

***Smith v. Van Gorkom*, Jurisdictional Competition, and the Role of Random Mutations in the Evolution of Corporate Law**

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I. INTRODUCTION

Random mutations play a crucial role in Charles Darwin's theory of evolution.¹ Over time, species evolve through the "natural selection" of random mutations that improve the survivability of a species. Random mutations can be either beneficial or detrimental. Those mutations that improve the gene pool survive, while those that harm the survivability of a species disappear. The evolutionary process continues through subsequent random mutations as new dominant traits replace the status quo. Herbert Spencer labeled this natural selection process "Survival of the Fittest."² The pace of change appears slow because most random mutations are small and imperceptible at the time they occur.

American corporate law has seen numerous changes that may be characterized as random mutations. Certainly the most notorious mutation is New Jersey's infamous Seven Sisters Acts of 1913 that thrust Delaware into its current market dominance.³ Of course, random mutations of corporate law are made by humans.⁴ Some mutations thrived, some died, but they all had a common trait—they were purposeful efforts to somehow improve corporate law. Natural selection through market forces determines whether one legislature's or one court's "improvement" is actually an improvement or a detriment. In American corporate law, the natural selection process is manifest

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1. CHARLES DARWIN, *ON THE ORIGIN OF SPECIES* (Watts & Co. 1950) (1859).

2. See, e.g., Wikipedia, Herbert Spencer, http://en.wikipedia.org/wiki/Herbert_Spencer (last visited Jan. 18, 2006). Professor Stephen Bainbridge responded to an effort to link the debate over "Intelligent Design" to corporate governance issues by concluding "corporate success all too often is a matter of survival of the least unfit." Stephen Bainbridge, *Intelligent Design? Not So Much!*, TCS DAILY, Jan. 11, 2006, <http://www.tcsdaily.com/article.aspx?id=0111006C>.

3. Henry N. Butler, *Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEGAL STUD. 129, 163 (1985).

4. The Sarbanes-Oxley Act of 2002 was a reaction to the meltdowns of Enron, WorldCom, and other major corporations. Congress preempted several areas of state corporate law. The congressional decision-making process clearly fits within the purview of random mutations. See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1549-68 (2005); see also Jayne W. Barnard, *Historical Quirks, Political Opportunism, and the Anti-Loan Provision of the Sarbanes-Oxley Act*, 31 OHIO N.U. L. REV. 325 (2005) (presenting detailed legislative history and background, focusing on executive loan provisions).

through the Economic Darwinism of jurisdictional competition.⁵ For an evolutionary process to work, catalysts—akin to random mutations—must occur and cause changes.⁶ In this process, inadequate laws and poor judicial decisions may lead to the discovery of improved corporate law.

The Delaware Supreme Court's decision in *Smith v. Van Gorkom*⁷ was just such a random mutation. *Van Gorkom* was a major and seemingly random change in the corporate law of fiduciary duties. It certainly took corporate law observers and commentators by surprise.⁸ And *Van Gorkom*'s reverberations continue to be felt.

This article applies an evolutionary perspective to the evaluation of the controversial role of *Van Gorkom* in American corporate law. Part II provides historical context to the evolution of corporate law through jurisdictional competition. Part III reviews the Delaware legislature's reluctant response to the mutation formerly known as *Trans Union*.⁹ Part IV speculates about the role of random mutations in improving corporate governance. Part V critiques the application of *Van Gorkom* to the debate over the merits of jurisdictional competition in the production of corporate law. Part VI considers the impact of the threat of federal preemption on the evolution of Delaware cor-

5. Economic Darwinism—a variation on the biological theory of natural selection—has been applied to numerous economic and legal contexts. In industrial organization economics, Nobel Laureate George Stigler used Economic Darwinism to study economies of scale. George J. Stigler, *The Division of Labor Is Limited by the Extent of the Market*, 59 J. OF POL. ECON. 185, 191-94 (1951). In the economic analysis of organizations, Eugene Fama and Michael Jensen used Economic Darwinism for their discussion of organizational forms. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 301 (1983). “Absent fiat, the form of organization that survives in an activity is the one that delivers the product demanded by customers at the lowest price while covering costs.” *Id.* And, in the economic analysis of law, several scholars applied a natural selection model to help explain Richard Posner's famous assertion that the common law tended to be efficient. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 27-29 (5th ed. 1998). Under these models, the common law evolved toward efficiency without conscious economic analysis or even without any such intent by judges. Efficient rules survive and inefficient ones die. For a thorough review and critique of the literature on the efficiency of the common law, see Todd J. Zywicki, *The Rise and Fall of Efficiency in the Common Law: A Supply-Side Analysis*, 97 Nw. U. L. REV. 1551 (2003).

