadopted regulations.

## A. Majority Voting for Directors

Even though shareholder activists have long posited that the "race to the bottom" creates incentives that make the adoption of shareholder-friendly changes to corporate law at the state level an impossibility, institutional investors have made substantial strides in having greater influence over director elections in the last four years. The key achievement was the culmination of a largely successful, multi-year lobbying effort to have corporations adopt majority voting rather than plurality voting in director elections. At the beginning of 2006, the laws in thirty-five states provided for the election of directors by a plurality vote.[44] That is, directors are elected by a plurality vote unless a majority vote is mandated in the certificate of incorporation, or, in some states (including Delaware), the bylaws.

In 2005, the International Corporate Governance Network ("ICGN") made majority voting one of its key advocacy initiatives, and the Council of Institutional Investors ("CII") also decided to support majority voting. In February 2005, the ABA created a task force to consider the issue of majority voting, and soon a working group of corporate and labor pension fund representatives was also examining the issue. Around the same time, CII wrote to 1,500 corporations requesting that they adopt majority voting,[45] and Pfizer amended its corporate governance guidelines to require that any director who receives a majority of withheld votes must submit his or her

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44 MOD. BUS. CORP. ACT ANN., § 7.28 at 7-191 (Statutory Comparison).

45 The letter, dated May 24, 2005, is available on the ICI's Web site at <www.cii.org/library/correspondence/061705_mvfordirectors.htm>.

resignation to the board, with the board to then decide what to do.[46] On June 15 and 22, 2005, CII and the California Public Employees Retirement System wrote nearly identical letters requesting that Delaware law be amended to provide majority voting as the default rule for the election of directors.

After considering this proposal, the Council of the Section of Corporation Law of the Delaware State Bar Association, which is the body that typically recommends amendments of Delaware's business laws to the Delaware General Assembly, recommended two amendments that were passed by the General Assembly in June 2006. The amendments had the effect of making it easier for shareholders and boards of directors to implement majority voting or governance structures of comparable operation if they determine to do so.[47] In essence, the amendments eliminated some (but not all) of the legal issues that may arise in implementing a majority-vote requirement for the election of directors.

After similar lobbying efforts by institutional investors,[48] in June 2006 the ABA, through its Committee on Corporate Laws, adopted similar amendments

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[46] Pfizer, Corporate Governance: Principles, Item 7, *available at* <www.pfizer.com/pfizer/are/mn_investors_corporate_principles.jsp#voting>.

[47] A fuller account of how majority voting became part of the DGCL, the nature of the amendments, and questions about the effectiveness of majority voting can be found in David C. McBride & Rolin P. Bissell, *Delaware's Flexible Approach to Majority Voting for Directors,* WALL STREET LAWYER, VOL. 10, NO. 6 (June 2006).

[48] John C. Wilcox, *TIAA-CREF, Letter to Norman E. Veasey, Chair, Committee of Corporate Laws re Changes to Model Business Corporation Act* (May 17, 2006).

facilitating the adoption of majority voting to the Model Business Corporation Act, which serves as the basis for corporate laws in more than 30 states.[49]

ISS reported that more than 65 publicly reporting companies have adopted some form of majority voting in 2006. These include such household names as General Electric,[50] Verizon Communications,[51] and Heinz. Institutional investors also lobbied corporations and this lobbying was a key driver in many corporations' decisions to adopt majority voting.[52] Put simply, the institutional investor's campaign on majority voting was highly effective.[53] By the 2008 proxy season, 66% of the

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[49] In addition, California passed legislation enabling majority voting on September 30, 2006. California Senate Bill No. 1207, available at <http://info.sen.ca.gov/cgi-bin/postquery?bill_number=sb_1207&sess=CUR&house=B&site=sen>.

[50] On November 3, 2006, General Electric announced that its board had agreed to submit a proposal to shareholders to adopt a majority voting standard at the company's next annual meeting in April 2007.[50]

[51] Verizon approved a bylaw change on November 2, following a 61% endorsement of a shareholder majority vote proposal at the company's annual meeting in May.

[52] *See*, *e.g.*, John C. Wilcox, *TIAA- CREF, Sample Letter Concerning Majority Voting Proposal* (Oct. 3, 2006), and John C. Wilcox, *TIAA-CREF, Policy Statement on Majority Voting.*

[53] Lipton, *Some Thoughts for Board of Directors for 2007* at 12 ("It is clear today that majority voting will become universal. In light of the ISS position and in an effort to avoid shareholder proxy proposals, it is advisable for companies to adopt proactively a majority voting bylaw.") (on file with author).

companies in the S&P 500 and over 57% of the companies in the Fortune 500 had adopted a form of majority voting.[54]

### B. Proxy Access Bylaws

In 2009, two new sections (Sections 112 and 113) were added to the DGCL to authorize Delaware corporations to adopt bylaws to grant proxy access to shareholders and to provide expense reimbursement for proxy contests.[55] Both of these new sections are enabling and permissive; they do not require that Delaware corporations provide proxy access or proxy expense reimbursement unless a corporation's bylaws are amended to do so.

Under the new Section 112, a corporation's bylaws may provide that if a corporation solicits proxies for an election of directors, individuals nominated by shareholders may also be included in the corporation's proxy solicitation materials. Significantly, bylaws can define the extent of the proxy access right granted and condition that right through procedures for governing its implementation. These limitations may include, for example, minimum stock ownership requirements, whether the proxy access right is limited to record or beneficial owners, and whether holders of stock options and other rights are covered. In addition, Section 112

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[54] C. Allen, *Study of Majority Voting in Director Elections* (Nov. 23, 2007), *available at* http://blogs.law.harvard.edu/corpgov/2007/11/23/study-of-majority-voting-in-director-elections/.

