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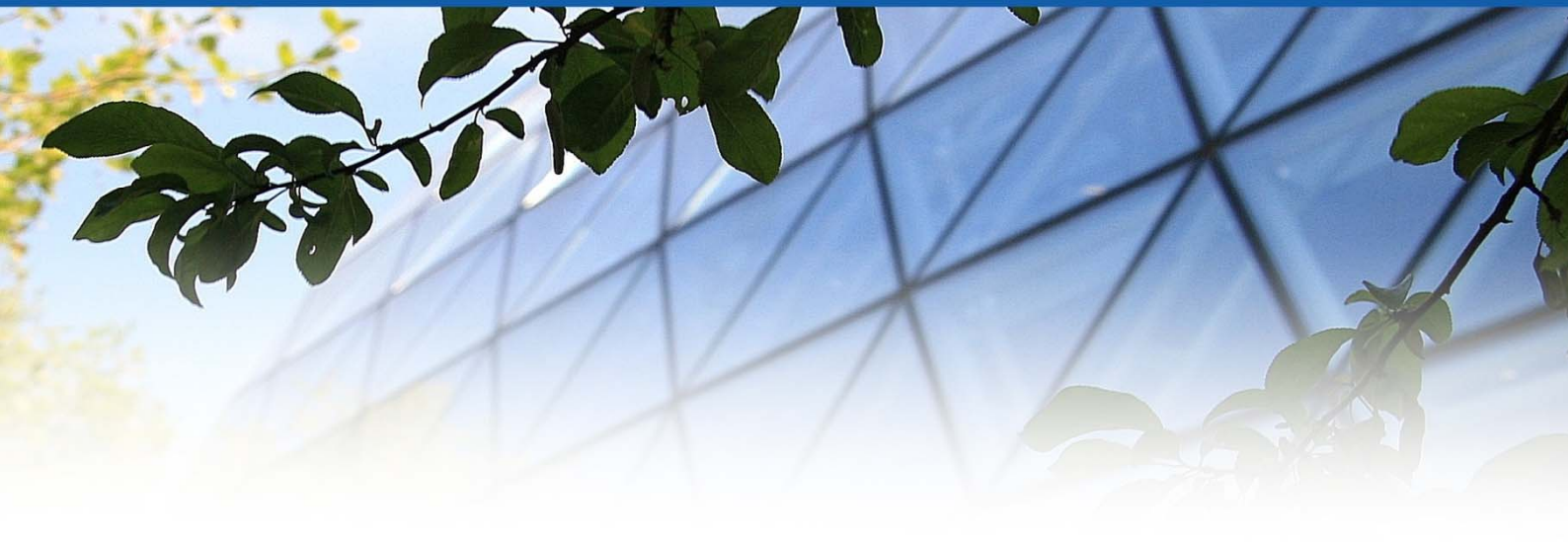
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Law Working Paper N° 261/2014
August 2014

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## Abstract

The most enduring and widespread academic disputes in American corporate law concern jurisdictional competition. Scholars have debated, at great length, questions stemming from the ability of corporations to choose what jurisdiction to incorporate in: To what extent do states compete for incorporations? Has the jurisdictional competition between states produced better or worse corporation law (has it been a “race to the bottom”, or one to the top)? To what extent has the Federal government influenced this state competition? Is meaningful state competition still occurring or was the race won or lost long ago?

Debates over these questions have often foundered because of difficulties associated with ascertaining whether the corporation law in question is good or bad, and whether it has gotten better or worse over time. In this Article, we seek to break the scholarly log jams concerning corporate law federalism by undertaking the first systematic attempt to measure how U.S. corporate law has evolved since 1900. Using three indices developed to measure the relative strength of corporation law across nations, we evaluate three vital bodies of U.S. corporate law, those of Delaware and Illinois and the Model Business Corporation Act, from the beginning of the twentieth century to the present day.

Our results are novel in several respects. We find that the protections afforded to shareholders by state corporation law have decreased since 1900 but only modestly so, which implies that state competition has not been very vigorous. When we use measures that count protections provided by federal as well as state law, however, we get a different result. We find that requirements adopted by the federal government since the 1930s have significantly increased shareholder protection, suggesting that federal intervention has played a crucial and perhaps underappreciated role in shaping U.S. corporate law and enhancing shareholder rights. Beyond its specific findings, this study’s methods provide scholars new ways to answer some of the most fundamental questions in corporate law.