6. Of course, to the extent that Sarbanes-Oxley preempts the ability of jurisdictions to compete through product differentiation, the potential benefits of jurisdictional competition are thwarted. See Larry E. Ribstein & Henry N. Butler, *Lessons from the Sarbanes-Oxley Fiasco* (unpublished manuscript presented at the American Enterprise Institute on March 13, 2006, on file with the *Washburn Law Journal*).

7. 488 A.2d 858 (Del. 1985).

8. See, e.g., Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1455 (1985) (describing the decision as “one of the worst decisions in the history of corporate law”); Jonathan R. Macey & Geoffrey P. Miller, *Trans Union Reconsidered*, 98 YALE L.J. 127, 131 (1988) (“The outcome of the case was exactly opposite to what virtually every observer of Delaware law would have predicted.”); Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1, 1 (1985) (“The Delaware Supreme Court in *Van Gorkom* exploded a bomb.”).

9. See MICHAEL P. DOOLEY, *FUNDAMENTALS OF CORPORATE LAW* 244 (1995) (“An initial tendency to refer to the [*Smith v. Van Gorkom*] opinion as the *Trans Union* case seems to have not caught on.”).

porate law. Part VII considers the counterfactual issue of whether *Van Gorkom* improved corporate law.

II. NEW JERSEY'S MUTATION AND DELAWARE'S LUCK

The history of American corporate law vividly illustrates how jurisdictional competition can weed out inefficient legal requirements and procedures. Prior to the passage of the first truly modern general incorporation statute in 1875, liberal corporate charter terms were available only through special charters, which, as their name suggests, were available only to special interest groups.¹⁰ The early general incorporation laws included numerous restrictions on duration, location, activities, and legal capital. Those restrictions became irrelevant once New Jersey started providing liberal charters to the national market in 1875. The ensuing competition between the states destroyed the local monopolies that had allowed state legislatures to sell liberal corporate terms as special corporate charters. In this sense, the early years of jurisdictional competition provided a great benefit by making the corporate form with liberal terms available through a simple filing with perfunctory approval instead of through lobbying and other rent-seeking activities.¹¹

From 1875 to 1913, New Jersey dominated the market for corporate charters. New Jersey was not a complacent market leader, as demonstrated by a major revision of its corporate law in 1894. Other states, such as West Virginia, were eager to overtake New Jersey. In 1899, Delaware adopted a statute identical to that of New Jersey, and the Delaware Supreme Court quickly followed by adopting New Jersey's judicial interpretations. Even with a lower tax rate and the same corporate laws, however, New Jersey corporations did not rush to reincorporate in Delaware. Evidently, reincorporation in Delaware was not worth the transaction costs. Moreover, Delaware would have been viewed as riskier because it did not have the long history of New Jersey in providing stable and reliable corporate law. It simply was not worthwhile for New Jersey firms to reincorporate in Delaware. Fortunately for Delaware, Woodrow Wilson provided the catalyst for New Jersey's demise and Delaware's ascension to dominance.¹²

New Jersey's Seven Sisters Acts of 1913 were passed at the behest of Woodrow Wilson shortly after he transitioned from Governor of New Jersey to President of the United States. At that time, New Jersey was the clear leader in the interstate competition for the lucrative corporate chartering business. Wilson, an anti-business progres-

10. See Butler, *supra* note 3, at 138-43.

11. *Id.*

12. *Id.* at 156-63.

sive, was unhappy with New Jersey's reputation as the "Mother of Trusts," so he attacked the trusts with state antitrust legislation designed to disintegrate the trusts of corporations chartered in New Jersey. New Jersey-chartered corporations quickly opted out of New Jersey corporate law by reincorporating in Delaware.¹³

The folly of New Jersey's mutation was quickly realized, but corrective legislation was too late—the proverbial cows had already left the barn. And they were not about to return to a state in which the legislature could no longer be trusted. Delaware, in turn, has dominated corporate law for almost a century.

A consideration of this historical mutation raises the issue of whether New Jersey's mutation mattered in the sense that the future course of corporate law was somehow altered by Delaware's natural selection, instead of New Jersey's continued dominance. It is significant that Delaware, and not New Jersey, dominated corporate law production for almost one hundred years. Delaware has always had stronger incentives to dominate the market because Delaware corporate chartering revenues have always represented a larger portion of the state budget than such revenues in New Jersey. The absolute amount of potential revenue from dominating the market is the same whether New Jersey or Delaware dominates, but the larger amount at stake, in terms of a percentage of state tax revenue, effectively bonds Delaware from taking huge risks. Of course, generating major mutations similar to New Jersey's could destroy Delaware's domination, but Delaware has demonstrated a stronger incentive than New Jersey to make its law attractive to corporations. Thus, the random mutation of New Jersey corporate law in 1913 impacted the evolution of corporate law far more than merely changing the name of the state of incorporation. Delaware was lucky, but perhaps the ultimate beneficiary of New Jersey's random mutation was the American economy because the body of American corporate law was improved by New Jersey's suicide. It is ironic that Woodrow Wilson, the anti-business progressive, was the catalyst for the development of legal institutions that supported large corporate entities.