[55] 8 *Del. Code* § § 112,113. For a good overview of Section 112 and 113 and the other 2009 Amendments to the DGCL *see* David C. McBride and Alexander D. Thaler, *Recasting the Gold Standard: Proposed Amendments to the DGCL,* THE METROPOLITAN CORPORATE COUNSEL (May 2009).

provides that a proxy access bylaw may require shareholders seeking to gain proxy access to disclose information that would indicate they have a financial incentive other than maximization of profit or stock price, such as holding short positions or other financial interests. Additionally, the right of proxy access may be limited to nominations of so-called short slates or, conversely, situations in which the shareholder seeks to nominate a majority of the board. The new Section 113 allows corporations to adopt bylaws granting its shareholders the right to be reimbursed for proxy expenses. Section 113 also expressly permits reimbursement to be conditioned upon a number of factors.

Section 112 and Section 113 became law on August 1, 2009 and so their effects will not be apparent until the 2010 proxy season. Nonetheless, they are noteworthy for two reasons. First, they give the tremendous flexibility to corporations to address the proxy access issue and experiment with it. Second, the fact that they were able to be enacted given the difficulty with doing anything on proxy access at the federal level.[56]

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[56] The Committee on Corporate Laws of the ABA Section of Business Law has also approved on second reading changes to the Model Business Corporation Act to clarify that a corporation's bylaws may include provisions requiring the inclusion of shareholder nominees in the corporation's proxy statement and form of proxy or consent and providing fro reimbursement to the extent and subject to such procedures and conditions as the bylaws may provide. *Changes in the Model Business Corporation Act – Proposed Shareholder Proxy Access Amendment to Chapters 2 and 10*, 64 BUS. LAW. 1157 (2009).

## C. North Dakota Publicly Traded Corporations Act.

Shareholder activists have also been successful in getting at least one state to adopt an explicitly "pro-shareholder" corporate code. In April 2007, the North Dakota Legislature adopted the North Dakota Publicly Traded Corporations Act (the "NDPTCA"). According to its sponsors, the NDPTCA:

> "provides a governance structure for publicly traded corporations that gives shareholders greater rights than they currently have under other state laws. It has been designed to reflect the best thinking of institutional investors and governance experts and addresses each of the current hot topics in corporate governance."[57]

(emphasis added). The NDPTCA permits companies incorporated under it to include in their articles of incorporation a provision stating that the company's affairs will be governed by the pro-shareholder provisions of the NDPTCA. These pro-shareholder provisions include: (1) majority voting for directors, (2) advisory shareholder votes on executive compensation committee reports, (3) a right for certain shareholders to propose board nominees on the company's proxy statement; (4) reimbursement of proxy expenses to shareholders to the extent they are successful in getting nominees elected; (5) a requirement of a non-executive board chair; and (6) restrictions on poison pills and other takeover devices.

So far, there has not been much interest by shareholder groups in lobbying companies to reincorporate in North Dakota under the NDPTCA and no one expects

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[57] Statement of the North Dakota Corporate Governance Council, *available at* http://www.ndcgc.org/.

there will be. It is likely to remain an unused corporate law curiosity.[58] Nonetheless, and whether one thinks the provisions of the NDPTCA are wise or unwise, it is an example of successful lobbying of a state legislature to obtain fairly sweeping change in a state's corporation laws.

## III. Shareholder Efforts to Enact Federal Legislation Have Been Unsuccessful

During the last six years, shareholder efforts to have Congress enact pro-shareholder legislation have been largely ineffective. The same can be said of efforts to have the SEC promulgate pro-shareholder regulation. Although the 2008 elections and the financial crisis appeared that they had the potential to bring movement on these issues, nothing significant has happened yet, except for the governance of a handful of companies receiving federal assistance through the TARP.

### A. Proxy Access

Activist investors' attempts over the last six years to gain greater control over the director election process at the federal level have been largely ineffective. In particular, attempts to get greater access to the corporate proxy for the purpose of nominating directors has gone on since 2003 without gaining real traction.[59] The proposed "shareholder access" rules seek to require corporations, under certain

[58] L. Ribstein, The North Dakota Experiment (Apr. 23, 2007), *available at* http://blogs.law.harvard.edu/corpgov/2007/04/23/the-north-dakota-experiment/.

[59] SEC Release No. 34-48626 (Oct. 14, 2003), *available at* <www.sec.gov/rules/proposed/34-48626.htm>.

circumstances, to include in their proxy materials shareholder nominees for election as director. Shareholder activists favor this change, arguing that access to the corporate proxy will decrease the cost of waging proxy fights by reducing the costs a shareholder must incur to print and mail their own proxies.