Keywords: corporate law, state jurisdictions, incorporation, shareholder protection

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# THE RACE TO THE BOTTOM RECALCULATED:

# SCORING CORPORATE LAW OVER TIME

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## I. INTRODUCTION

In the United States, companies are incorporated under the laws of one of the fifty states rather than under a federal statute. Since a business can be incorporated in a state other than the one in which it is headquartered,[1] states can compete for incorporation business and have in fact done so, with Delaware being the clear winner.[2] Regulatory competition has been the source of widespread and enduring debate in corporate law,[3] with more than half of all law review articles on corporate law engaging with the topic.[4] Indeed, the question whether the ability to choose the state of incorporation is beneficial or detrimental has been referred to as "the most overwritten theme in the academic literature on corporate law"[5] and as the "longest-standing and most hackneyed debate in corporate law."[6]

Given the extent to which academics have focused on states as competitive actors in the corporate law realm, one might assume that by now someone would have undertaken to measure empirically the manner in which the law evolved. This has not been done, however, in any sort of systematic way. That is what this Article does, with results that cast doubt on some aspects of the received wisdom concerning regulatory competition in the corporate law

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1 JAMES D. COX AND THOMAS LEE HAZEN, THE LAW OF CORPORATIONS, § 3.02 (3rd ed., 2010); see also Part II.A, *infra*.

2 John Armour, Bernard Black and Brian Cheffins, *Delaware's Balancing Act*, 87 IND. L.J. 1345, 1346, 1348 (2012).

3 Lucian A. Bebchuk and Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793, 1794 (2006) [hereinafter Bebchuk & Hamdani, *Federal Corporate Law*]; see also Daniel J.H. Greenwood, *Democracy and Delaware: The Mysterious Race to the Bottom/Top*, 23 YALE L. & POL'Y REV. 381, 381 (2009) ("Corporate law scholarship has focused on the role of the state as competitive actors in producing corporate law"); Robert B. Ahdieh, *Trapped in a Metaphor: The Limited Implications of Federalism for Corporate Governance*, 77 GEO. WASH. L. REV. 255, 257 (2009) [hereinafter Ahdieh, *Trapped*] (referring to "the corporate law literature's singular emphasis on a race among the states").

4 Robert B. Ahdieh, *The (Misunderstood) Genius of American Corporate Law*, 77 GEO. WASH. L. REV. 730, 731-32 (2009) (indicating that in a search of articles published in leading law reviews, almost three-quarters referred to one of a series of topics relevant to regulatory competition).

5 John C. Coffee et al., *The Direction of Corporate Law: The Scholars' Perspective*, 25 DEL. J. CORP. L. 79, 88 (2000).

6 M. Todd Henderson, *Two Visions of Corporate Law*, 77 GEO. WASH. L. REV. 708, 708 (2009).

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realm while affirming others. In so doing, the Article provides scholars with new ways to answer some of the most fundamental questions in corporate law.

For decades, analysis of regulatory competition and corporate law presupposed that states competed actively for corporate charters and resulting revenues, with Delaware firmly in the lead.[7] There was vigorous disagreement whether the "race" between the states was, from a normative perspective, to the "bottom," in the sense that states competed by adopting more manager-friendly laws, or the "top," in the sense that states competed by adopting laws that were considered to enhance company value and therefore would be attractive to investors.[8] It was generally accepted, though, that the race resulted in a net reduction in the rights corporate law provided to shareholders, either because states were cynically watering down their corporate law to appeal to managers (i.e., racing to the bottom) or because states were displacing superfluous or inefficient rules (i.e., racing to the top).[9] There have been dissenting voices, however, emphasizing the contribution of federal law. A significant trend in the recent competitive federalism literature has indeed been to stress that the federal government casts a long shadow over the development of corporate law.[10]

Resolving debates concerning competitive federalism is challenging because underlying the claims concerning corporate law federalism are competing ideological visions

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[7] Lucian A. Bebchuk and Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters*, 112 YALE L.J. 553, 554, 561 (2002) [hereinafter Bebchuk & Hamdani, *Vigorous Race*]; Mark J. Roe, *Is Delaware's Corporate Law Too Big to Fail?*, 74 BROOKLYN L. REV. 75, 76 (2008) [hereinafter Roe, *Is Delaware*].