III. DELAWARE'S DANCE WITH *VAN GORKOM*: RENT-SEEKING AND A RELUCTANT LEGISLATURE

New Jersey blew it. Is it possible for Delaware to do the same? Is it possible for Delaware to generate a random mutation of such a magnitude that it loses dominance in the corporate charters market? It may appear that Delaware has effectively bonded itself from mak-

13. *Id.* at 163 & n.136.

ing a mistake of the magnitude of that in New Jersey in 1913. Politicians have been known, however, to do many foolish things.

When New Jersey's progressives effectively threw away twenty-five percent of New Jersey's revenue, without knowing the perceptible impact of their legislation, they broke what must have appeared to be a lasting bond for New Jersey to continue to provide state-of-the-art corporate law. Today, Delaware's tax revenue from the corporate chartering business is only twenty percent of general revenues, which is less than the percentage at issue for the New Jersey legislature in 1913. Thus, history suggests that Delaware's dominance may not be as secure as is often assumed.¹⁴

Although it is widely agreed that Delaware's corporate law is superior to that of other jurisdictions, Delaware's efforts to capture the maximum revenue associated with its superior product and dominant position ultimately make it a less attractive state of incorporation. Interest groups exploit Delaware's market power by tailoring corporate law in a manner that, while maintaining Delaware's dominance, also generates above-normal returns to lawyers and other service providers that operate in the state.¹⁵ Those above-normal returns occur at the expense of Delaware corporations¹⁶—making Delaware less attractive for incorporation than it would be without interest-group bargains.¹⁷ This confluence of interests provides strong incentives for Delaware law to avoid crossing the fine line between providing a net benefit to Delaware corporations and making other jurisdictions more appealing. Thus, rent-seeking threatens Delaware's dominance, but the rent-seekers know this and do not push the law to the point that Delaware corporations leave *en masse*.

From the interest-group perspective, the goal of Delaware legislators is to maximize the combined return from two sources—franchise taxes and rents provided to, and extracted from, interest groups. Higher franchise tax rates reduce the number of corporations. More aggressive rent creation and rent extraction via corporate legislation increase the costs of incorporating in Delaware and encourage Delaware corporations to migrate. Entrepreneurial politicians would exploit both opportunities to the point that corporations will not receive much benefit from locating in Delaware.

14. See *id.* at 162-63. Delaware legislators and interest groups are mindful of this history lesson, and consequently, its recurrence is less likely.

15. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 472 (1987).

16. See Jonathan R. Macey, *Smith v. Van Gorkom: Insights About C.E.O.s, Corporate Law Rules, and the Jurisdictional Competition for Corporate Charters*, 96 NW. U. L. REV. 607, 626 (2002) (characterizing the interest-group bargain as “a transaction tax on major corporate decisions in Delaware”).

17. At the heart of this interest-group approach is the agency issue of whether Delaware lawyers and investment bankers are giving sound advice to their corporate clients.

The pressure of interest groups to extract the maximum benefit means that at any given time incorporating in Delaware may not be superior to incorporating in other jurisdictions. Some firms are always on the margin with regard to incorporation in Delaware. Delaware has *only* fifty-five percent of the market. Close substitutes are available in other jurisdictions; this generally serves to constrain Delaware's interest groups. There is no guarantee that Delaware's courts and legislature will not, either intentionally or unintentionally, overstep and kill the proverbial goose that laid the golden egg. Delaware may have come perilously close to that margin with *Van Gorkom*.

Although there was a great deal of concern about *Van Gorkom* and what to do about it, the Delaware legislature initially responded as if dealing with a captive market. For Delaware corporations, the voice option was in full swing because the exit option was not considered a viable alternative. The legislature appeared secure in its assessment that *Van Gorkom*, by itself, could not cause Delaware to crash and burn. This was a reasonable response by a dominant firm not threatened by inferior substitutes. It was also exactly the response predicted by Jonathan Macey and Geoffrey Miller's interest-group theory of Delaware corporate law,¹⁸ which posited that the *Van Gorkom* opinion was beneficial to powerful political interests that would prefer for the decision to stand. Far from being responsive to the howls coming from corporate boardrooms, the Delaware legislature was going to fix the law on its own schedule—if at all.