In 2006, perhaps frustrated by the pace of the SEC's deliberations, one activist investor sought to achieve proxy access through a shareholder-proposed bylaw amendment and the courts. In *AFSCME v. Am. Int'l Group, Inc.,* 462 F.3d 121 (2d Cir. 2006), the Second Circuit handed institutional investors some hope of shareholder access to the corporate proxy through the proposal of shareholder-adopted bylaws. In the *AFSCME* case, AFSCME proposed to AIG that it include in its annual proxy a binding bylaw amendment proposal that would allow large, long-term holders of AIG's stock access to management's proxy in subsequent years for purposes of nominating competing board candidates. The Second Circuit found that the proposal was not properly excludable under Rule 14a-8 of the proxy rules, thereby disagreeing with the position taken by the SEC staff. The matter went back before the SEC and was the subject of lobbying by institutional investors.[60] On November 28, 2007, in a blow to shareholder access, the SEC voted to amend Rule 14a-8 to clarify that public companies were permitted to exclude shareholder proposals to adopt bylaws granting

[60] John C. Wilcox – *TIAA-CREF, Letter to SEC re: Review of Rule 14a-8(i)(8)* (November 10, 2006).

shareholders rights to nominate director candidates for inclusion in management's proxy.[61]

On May 20, 2009, the SEC again proposed proxy access rules. The current proposal has two principle elements. First, a new Rule 14a-11 that would mandate proxy access for shareholders owning at least one percent of the stock for at least one year; and second, an amendment to Rule 14a-8 that would allow shareholders to use the corporation's proxy materials to propose bylaws that would establish the terms of proxy access, as long as those terms did not limit access rights otherwise available under the new Rule 14a-11.

As the SEC's May 22, 2009 press release concerning the proxy access proposal indicated, "the proposal represents nearly seven years of debate" on the proxy access issue. It is not clear the proposal has done much to bring closure to that debate. In fact, the proposal has drawn a wide amount of comment (positive and negative) including from major New York law firms, the ABA Section of Business Law, the Business Roundtable, a group of corporation law professors, and the Delaware State Bar Association. The SEC has deferred voting on the proposal until 2010 in light of the comments and opposition received. The adoption of the current proxy access proposal remains an uncertainty.

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[61] Exchange Act Release No. 34-56914, IC-28075; file no. S7-17-07, *available at* http://www.sec.gov/rules/final/2007/34-56914fr.pdf.

### B. Executive Compensation and "Say on Pay"

The debate at the federal level concerning executive compensation has also been inconclusive. In July 2006, the SEC adopted new pay disclosure rules.[62] SEC approval of new executive compensation disclosure rules was the first major overhaul of U.S. pay disclosure standards since 1992, and once again, the issue was lobbied heavily by institutional investors.[63] Under the new rules, corporations were required to disclose clearly how much the five most-senior executives earn from salary, stock options, and other benefits. The rules also required corporations to explain the methodology they use for determining pay and short-term incentives. In particular, institutional investors sought more disclosure about how executive pay plans are correlated to performance. CII, TIAA-CREF, and ISS identified poor compensation practices and executive compensation reforms as their lead issues for 2007.

In March 2007, Congressman Barney Frank, Chairman of the Financial Services Committee, introduced H.R. 1257, "The Shareholder Vote on Executive Compensation Act." The bill would require that public companies ensure that shareholders have an annual nonbinding advisory vote on their company's executive compensation plans; and an additional nonbinding advisory vote if the company

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[62] The final rule (17 CFR Parts 228, 229, 232, 239, 240, 245, 249 AND 274, SEC Release Nos. 33-8732A; 34-54302A; IC-27444A; File No. S7-03-06), *available at* <http://www.sec.gov/rules/final/2006/33-8732a.pdf>.

[63] John C. Wilcox, *TIAA-CREF, Letters to the SEC on SEC Executive Compensation Proposal.*

awards a new golden parachute package while simultaneously negotiating the purchase or sale of the company.

The White House has indicated that it opposes the bill. In a Statement of Administration Policy issued on April 17, 2007, the Executive Office of the President, Office of Management and Budget gave the following reasons for its position: (1) recent corporate governance changes have made boards more independent, including through the establishment of compensation committees composed solely of independent directors; (2) as a result of the SEC's revised disclosure rules on executive compensation, shareholders are receiving comprehensive information on executive compensation; and (3) before additional corporate governance requirements are legislated, the Administration believes that recent enhancements should be given time to take effect.

On April 20, 2007, the House of Representatives passed "The Shareholder Vote on Executive Compensation Act" by a vote of 269-134. The Senate never put the measure to a vote and it dies with the end of 110th Congress.

The global financial crisis rekindled efforts to create federal limits on executive compensation. But, so far, these efforts have created a lot of proposed legislation and very little law, except as to financial institutions and other companies receiving federal assistance. For example, the Emergency Economic Stabilization Act of 2008, is limited to financial institutions selling "troubled assets" to the Treasury. Accordingly, even though it authorized the Treasury Secretary to establish "appropriate standards for executive compensation and corporate governance,"

including limits on incentive payment to senior executives, clawback of bonuses or incentive compensation paid to senior executives, and prohibition of golden parachute payments,[64] those powers can be exercised only over a handful of companies. Similarly, the American Recovery and Reinvestment Act also imposed compensation rules and mandated "say on pay" on overall executive compensation, but again was limited to financial institutions receiving financial support.[65]

More recently, the federal government's new power-over-pay in the financial industry has given some indication about how executive compensation strictures aimed at all public companies might work. On October 22, 2009, the Federal Reserve announced proposed guidance on "Sound Compensation Policies," which will apply to all financial firms it regulates.[66] Under the policies, federal banking regulators will review compensation and compensation policy for:

- Senior executives who are responsible for oversight of the organization's firm-wide activities;
- Individual employees, including non-executive employees, whose activities may expose the firm to material amounts of risk. (e.g. traders

[64] Public Law No. 110-343.

[65] Public Law No. 111-5.