[8] *Compare* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663, 701 (1974) (arguing that there was a race to the bottom) and Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 275-76 (1977) (responding to Cary with what became known as the race to the top hypothesis); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 21 (1993) (providing support for a race to the top). For further discussion of this debate, *see* Roe, *Is Delaware*, *supra* note xx, at 76-77; J. Robert Brown, *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 324, (2004).

[9] Roe, *Is Delaware*, *supra* note xx, at 76-77.

[10] *See infra* Section II.C.

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regarding the suitable balance between markets and the law.[11] Providing definitive answers is also difficult because, reputedly, "[i]t is quite hard to determine the quality of a corporate law system and how far it has gone in favoring the interest of managers."[12] It is on this latter count that this Article makes a particularly valuable contribution, as it measures the quality of the U.S. corporate law system over time using recently developed tools for the quantitative measure of law ("leximetrics").[13]

To execute a historically-based leximetric analysis of the development of U.S. corporate law we draw upon quantitative techniques developed by academics researching comparative corporate governance. In particular, we rely on three indices constructed to measure aspects of corporate law on a cross-border basis. These are a six element "anti-director rights index" (ADRI), an "anti-self-dealing index" (ASDI) and a 10 variable shareholder protection index constructed by an academic team associated with the Cambridge, U.K.-based Centre for Business Research (CBR SPI).[14]

We use each of these indices to measure corporate law in three different regimes: Delaware, Illinois and the Model Business Corporations Act (MBCA), the model set of laws promulgated by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association. Delaware is an obvious choice, given that for nearly a century more publicly traded companies have been incorporated under its laws than the laws of any

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[11] Henderson, *supra* note xx, 713.

[12] Brett H. McDonnell, *Recent Skirmishes in the Battle Over Corporate Voting and Governance*, 2 J. BUS. TECH. L. 349, 355 (2007).

[13] Priya P. Lele and Mathias Siems, *Shareholder Protection: A Leximetric Approach*, 7 J. CORP. L. STUD. 17, 18 (2007) (hereinafter *Shareholder Protection I*). The term "leximetrics," described as the "systematic quantitative analysis of law," was apparently coined in a 2003 working paper by Robert Cooter and Tom Ginsburg, *Leximetrics: Why the Same Laws are Longer in Some Countries than Others*, U. OF ILLINOIS LAW & ECONOMICS WORKING PAPER LE03-012 (June 2003).

[14] Mathias Siems, *Shareholder Protection Around the World (Leximetric II)*, 33 DEL. J. CORP. L. 111 (2008) [hereinafter Siems, *Shareholder Protection II*].

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other state.[15] It is unwise, however, to restrict analysis of this sort to one state, given that, as William Roy observed in a 1997 book, "[s]tockholders' rights were actively protected in some states and ignored in others."[16] The MBCA is an obvious second choice, given that it has been a highly influential model statute, having been adopted substantially in more than 30 states.[17] Due to the high degree of uniformity between the MBCA and the corporate law statutes of numerous states, it has been referred to as "the backbone of U.S. statutory corporate law."[18]

Illinois we chose in large measure to foster continuity in our analysis. We score Delaware's corporate law back to 1899, the year when the state first enacted a new general incorporation statute intended to attract incorporation business.[19] The first Model Act was only produced in 1950, however,[20] so we needed a proxy for developments before promulgation of the MBCA. We chose Illinois because the Illinois Business Corporations Act of 1933 was the primary precedent for the 1950 Model Act, partly because the principal drafters of the initial Model Act were from Illinois.[21] Moreover, the 1933 Illinois legislation

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15 Brian R. Cheffins, Steven A. Bank, and Harwell Wells, *Questioning "Law and Finance": U.S. Stock Market Development, 1930-70*, 55 BUS. HIST. 598, 605 (2013) [hereinafter Cheffins, Bank & Wells, *Questioning*].

16 WILLIAM G. ROY, SOCIALIZING CAPITAL: THE RISE OF THE LARGE INDUSTRIAL CORPORATION IN AMERICA 156 (1997).

17 MODEL BUS. CORP. ACT, INTRODUCTION, GENERAL DESCRIPTION OF THE MODEL ACT ix (2008) (saying 30 states had adopted all or substantially all of the provisions of the current Act and three others had statutes based on the 1969 version of the MBCA).