Delaware's dominant role as the interpreter of corporate law also builds in some protection against losing market share in response to poor or unpopular judicial decisions. Because many other states closely follow Delaware decisions, *Van Gorkom* also adversely affected many of Delaware's competitors. As a consequence, Delaware legislators could have expected Delaware's corporate dominance to survive under *Van Gorkom*. Any state that follows *Van Gorkom* will not gain a competitive advantage over Delaware.¹⁹ The Delaware leg-

18. Macey & Miller, *supra* note 15, at 519.

19. Although *Van Gorkom* may have increased the costs of doing business as a Delaware corporation, this decision did not substantially disadvantage Delaware corporations because, to the extent that *Van Gorkom* also impacted corporations in other jurisdictions, the resulting increase in costs would not give other states an advantage. For example, in response to increased director liability, some directors left and those who stayed commanded higher compensation for the risk. The initial effect of *Van Gorkom* was to increase directors and officers (D&O) insurance rates or to make D&O insurance unavailable. This led to an exodus of experienced board members. Delaware changed the default rule from gross negligence, and directors demanded more compensation. In this manner, market and contractual adjustments forced Delaware corporations to adopt the next best solution available under *Van Gorkom*. For example, assume that the federal government had preempted state corporation law by adopting a federal law exactly like Delaware's and then the United States Supreme Court had handed down *Van Gorkom*. Corporations would be forced to adapt their governance structure to this changed legal environment. Instead of jurisdictional competition between states, the federal government would be faced with competition from other nations or unincorporations. See Symposium, *Un-*

islature was undoubtedly aware that the potential multi-jurisdictional impact of *Van Gorkom* served to protect Delaware's dominance. The Delaware legislature had no reason to respond.

Initially, *Van Gorkom* was a mutation of Delaware corporate law that did not threaten Delaware's dominance in the market for corporate charters. Once one jurisdiction, Indiana, recognized and acted on the entrepreneurial opportunity created by the Delaware Supreme Court,²⁰ a reluctant Delaware legislature had to adapt to its court's mistake (mutation)—or face extinction.²¹

"Extinction" may sound overly dramatic, but it is conceivable that many corporations would have exited Delaware if the legislature had not responded to Indiana's challenge. Of course, the Delaware legislature did find it necessary to respond. One could also argue that it is inconceivable that the Delaware legislature would fail to act in the face of a declining market share. The Delaware Supreme Court's decision in *Van Gorkom*, however, was similarly inconceivable. One of Delaware's virtues was the expertise and reliable predictability of the judiciary. Yet, in *Van Gorkom*, the judiciary leapt off the well-worn path of reliability and predictability.²² Delaware's reputation was devalued. Jurisdictional competition ultimately forced Delaware to develop a solution to the problems created by *Van Gorkom*. It is important to note that the Delaware legislature might not have passed corrective legislation but for Indiana's challenge.

corporation: A New Age?, 2005 U. ILL. L. REV. 1. Because the adverse effects of *Van Gorkom* could be ameliorated through market adjustments, the Delaware legislature could have believed that no pressing need required intervention to purge the mutation.

20. See Fred S. McChesney, *A Bird in the Hand and Liability in the Bush: Why Van Gorkom Still Rankles, Probably*, 96 NW. U. L. REV. 631, 648-49 (2002) ("Delaware's imposition of an inefficient law (one whose costs exceeded its benefits) created a profit opportunity for politicians in other states to install rules guaranteeing that *Van Gorkom* could not happen in their jurisdictions. That competition would force Delaware to mitigate the effects of the inefficient rule it created.").

21. Delaware did not become concerned about the exit option until Indiana passed its statute. The exculpatory provision was part of a general revision of Indiana corporation law. This included the anti-takeover provision that was upheld by the United States Supreme Court in *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69 (1987). The Indiana statute shielded directors of Indiana corporations from personal liability in duty-of-care cases. Delaware became concerned that Indiana had invented an effective way for other states to take advantage of what had now become Delaware's mistake (or mutation). Delaware was forced to adopt section 102(b)(7), providing Delaware corporations with the option of shielding directors from personal liability. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). Numerous states followed Indiana's lead or Delaware's response. The vast majority of corporations adopted the statutory protections. See Lawrence A. Hamermesh, *Why I Do Not Teach Van Gorkom*, 34 GA. L. REV. 477 app. a (1999); Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160 (1990).

22. See RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 1054 (2d ed. 1995) ("The Delaware Supreme Court's decision in [*Van Gorkom*] was met by astonishment in the corporate bar."); ROBERT W. HAMILTON, *CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES* 698 (6th ed. 1998) ("The response of the corporate bar to *Van Gorkom* was one of shocked incredulity.").

Prior to the reluctant intervention by the Delaware legislature, Delaware corporations could not contract out of *Van Gorkom*.²³ The decision altered the default rules, leaving Delaware corporations with a mandatory rule that was appropriate only for a few firms.²⁴ Jurisdictional competition ensured that this inefficient mutation had a short life. Such competition is beyond the control of the Delaware legislature, judiciary, and interest groups. Indiana started the competitive response to *Van Gorkom* and triggered a nationwide contractarian response—statutes giving corporations the ability to opt-out of *Van Gorkom*'s onerous imposition of liability. Delaware had to adapt to the Delaware Supreme Court's mistake or potentially lose market dominance. The Delaware legislature intervened with the passage of section 102(b)(7)—a contractarian opt-out provision that allowed corporations to shield their directors from personal liability except in the most egregious circumstances.²⁵ Section 102(b)(7) also created the "good faith" standard that was applied by Chancellor William B. Chandler III in the *Disney* decision.²⁶ This contractarian "charter option" approach, which was reluctantly adopted by Delaware, may be the most important and lasting consequence of *Van Gorkom*.