[66] Press Release, Board of Governors of the Federal Reserve System, Oct. 22, 2009, http://www.federalreserve.gov/newsevents/press/bcreg/20091022a.htm; Proposed Guidance on Sound Incentive Compensation Policies, 74 Fed Reg. 55,227 (Oct. 27, 2009)(proposed guidance with request for public comment).

with large positions limits relative to the firm's overall risk tolerance); and

- Groups of employees who are subject to the same or similar incentive compensation arrangements and who, in aggregate, may expose the firm to material amounts of risk, even if no individual exposes the firm to material risk.

On the same day, Kenneth Feinberg, the Obama Administrations' Special Master for Executive Compensation, set salary limits for 175 employees at financial firms receiving large amounts of government aid. Feinberg's decisions cut pay for the banking executives in half, limiting pay for most of them to $500,000 or less.[67] This decision has had rapid side-effects. Robert Benmosche, the CEO of AIG has threatened to step down, just three months after taking the job.[68] Benmosche is reported to believe that complying with Mr. Feinberg's pay limits would make it impossible for AIG to retain key talent. Feinberg himself has indicated that he shares these concerns.[69] Although Feinberg intends to track the effect of his pay decisions

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[67] Deborah Solomon and Dan Fitzpatrick, *Pay Czar to Slash Compensation at Seven Firms,* WALL ST. J., Oct. 22. 2009, http://online.wsj.com/article/SB125615172396299535.html.

[68] Liam Pleven, Serena Ng, and Joann S. Lublin, *AIG's Benmosche Threatens to Jump Ship,Chafing Under Government Oversight, Chief Executive Tells Board He's 'Done'; 'An Impossible Situation',* WALL ST. J., Nov. 11, 2009, http://online.wsj.com/article/SB125615172396299535.html.

[69] Ian Katz, *Feinberg 'Concerned' Pay Cuts Could Drive Out Talent,* BLOOMBERG, Nov. 12, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aul0W3P03QFY.

on financial firms, there remains great uncertainty about how his pay decisions will impact those firms.

In the meantime, Congress is apparently unwilling to wait and see how executive compensation oversight experiment plays out in the financial sector and seems eager to extend it to a larger swath of the economy. On July 17, 2009, Congressman Barney Frank circulated a discussion draft of HR 3296, the Corporate and Financial Institution Compensation Fairness Act of 2009 (the "Frank Bill"). The Frank Bill has four major components: (1) application of say-on-pay to all public companies; (2) the requirement of an independent compensation committees for all public companies; (3) incentive-based compensation disclosure requirements that apply to financial institutions; and (4) compensation standards for financial institutions. On July 31, 2009, the House passed the Frank Bill. It has been referred to the Senate, but it is not clear that the Senate will vote on it.

Indeed, the Senate has been busy with its own bill. On November 10, 2009, Senator Dodd submitted a discussion draft of financial reform bill.[70] Although the bill focuses on and overhaul of financial industry regulations and regulatory agencies,

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[70] Press Release, United States Senate Committee on Banking Housing and Urban Affairs, Nov. 10, 2009, http://banking.senate.gov/public/index.cfm?FuseAction=Newsroom.PressReleases&ContentRecord_id=df7bf893-bb40-6970-cd5f-c75f56d0fb64&Region_id=&Issue_id=. A copy of the draft bill is available at: http://banking.senate.gov/public/_files/AYO09D44_xml.pdf.

tucked away in 20 of its 1,136 pages, are a number of corporate governance measures.[71] In particular, the Dodd bill proposes:

- mandatory majority voting standard in uncontested elections of directors, with the requirements that (1) any director who does not receive a majority vote submit a resignation, and (2) that the board accept the resignation or vote unanimously to reject it, in which case the company must disclose the reasons for the rejection and why the rejection was in the best interests of the company and its shareholders;
- a requirement that the SEC to adopt proxy access rules within 180 days,
- a requirement that companies to disclose in their annual meeting proxy statements why they have chosen either to separate or not to separate the positions of the chairman and CEO;
- a prohibition against staggered boards unless adopted or ratified by the shareholders of the company;
- several requirements related to executive compensation provisions including (1) a non-binding shareholder vote on executive pay and golden parachutes, (2) independent compensation committees for exchange listed corporations; (3) companies set polices providing for clawback of executive compensation if the compensation is based on inaccurate financial

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[71] The executive compensations and governance aspects of the draft bill can be found at its pages 728 through 740 and 755 through 762.

statements; (4) additional disclosure rules concerning executive compensation.

In addition, through bills introduced by Senator Schumer and Congressman Peters, Congress has considered a variety of federal corporate governance measures for all public companies that include a prohibition against staggered boards, separation of chief executive office and chairman of the board of directors, mandatory majority vote standard and requiring creation of a risk committee for boards of directors.[72]

The enactment of any of these bills, in their current or altered form, remains an uncertainty.

## IV. Towards A Cooperative Federalism?

In a period of rising global competition for capital market preeminence, the competitive response that the U.S. will need to make likely requires greater coordination between federal regulatory and state law regimes. Happily, while the rhetorical battle between the academics and activists concerning whether there is a "race to the bottom" has roared on, the SEC and Delaware have been engaged in less noisy cooperation.

[72] S.1074 titled the "Shareholder Bill of Rights Act of 2009" and H.R. 2861 titled the "Shareholder Empowerment Act of 2009."