IV. RANDOM MUTATIONS AND THE DISCOVERY OF BETTER CORPORATE GOVERNANCE

Van Gorkom presented real problems for Delaware corporations. It certainly was a resounding wake-up call to passive boards. *Van Gorkom* triggered a search for solutions—a search for better corporate governance. Delaware corporations, forced to experiment, adapted their governance structures on a number of dimensions. For example, *Van Gorkom* triggered procedural adaptations by corporate boards in two long-lasting and vilified ways: (1) reliance on third-party

23. The contractarian approach to corporate law suggests that corporations should be free to alter the default rules. Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 71 (1990); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993). The contractual theory of the corporation views the corporation as a nexus of contracts among shareholders, managers, directors, creditors, and employees. The corporation is founded in mutually beneficial exchange. Market forces provide strong incentives for contracting parties to perform as promised. Corporate law plays the important role of providing standard terms and gap-fillers that define the legal relationships among the parties. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 1-39 (1991); Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON L. REV. 99, 99 (1989).

24. One interpretation of *Van Gorkom* is that it provided default rules that made sense for poorly managed corporations but made no sense for well-managed firms. For a critique of "one-size-fits-all" rules, see Macey, *supra* note 16, at 621. Shareholders have a diversified portfolio of well-governed and poorly governed corporations. Imposing costs on all well-governed corporations to prevent the mismanagement costs of a relatively few poorly managed firms is not beneficial to diversified shareholders.

25. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

26. *In re Walt Disney Co. Derivative Litig.*, No. 15452 (Del. Ch. Aug. 9, 2005), available at [http://courts.delaware.gov/opinions/\(anhs4mjxxwbg345smau20vm\)/download.aspx?ID=64510](http://courts.delaware.gov/opinions/(anhs4mjxxwbg345smau20vm)/download.aspx?ID=64510).

advisors to provide expert opinions; and (2) development of elaborate decision-making procedures to demonstrate that the board adequately considered the decision.

These procedural innovations give the appearance of sound board practices that may provide for improved decision-making. In theory, *Van Gorkom* could be viewed as forcing corporations to adopt improved procedures. In practice, however, the procedural innovations are charades that served to protect directors without improving corporate governance. The innovations have been routinely criticized because they promote form over substance. For example, corporate boards may easily find an expert to give the desired opinion. Board meetings thus evolved into well-choreographed charades. It is doubtful that the expense of such procedures is in shareholders' interests because shareholders are interested in substance, not form. In this regard, the Delaware Supreme Court imposed an inefficient rule with costs that outweigh benefits.

Van Gorkom may have changed the composition of people who are willing to serve on boards.²⁷ Executives and entrepreneurs may find serving on boards excruciating because board meetings have become bureaucratic charades, focused on form over substance. In this regard, *Van Gorkom* may deserve some credit for accelerating the trend toward an increasing percentage of independent directors that emerged in the 1980s and continued into the 1990s. Market forces, however, were probably a more powerful impetus for evolution of board composition. As state legislatures increase the costs of hostile takeovers, governance mechanisms should evolve to provide substitutes for the monitoring previously provided by the market for corporate control.

Van Gorkom also may have triggered other innovations and developments in corporate governance, but for reasons discussed below one should exercise care in giving it too much credit. Through jurisdictional competition, *Van Gorkom* led to section 102(b)(7), which created the "good faith" standard applied by Chancellor Chandler in *Disney*,²⁸ effectively eliminating the most objectionable parts of *Van Gorkom*.²⁹ To the extent that *Van Gorkom* was undesirable, jurisdic-

27. See Macey, *supra* note 16, at 621 ("This 'selection effect' could undermine the entrepreneurial focus of U.S. business.").

28. *In re Disney*, No. 15452.

29. Some parts of *Van Gorkom* have survived. Numerous scholars have discussed the potential positive impact of the procedural innovations that developed in *Van Gorkom*'s wake. Some are more enthusiastic than others. See, e.g., Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule*, 96 *Nw. U. L. REV.* 675 (2002). Lawrence Hamermesh suggests the following as beneficial survival traits of *Van Gorkom* in the law of mergers and acquisitions: (1) rejecting the passivity thesis; (2) creating the "recommendation" duty of disclosure; (3) reinvigorating the law of contract in corporate mergers; and (4) enriching the law of share valuation. Lawrence A. Hamermesh, *A Kin-*

tional competition gradually eliminated the negative parts of *Van Gorkom* from the gene pool of American corporate law.

V. MUSINGS ABOUT RANDOM MUTATIONS AND THE NORMATIVE EVALUATION OF JURISDICTIONAL COMPETITION

Delaware is the leader in the competition between the states for corporate chartering. A significant amount of empirical evidence supports the view that the competition between the states is beneficial for shareholders. This jurisdictional competition is a dynamic process that penalizes mistakes and forces state law to evolve to meet the changing needs of businesses or face extinction.³⁰ Many legal commentators believe that this competition has served us well since 1875 when New Jersey passed the first truly modern general incorporation law.³¹

Jurisdictional competition in corporate law has been controversial. American corporate law has survived numerous efforts to nationalize or standardize the law.³² Those efforts have been massive failures, possibly because serious questions arose about what was the appropriate corporate law to impose on all corporations.³³

Jonathan Macey provided an excellent analysis of *Van Gorkom* in the context of the normative debate about jurisdictional competition.³⁴ After surveying the three dominant views of jurisdictional competition—William Cary’s “Race to the Bottom,”³⁵ Ralph Winter’s “Climb to the Top,”³⁶ and Jonathan Macey and Geoffrey Miller’s “Interest Group Theory”³⁷—Macey uses *Van Gorkom* to test or validate these alternative theories.

The race-to-the-bottom thesis is based on the following syllogism: Management can select the state of incorporation; Delaware benefits from firms incorporating in the state; Delaware needs to provide a law that caters to management; therefore, Delaware law is pro-manage-

der, *Gentler Critique of Van Gorkom and Its Less Celebrated Legacies*, 96 NW. U. L. REV. 595, 596-602 (2002).

30. See generally ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 265-73 (1985).

31. See generally ROMANO, *supra* note 30; Romano, *supra* note 30; Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

32. See, e.g., RALPH NADER, MARK GREEN & JOEL SELIGMAN, *TAMING THE GIANT CORPORATION* (1976); *PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS* (Tentative Draft No. 1, 1982).

33. The Sarbanes-Oxley Act of 2002 preempted several areas of state corporate law. See Romano, *supra* note 4.

34. Macey, *supra* note 16, at 621-26.

35. William Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 666 (1974).

36. Winter, *supra* note 31.

37. Macey & Miller, *supra* note 15, at 519.

ment at the expense of shareholders. Macey argues that the decision in *Van Gorkom* appears to be at odds with the race-to-the-bottom theory because *Van Gorkom* is decidedly antagonistic toward management interests. Indeed, Macey calls *Van Gorkom* “the final nail in the coffin of the race-to-the-bottom theory.”³⁸

In isolation, Macey’s analysis of *Van Gorkom* appears to be correct. When the entire *Van Gorkom* episode with pro-management legislative responses is considered, however, *Van Gorkom* and section 102(b)(7) appear to be a stunning verification of the race-to-the-bottom theory. The Delaware legislature’s response to *Van Gorkom* is consistent with the race-to-the-bottom theory. In the race-to-the-bottom interpretation, the Delaware Supreme Court, in *Van Gorkom*, finally decided to get serious about the issue of fiduciary duties, but the forces of the jurisdictional competition compelled the Delaware legislature to cater to management interests by overturning the most important part of *Van Gorkom*. The race-to-the-bottom argument is as follows: The Delaware legislature was compelled to protect the directors—even when the Delaware Supreme Court tried to do the right thing. Adherents to the race-to-the-bottom theory could view *Van Gorkom* as a beneficial decision that was partially trumped by the legislative side of the market for corporate charters.

The climb-to-the-top theory claims that jurisdictional competition has made corporate law better for shareholders because states compete to add value.³⁹ However, *Van Gorkom* was not good for shareholders in general. It required a one-size-fits-all solution, and corporations adapted by making wasteful expenditures on board processes, such as expert reports. *Van Gorkom*, therefore, does not manifest the increased value of jurisdictional competition as suggested by the climb-to-the-top theory. The legislative responses triggered by *Van Gorkom* demonstrate that jurisdictional competition can repair the law when it is broken, which is a clear illustration of the type of beneficial competition consistent with the climb-to-the-top theory.

In the evolutionary perspective offered in this article, *Van Gorkom* is a random event that should not be used to support or reject any theory of jurisdictional competition or corporate governance. The legislative response to *Van Gorkom*, however, was not random, rather it was what would be predicted by the climb-to-the-top theory.

The interest-group theory suggests that special interest groups in Delaware use their market power to tailor corporate law in a manner that, while maintaining Delaware’s dominance, also generates above-normal returns to lawyers and other service providers that operate in

38. Macey, *supra* note 16, at 629.

39. ROMANO, *supra* note 30.

the state. Macey argues that *Van Gorkom* benefited Delaware lawyers and investment bankers:

[O]ne universally acknowledged ramification of *Smith v. Van Gorkom* is an increase in demand for the services of lawyers and investment bankers who advise Delaware corporations. The decision tells managers that they can insulate their decisions from subsequent attack, but only if they hire investment bankers and Delaware counsel to structure the appropriate procedural framework for the decisional process. From an economic perspective, this result is the functional equivalent of imposing a transaction tax on major corporate decisions in Delaware, with the proceeds from the tax being paid to lawyers and investment bankers. These lawyers and investment bankers find this result beneficial and, thus they have strong incentives to recommend Delaware as a situs of incorporation to their clients.⁴⁰

Those beneficiaries of *Van Gorkom* continued to recommend incorporation in Delaware both before and after the passage of section 102(b)(7). The legislative solution certainly did not destroy *Van Gorkom*-induced procedural charades.⁴¹ This observation is consistent with the Macey and Miller interest-group theory.