### A. The Certification Process

In 2007, an amendment to the Delaware State Constitution became effective to permit the SEC to certify to the Delaware Supreme Court questions of law.[73] The federal securities laws and Delaware corporation law are largely consistent and compatible. Through its prescriptive and detailed requirements, federal securities regulation seeks to ensure that publicly traded companies make fair disclosure of their affairs to their shareholders through a comprehensive system of reporting and proxy regulation. By contrast, the Delaware General Corporation Law is a broad enabling statute that aims at giving Delaware chartered corporations flexibility in ordering their internal affairs and management. Indeed, the compatibility of the Delaware and federal systems and the desirability of maintaining federal regulation of the securities markets with State control of chartering is well established. As explained by Brian G. Cartwright, SEC general counsel in a press release announcing the enactment of the amendment: "In our constitutional system, federal and state law coexist side by side, each with its distinctive role. As a result, the administration of the federal securities laws often requires interpretation of state laws. I am delighted that the SEC now has this new ability to obtain definitive answers to important questions of Delaware law."[74]

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[73] The amendment changed Article IV, § II, paragraph (8) of the Delaware Constitution of 1897. The amendment is codified at Delaware Supreme Court Rule 41(a).

[74] The press release is available at <http://courts.delaware.gov/Courts/SupremeCourt>.

Delaware, like most state courts, already had a certification procedure in place that allows federal and other states' courts to seek definitive interpretations of Delaware law.[75] Delaware is the first state to permit the SEC to bring questions to its courts, reflecting the unique role the Delaware courts hold in adjudicating corporate law disputes and the significance of Delaware corporation law generally. Despite their similar goals, at some points along their adjoining borders, federal securities regulation and Delaware corporation law do not mesh as neatly as they might.

Acknowledging the need for direct communication between the Delaware courts and the SEC and formalizing the method for those communications to take place are significant steps forward. The harmonization of corporations' obligations under the federal securities laws and Delaware corporation law would seem desirable for the corporations themselves and to promote comity between the federal and state systems. Corporations and their shareholders should welcome a new method to reconcile potentially inconsistent obligations they may face under the federal and state statutory schemes. With hope, it is a harbinger of even greater cooperation between the United States' leading state of incorporation and the leading regulator of its capital markets.

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[75] De. Supr. Ct. R. 41.

### B. First Certification – The AFSCME Proposal

On June 27, 2008, the SEC made its first certification under Rule 41. It arises out of the AFSCME Employees Pension Plan's request to include a shareholder proposal in CA Inc.'s proxy materials for its annual meeting. The AFSCME proposal requests that CA's bylaws be amended to require CA to reimburse the reasonable expenses of shareholder group running short slate of directors for election if one or more of those directors is elected to CA's board. CA submitted a "no-action" letter to the SEC to get a ruling that it could exclude the AFSCME proposal from the CA proxy pursuant to Exchange Rule 14a-8. CA's request for a "no action" letter included an opinion from CA's Delaware counsel that the bylaw proposal was not permitted under Delaware law. AFSCME submitted a response to the CA request that included an opinion from its Delaware counsel that the bylaw proposal is permitted under Delaware law. The SEC asked the Delaware Supreme Court for guidance on the Delaware law issues.

On July 1, 2008, the Delaware Supreme Court accepted the certification.[76] Oral argument was held on July 9, and the Delaware Supreme Court issued its decision eight days later on July 17, 2008.[77]

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[76] *CA, Inc. v. AFSCME Employees Pension Plan*, Order No. 329, 2008 (Del. Supr. Jul. 1, 2008).

[77] *CA, Inc. v. AFSCME Employees Pension Plan*, 2008 Del. LEXIS 329 (Del. July 17, 2008).

In its decision, the Delaware Supreme Court answered the two questions the SEC certified to it:

> 1. Is the AFSCME Proposal a proper subject for action by shareholders as a matter of Delaware law?
>
> 2. Would the AFSCME Proposal, if adopted, cause CA to violate any Delaware law to which it is subject?

On the first certified question, the Court held that the proposed reimbursement bylaw was the proper subject for shareholder action under Delaware law. The Court found:

> the process for electing directors – a subject in which shareholders of Delaware corporations have a legitimate and protected interest.
>
> * * *
>
> The Bylaw would encourage the nomination of non-management board candidates by promising reimbursement of the nominating stockholders' proxy expenses if one or more of its candidates are elected. In that the shareholders also have a legitimate interest, because the Bylaw would facilitate the exercise of their right to participate in selecting the contestants.[78]

Even though the Court found that the proposed bylaw was on a proper subject for shareholder action, it answered the second certified question in the affirmative and found that the proposed bylaw was potentially inconsistent with Delaware law. Although the proposed bylaw did not facially violate the provisions of the DGCL, it was potentially inconsistent with Delaware court decisions that have "invalidated

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[78] *Id.* at *24-25.

contracts that would require a board to act or not act in such a fashion that would limit the exercise of their fiduciary duties."[79] Accordingly, the Court found that the proposed bylaw was not "legally permitted under the DGCL."

The decision is significant beyond its holding for several reasons. First, it provides an excellent summary of how the DGCL and the Delaware courts balance shareholder and director power. Second, it suggests in several spots how shareholders could fashion a similar bylaw or charter amendment to achieve the proposed bylaw's goals. Third, it demonstrates the utility of the new certification process and how the SEC and the Delaware Supreme Court can work together to clarify unresolved issues of corporation law.

### C. Making the Conversation Two-Way

Two cases show that the Delaware courts might benefit if the certification process ran both ways (*i.e.,* the Delaware courts could certify questions to the SEC to get definitive guidance on the SEC's position on federal securities regulation). The new certification process only provides a partial solution to this problem by opening a channel through which the SEC can put questions to the Delaware Supreme Court and obtain authoritative guidance. It does not address the dilemma Delaware courts face when asked to predict how the SEC would interpret its rules and regulations.