The Delaware judiciary is extraordinarily sophisticated. They are unlikely to make serious mistakes or miscalculations. Yet, they are not infallible. Under the interest-group theory, the Delaware Supreme Court's intent to benefit special interests is inferred from the consequences of their decision in *Van Gorkom*. Because *Van Gorkom* benefited Delaware lawyers and investment bankers, the interest-group theory suggests that the Delaware Supreme Court reached its decision with that specific result in mind. In states in which judges are appointed, rather than elected, judicial decisions do not have the same direct linkage between campaign contributions and decisions benefiting specific interest groups, as compared to traditional special interest legislation.

In analyzing an individual case, there is the possibility of reading too much into the decision. For example, using a specific case to validate or reject a more general theory is fraught with logical and statisti-

40. Macey, *supra* note 16.

41. It is interesting to note that although section 102(b)(7) and similar state statutes shield directors from personal liability, in most circumstances, for failing to meet the duty of care, directors nonetheless have changed board procedures. One explanation for this development is that directors believed that failing to meet the duty of care could still lead to injunctive action. See Charles M. Elson & Robert B. Thompson, *Van Gorkom's Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives*, 96 Nw. U. L. REV. 579, 584-85 (2002). If the transaction benefits shareholders, then the directors are acting in the shareholders' best interests by taking steps to secure the protection of the business judgment rule for the transaction. Similarly, even directors who are not strongly motivated to act in the shareholders' best interest, might nonetheless take steps to avoid having their actions determined to be in violation of the duty of care because such a determination would surely harm their reputation, cause problems with their D&O coverage, and reduce the value of their services in the market for directors.

cal frailties. An individual case is appropriately viewed as simply one observation that may or may not be consistent with a hypothesis. Certainly, this is not serious empirical analysis. This caveat is particularly suitable considering that courts can make mistakes. Perhaps the Delaware Supreme Court made a mistake in the sense that it did not foresee the dramatic impact of *Van Gorkom* on either the cost of directors and officers insurance or the market for directors. Or perhaps *Van Gorkom* should be characterized as a random mutation of corporate law.

VI. OF DELAWARE AND DINOSAURS: FEDERAL PREEMPTION AND EXTINCTION

Like the dinosaurs, Delaware's dominance is more likely to be destroyed by the equivalent of a giant asteroid—the federal government—than a glaring misjudgment by Delaware courts or its legislature. Mark Roe has argued the threat of extinction at the hands of the federal government explains the Delaware Supreme Court's decision in *Van Gorkom*.⁴² In his view, Delaware's ability to maintain dominance in the market for corporate charters through pro-business decisions and statutes is constrained by the perceived threat of federal preemption. When *Van Gorkom* was decided, there were rumblings from Washington that states were not doing a good job in corporate governance and that the federal government might need to take over a larger part of corporate governance. At the same time, the American Law Institute's controversial corporate governance project reflected dissatisfaction with the current structure of corporate law.⁴³ According to Roe, the Delaware Supreme Court's surprising decision in *Van Gorkom* was intended to send a message to Washington that preemption was not necessary.⁴⁴ Under Roe's theory, the Delaware Supreme Court knew that *Van Gorkom* was inconsistent with Delaware's prior jurisprudence, yet was necessary to maintain Delaware's dominance.

Paradoxically, the threat of federal preemption also deters some potential competitors from attempting to “out-Delaware” Delaware. A massive re-incorporation migration from Delaware to, say, Nevada, is sure to trigger congressional hearings and SEC investigations.⁴⁵ A probable result of Delaware's extinction by the efforts of another state is federal preemption. Moreover, even if the migration is

42. Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 600-02 (2003).

43. See PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (Tentative Draft No. 1, 1982).

44. See Roe, *supra* note 42, at 641-43.

45. A massive re-incorporation migration might even trigger investigations and lawsuits by New York Attorney General Elliot Spitzer.

triggered by Delaware's mistake, threat of preemption would be very real—the migration would be seized upon by entrepreneurial federal legislators and regulators, declared a federal problem, and halted by federal preemption. If federal preemption is foreseeable by the competing states, then there is less incentive to challenge Delaware.⁴⁶ It is nonsensical for states to build a better mousetrap when an asteroid, in the form of federal preemption, is about to strike.

Assuming the political threat of federal preemption constrains Delaware corporate law's ability to evolve, every major decision is layered with an intriguing subplot. For example, Chancellor Chandler's recent decision in *Disney* becomes even more fascinating. In the face of continuing public and political outrage over Enron and WorldCom, Chancellor Chandler spurned the trend of bashing corporations and corporate executives and protected the Disney board from liability.⁴⁷ The case is on appeal to the Delaware Supreme Court. Perhaps the Delaware Supreme Court will be emboldened by the perception of federal overreaching by the Sarbanes-Oxley Act of 2002.⁴⁸ And, perhaps, Chancellor Chandler's recent statement that corporate boards need to bring executive compensation under control is merely part of a political ruse to keep Congress from attacking Delaware's failure to rein in exorbitant executive compensation.⁴⁹

VII. DID *VAN GORKOM* IMPROVE CORPORATE GOVERNANCE?: A COUNTERFACTUAL LOOK

Van Gorkom, for the most part, has been supplanted by the recent Delaware Chancery Court decision in *Disney*, assuming the decision is upheld on appeal. Chancellor Chandler exonerated the Disney board for decisions related to the hiring and severance of Michael Ovitz. Ovitz walked away with \$140 million for nine months on the job at Disney. The importance of the *Disney* case is the holding, not the specific rule. For purposes of the duty of care and the business

46. In this manner, the threat of federal preemption greatly reduces the benefits of competitive federalism. If Roe is correct, jurisdictional competition is futile and unlikely to be meaningful.

47. *In re Walt Disney Co. Derivative Litig.*, No. 15452 (Del. Ch. Aug. 9, 2005), available at [http://courts.delaware.gov/opinions/\(anhs4mjxxwbgr345smau20vm\)/download.aspx?ID=64510](http://courts.delaware.gov/opinions/(anhs4mjxxwbgr345smau20vm)/download.aspx?ID=64510). Actually, Chancellor Chandler had plenty of harsh words for Michael Eisner and the Disney board. After the tongue lashing, Chancellor Chandler applied the business judgment rule protecting Eisner's actions.

48. Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of titles 11, 15, 18, 28, and 29 U.S.C.).

49. Chancellor Chandler Speaks on Executive Compensation, <http://www.thecorporatecounsel.net/blog/archive/000786.html> (Oct. 27, 2005) ("If neither the courts nor the markets are able to restrain executive compensation, and if you the decision-makers fail . . . the result will be imposition of regulatory controls," said Chandler, whose court handles many important business cases.).

judgment rule, *Van Gorkom* is dead, and the business judgment rule is alive and well.

To some extent, Delaware law has come full circle and has evolved back to a duty-of-care standard similar to the pre-*Van Gorkom* gross negligence standard. Nevertheless, during the intervening twenty years, it is possible that *Van Gorkom*, in spite of being such a terrible decision,⁵⁰ may have had a positive impact on corporate governance. This random mutation could have been a catalyst for evolutionary changes in contracting for fiduciary duties and the improved practices and composition of corporate boards. To evaluate *Van Gorkom*'s influence, however, it is necessary to consider the counterfactual: What would corporate governance look like today if *Van Gorkom* had been decided in favor of the board?

Assuming *Van Gorkom* was a random mutation, it is plausible to also assume that the Delaware Supreme Court would not have made an intervening ruling with the same effect as *Van Gorkom*. The twenty years since *Van Gorkom* have witnessed extraordinary changes in corporate governance. Indeed, the economic and financial changes—including two major stock market collapses—make *Van Gorkom* seem trivial. Perhaps the most important change in the corporate governance landscape was the explosive growth of institutional investors and their emergence as corporate governance activists. The development of new financing techniques that subjected even the largest corporations to the threat of the market for corporate control forced corporate boards to focus on their jobs. In turn, state anti-takeover laws passed during the 1980s crippled the market for corporate control.

Van Gorkom may have influenced board composition and board practices, but it is difficult to segregate the impact of the decision from other changes. For example, board independence has increased since 1985. But a long movement toward increased board independence pre-dated *Van Gorkom*. Indeed, one would expect increased board independence to have occurred as a counter to insulation from the market for corporate control that was created by state anti-takeover laws. Thus, it is difficult to conclude that *Van Gorkom* increased board independence, as *Van Gorkom* emphasized procedure instead of structure.⁵¹

Arguably, the most important change created by *Van Gorkom* is the duty of care opt-out provision of section 102(b)(7) and the demonstration that such a contractarian approach to corporate governance is

50. See McChesney, *supra* note 20, at 631 (“If sheer wrong-headedness of result were disqualifying, *Van Gorkom* would not be worth rereading.”).

51. See Elson & Thompson, *supra* note 41, at 582-87.

workable. One size does not fit all. Opt-out is an ideal solution to the problems created by one-size-fits-all decisions. Indeed, more than one size can survive in a competitive evolutionary environment.