In *New Castle Partners L.P. v. Vesta Insurance Group, Inc.*, 887 A.2d 975 (Del. Ch.) *affirmed,* 2005 Del. LEXIS 463 (Del. Supr. Nov. 16, 2005), Vesta Insurance Group, Inc. attempted to defend its failure to schedule an annual

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[79] *Id.* at *28-30.

shareholder meeting to vote on the election of directors on the basis that it had not produced its financial statements, it could not produce a proxy and, as a result, was incapable of holding an annual meeting. Federal securities regulation governing the dissemination of proxies requires that a corporation include its current financial statements in a proxy statement sent to its shareholders in connection with a corporation's annual meeting, where directors are typically elected. If the corporation cannot complete its financial statements, it cannot produce a proxy statement that would allow it to solicit proxies. Thus, without a proxy, Vesta could not, as a practical matter, hold an annual shareholder meeting to elect directors. Section 211 of the DGCL gives shareholders the right to compel an annual shareholders meeting if one has not been held for more than thirteen months since the last annual meeting. The Delaware Court of Chancery ruled that, notwithstanding Vesta's inability to comply with federal proxy regulation, Section 211 required it to hold an annual meeting to elect directors anyway.

Similarly, Section 271 of the DGCL requires a shareholder vote before a corporation can sell "all or substantially all of its assets." In *Esopus Creek Value LP v. Hauf*, 913 A.2d 593 (Del. Ch. 2006), a shareholder, Esopus Creek Value L.P., successfully enjoined Metromedia International Group, Inc. from completing a sale of substantially all of its assets without holding a shareholder meeting. One of Metromedia's defenses was that it could not hold a shareholder meeting because it had been unable to issue financial statements, and thus could not prepare a proxy in

conformance with federal securities regulation. The Delaware Court of Chancery rejected this defense.

As suggested by both the *Newcastle Partners* and *Esopus Creek* decisions, it may be just as typical for the Delaware courts (or the parties before them) to need guidance concerning the SEC's position under the federal securities laws, as for the SEC to need the Delaware Court's guidance concerning Delaware corporation law. Although private parties can seek some guidance on the SEC's stance on a limited range of issues by seeking no action, interpretative, and exemptive letters, there remains no directive way for the Delaware courts to certify questions to the SEC.

### D. Taking Advantage of the Relative Nimbleness of the States

The states, and Delaware in particular, can often move more nimbly to address emerging issues than can the federal government. Indeed, over the last few years, corporate governance reformers seem to have had more success pursuing incremental changes at the state level (*e.g.,* majority voting and proxy access bylaws) than they have had at the federal level pursuing sweeping, one-size-fits-all reforms (*e.g.*, proxy access and "say on pay"). Put differently, federalization may make pursuing corporate governance reforms more difficult because achieving anything at a national level is more difficult. This suggests that pursuing incremental and less prescriptive change at the state level may be the more effective reform strategy.

## Conclusion

Shareholder activism and increased global competition show no sign of abating. Accordingly, innovation and reform in corporation law is inevitable. But, the traditional "federalism" debate, which was couched in terms of " should the federal government preempt the states," is increasingly beside the point. The real challenge for the combined scheme of federal securities regulation and state incorporation law will be to develop a blend of flexibility and prescription that makes that scheme both attractive to capital and managerially effective. As the development of the new certification procedure between the SEC and the Delaware Supreme Court suggests, there are great opportunities for cooperation between federal government and the states to develop the optimal and internationally competitive regulatory blend.

# PANEL BIOGRAPHIES

ABA Business Law Section

2009 Winter Meeting--CLE Program

November 20, 2009
Washington, DC

**Federalization of Corporation Law in a Time of Crisis – Which Institutions are Best Able to Improve Corporate Governance and Performance Going Forward.**

*Presented by:*

*The Committee on Business and Corporate Litigation,*

*The Committee of the Federal Regulation of Securities*

Chief Justice Myron T. Steele
Supreme Court of Delaware
57 The Green, Dover, DE 19901
302.739.4214 • myron.steele@state.de.us

BIOGRAPHY:

The Senate confirmed Governor Ruth Ann Minner's nomination of Justice Myron T. Steele as Chief Justice on Wednesday, May 5, 2004. Chief Justice Steele is the 7th Chief Justice of the Delaware Supreme Court. Before his appointment as Chief Justice, he served as a Supreme Court Justice from July 28, 2000 to May 5, 2004. Previously, he served as a Vice Chancellor of the Court of Chancery from 1994 to 2000, as Resident Judge of the Superior Court in Kent County from 1990 to 1994, and as a Superior Court Judge from 1988 to 1990.

Chief Justice Steele graduated from the University of Virginia (B.A., Foreign Affairs, 1967) and the University of Virginia School of Law (J.D., 1970; LL.M. 2005). He served on active duty in the U.S. Army and retired as a Colonel in the Delaware Army National Guard. He was a Deputy Attorney General, Senate (Delaware) Attorney and Chairman of the Consumer Affairs Board. Before being appointed to the bench, he was a litigation partner in Prickett, Jones & Elliott of Wilmington and Dover. He also served as outside counsel, Director and Chairman of the Central Delaware Health Care Corporation.

In addition to his judicial activities, Chief Justice Steele has been appointed to the Judicial Conference Committee on Federal-State Jurisdiction by Chief Justice John Roberts. He is a continuing advisor to the Business Law Section of the American Bar Association, a member of and judicial liaison to the Mergers & Acquisitions Committee of the Business Law Section and that Section's representative to the ABA Council on Diversity in the Profession. He is also the first member of the Delaware Judiciary invited to join the American Board of Trial Attorneys.

As Vice Chancellor and Superior Court Judge, Chief Justice Steele presided over major corporate litigation and LLC and limited partner governance disputes. Some of the most noteworthy trials over which he presided include the Viacom/Universal Studios dispute over ownership of the USA Television Networks; Painewebber v. Centocor, an internal governance dispute in a nationally traded limited partnership; CFLP v. Cantor, et al., a dispute seeking injunctive and contractual remedies between limited partners and a general partner in a closed partnership; and the DuPont v. Admiral environmental insurance coverage litigation. Chief Justice Steele has published over 400 opinions resolving disputes among members of limited liability companies and limited partnerships, and between shareholders and management of both publicly traded and closely held corporations.

Chief Justice Steele speaks and writes frequently on issues of corporate document interpretation and corporate governance. His thesis for the LL.M. degree, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, focused on the application of common law fiduciary duties within the contractual framework of alternative business organizations. It was published in the *Delaware Journal of Corporate Law* (32 DEL. J.

CORP. L. 1 (2007)). The November 2005 issue of *The Business Lawyer* included an article he co-authored with Sean J. Griffith entitled *On Corporate Law Federalism: Threatening the Thaumatrope* (61 BUS. LAW. 1 (2005)). He co-authored an article with J.W. Verret entitled *Delaware's Guidance: Ensuring Equity for the Modern Witenagemot* published in the Fall 2007 issue of the Virginia Law & Business Review (2 VA. L. & BUS. REV. 188 (2007)). That article formed the basis for a keynote speech to the Business Section at the 2007 ABA Annual Meeting. Chief Justice Steele served as Adjunct Professor of Law at Penn Law to co-teach "Advising the Board of Directors," and will teach at the University of Virginia Law School in the Spring of 2010.

In September 2007, Directorship Magazine ranked Chief Justice Steele as one of the 100 most influential people in corporate governance in the United States. In December 2007, Ethisphere Magazine ranked Chief Justice Steele second in its list of "the 100 Most Influential People in Business Ethics for 2007." Lawdragon Magazine has consistently placed Chief Justice Steele among its annual Lawdragon 500 "Leading Lawyers in America" and "Top Judges in America."

J. Travis Laster is a Vice Chancellor on the Court of Chancery of the State of Delaware. He received his A.B *summa cum laude* from Princeton University and his J.D. and M.A. from the University of Virginia, where he served on the Virginia Law Review, was a member of the Order of the Coif, and received the Law School Alumni Association Award for Academic Excellence. Prior to his appointment, he was one of the founding partners of Abrams & Laster LLP. While in private practice, he specialized in high stakes litigation involving Delaware corporations and other business entities, and advising on transactional matters carrying a significant risk of litigation. He also wrote and spoke frequently on aspects of business law. Before forming Abrams & Laster, he was a director of Richards, Layton & Finger P.A. Before joining Richards Layton & Finger, he clerked for the Honorable Jane R. Roth of the United States Court of Appeals for the Third Circuit. He is a member of the American Bar Association, Delaware State Bar Association, and the Rodney Inn of Court.

**JILL E. FISCH**
**Perry Golkin Professor of Law; Co-Director, Institute for Law and Economics**
Tel: 215.746.3454
Email: jfisch@law.upenn.edu

### EXPERTISE

- Corporate Governance
- Federal Courts
- Litigation
- Securities Regulation

### BIO

Jill Fisch is a nationally known scholar, whose work focuses on the intersection of business and law, including the role of regulation and litigation in addressing limitations in the disciplinary power of the capital markets. Her 1997 paper, *Retroactivity and Legal Change: An Equilibrium Approach* (Harvard Law Review), introduced a new framework for retroactivity analysis that could apply to both adjudication and legislation. Her 2003 paper (with Stephen Choi), *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries* (Yale Law Journal), introduced a voucher financing mechanism to increase accountability for securities intermediaries such as research analysts, proxy advisors and credit rating agencies.

Fisch is a member of the American Law Institute and a former chair of the Committee on Corporation Law of the Association of the Bar of the City of New York.

### REPRESENTATIVE PROFESSIONAL POSITIONS

Penn Law – Perry Golkin Professor of Law (2009- ); Professor of Law (2008-09)

Fordham – T.J. Maloney Professor of Business Law and Director, Corporate Law Center (1989-2008)

Visiting Professor – Georgetown, Penn Law, Columbia, Harvard

Cleary, Gottlieb, Steen & Hamilton - Associate (1987-89)

U.S. Justice Department (Honors Program), Criminal Division Trial Attorney (1985-87)

### REPRESENTATIVE PUBLICATIONS

*Attorneys as Arbitrators*, J. LEG. STUD. (forthcoming 2010) (with Stephen Choi and A.C. Pritchard).

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### CURRICULUM VITAE

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### RESEARCH AREAS

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For additional publications, please consult
**Current & Recent Research**

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**Thomas J. Kim**

Mr. Kim is the Chief Counsel and an Associate Director of the Division of Corporation Finance at the Securities and Exchange Commission.

Mr. Kim has written widely on the federal securities laws and recently served as Co-Chair of the ABA's Task Force producing the fifth edition of the ABA's Corporate Director's Guidebook.

From 1995 to 1996, Mr. Kim served as a law clerk to the Hon. Louis F. Oberdorfer, U.S. District Court for the District of Columbia.

Mr. Kim earned his J.D., *magna cum laude*, from Harvard Law School, where he was an editor of the Harvard Law Review. He graduated *summa cum laude* from Yale College with a B.A. in English.

# Michele E. Rose

***Partner***

**Practices**

Securities Litigation and Professional Liability

**Bar Qualifications**

California
District of Columbia
Virginia

**Education**

JD, Loyola Marymount University, 1991

AB, Univ. of California, Berkeley, 1987

**WASHINGTON, D.C. OFFICE**
555 Eleventh Street, NW
Suite 1000
Washington DC 20004-1304
+1.202.637.1008 Phone
+1.202.637.2201 Fax

michele.rose@lw.com

**Experience**

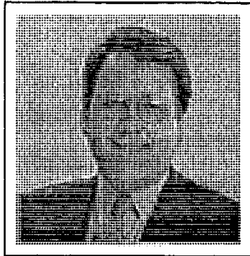
Michele Rose is a partner in Latham & Watkins' Litigation Department. She practices primarily in the areas of securities litigation, including the defense of securities class actons, derivative, mergers and acquisitions, corporate control, Securities and Exchange Commission enforcement actions and internal investigations. Ms. Rose also counsels clients with respect to disclosure obligations, fiduciary duties and financial crisis management. Ms. Rose has assisted on the successful defense of over 30 securities class actons and derivative actions, including representing such companies as ProQuest Company, Willbros Group, Inc., Cambrex Corporation, Emcor Group, Inc., Republic Services, Frontier Insurance, J.D. Edwards, Prime Retail, Inc. and USInternetworking, as well as directors, officers and special committees.

Ms. Rose has conducted numerous intemal investigations on behalf of board members and/or special committees. Those investigations include issues relating to financial restatements, insider trading and other acts of corporate mismanagement.
Ms. Rose has also represented numerous Companies, Individuals, Professional Firms and Financial Institutions Governments in SEC and other regulatory and governmental investigations and regulatory proceedings.

Ms. Rose is the Co-Chair of the Securities Litigation Subcommittee of the Business Law Section of the American Bar Association. Ms. Rose has lectured at Practicing Law Institute and other seminars on topics such as "The New Standards of Corporate Governance, Scrutinizing the Impact of the Sarbanes-Oxley Act," "Responding to A Corporate Crisis," "Regulation FD - Best Practices," "Potential Securities Law Exposures for the Newly Minted Public Company" and "The Key to a Successful IPO."

Ms. Rose was a law clerk to the Honorable Richard A. Paez, United States District Judge for the Central District of California. Prior to joining Latham & Watkins in 2002, Ms. Rose was a partner at a national law firm in Palo Alto, California and McLean, Virginia.

Ms. Rose is admitted to practice before the United States Supreme Court, the District of Columbia Court of Appeals, the US District Courts for the District of Columbia, the Eastern and Western Districts of Virginia, the Northern, Eastem and Central Districts of California, the Eastern District of Michigan, as well as the District of Cobrado.



*Partner*

*Corporate Counseling and Litigation*

*direct dial (302) 571-6560*
*direct fax (302) 576-3474*
*rbissell@ycst.com*

*Admissions:*
*State of Delaware*
*State of New York*

*Education:*
*University of Virginia J.D.*
*Columbia University A.B.*

# ROLIN P. BISSELL

Mr. Bissell's practice focuses on corporate litigation in the Delaware Court of Chancery, including disputes about mergers and acquisitions, going private transactions, "interested party" transactions, proxy contests, valuation and appraisal issues, indemnification and advancement and stockholder access to books and records. In addition, he has tried and handled a broad array of securities, financial, accounting malpractice, RICO, antitrust, patent, copyright, trade secret and other business disputes that involve complex financial, economic, or accounting concepts in federal and state courts throughout the country. Mr. Bissell has also assisted Boards of Directors and special litigation committees in connection with derivative claims and has assisted boards, officers and others in SEC investigations.

Before joining Young Conaway, Mr. Bissell was a partner at Schnader Harrison Segal & Lewis LLP, Philadelphia, Pennsylvania, an associate at Dewey Ballantine, Bushby, Palmer & Wood, New York, NY, and a Law Clerk to Hon. Justice Richard Neely, Justice of the West Virginia Supreme Court of Appeals, Charleston, W.Va.

## Professional Memberships

American Bar Association, Section of Business Law, Section of International Law, Section of Litigation

Delaware State Bar Association, Section of Corporation Law

## Activities

Richard Rodney Inn of Court (Master, 2004 to present); Weinberg Center for Corporate Governance of the Lerner School of the University of Delaware (2006 to present)

Mr. Bissell has also served as a board member for The Philadelphia Society for Preservation of Landmarks, the Committee of Seventy of Philadelphia, Chestnut Hill Historical Society and has done *pro bono* work on behalf of Philadelphia Volunteer Lawyers for the Arts.

## Representative Cases

*Frontier Oil Corp. v. Holly Corp., C.A: No. 20502, Court of Chancery*

*Hexion Specialty Chemicals, Inc., et. al. v. Huntsman Corp.*

*HMG/Courtland Properties Inc. v. Lee Gray, et al.*

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## Associated Online Publications

*Deal Certainty In Uncertain Times--2007 Lessons From The Delaware Court of Chancery*

*Delaware's Flexible Approach to Majority Voting for Directors*

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