18 Mark D. West, *The Puzzling Divergence of Corporate Law: Evidence and Explanations from Japan and the United States*, 150 U. PA. L. REV. 527, 548 (2001); see also Michael P. Dooley and Michael D. Goldman, *Some Comparisons Between the Model Business Corporation Act and the Delaware General Corporation Law*, 56 BUS. LAW. 737, 738 (2001) (referring to "The relatively greater success of the Model Act in terms of adoptions…")

19 Cheffins, Bank and Wells, *Questioning*, *supra* note xx, at 605.

20 COX & HAZEN, *supra* note xx, § 2.3 ("The Model Act first appeared in completed form in 1950"); Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209, 236, n. 73 (2006) [hereinafter Romano, *States as a Laboratory*] ("the 1950 revision of (a 1946) draft statute is now considered the first Model Act").

21 West, *supra* note xx, at 543; Romano, *States as a Laboratory*, *supra* note xx, at 236, n. 53. *Cf.* Jeffrey M. Gorris, Lawrence A. Hamermesh and Leo E. Strine, *Delaware Corporate Law and the Model Business Corporation Act: A Study in Symbiosis*, 74 LAW & CONTEMP. PROBS. 107, 109 (acknowledging the Illinois

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was considered to be innovative and influential in its own right[22] and, seemingly contrary to the 20th century trend of states reducing shareholder rights in corporate law,[23] was ostensibly structured to protect shareholders from alleged abuses.[24] As with Delaware, we score Illinois law back to 1899.

Part II of the Article provides necessary context for our project by summarizing who makes corporate law under the United States' system of corporate law federalism. Part III describes our leximetric methodology. Part IV identifies formally the hypotheses we test and describes our findings. Essentially, our findings, partly anticipated by our prior research, [25] are that whatever erosion of shareholder protection has occurred under state law since 1900 has been modest and has been more than cancelled out by a federally-prompted surge in shareholder rights. As to the former, we find that ADRI scores, which are governed purely by state law, did drop over time, but generally only modestly. Given that competition between states on the corporate law front has reputedly eroded shareholder rights, the direction is what would be anticipated. On the other hand, the modest rate of change indicates there was not much of a "race" between states in the period we covered. Our findings correspondingly confirm conjectures that meaningful competition between states in the corporate law realm "has now long since ended"[26] and amounts not to a race but a "leisurely walk."[27]

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influence but saying the statutes the Model Act drafters used as their departure point had been modelled largely after the Delaware General Corporation Law).

22 West, *supra* note xx, at 542-43; COX & HAZEN, *supra* note xx, at 140.

23 *Supra* note xx and related discussion.

24 Harwell Wells, *The Modernization of Corporation Law, 1920-1940*, 11 U. PA. J. BUS. L. 573, 594 (2009) [hereinafter Wells, *Modernization*].

25 Cheffins, Bank and Wells, *Questioning*, *supra* note xx, at 605.

26 Marcel Kahan and Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 724 (2002).

27 Bebchuk and Hamdani, *Vigorous Race*, *supra* note xx.

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As to the latter finding, we show that federal intervention was significant and more than offset any erosion of shareholder protection at the state level. Whereas the ADRI scores of Delaware, Illinois and the MBCA dropped, albeit modestly, from 1899 onwards, the aggregate ASDI and CBR SPI scores for these jurisdictions generally *increased,* dramatically in the case of the CBR SPI, which is contrary to what one would expect if vigorous state competition was eroding shareholder rights. The divergence from expectations and from the ADRI trend can be explained in large measure by federal intervention. While the ADRI is governed exclusively by state law, federal law affects some aspects of the ASDI and impacts upon numerous CBR SPI variables. Since the 1930s, federal reforms, introduced either directly by the federal government or by other bodies following federal dictates, have bolstered shareholder rights, as measured by these two indices. The time trend for the CBR SPI and to a lesser extent the ASDI correspondingly indicates that federal intervention has not been a mere side-show from a corporate law perspective and has, on a net basis, bolstered quite significantly protection afforded to shareholders.

Part V of the Article assesses the implications of our findings and Part VI concludes. One point we make in Part V is that while the indices we focus on have been developed over the past two decades they provide a suitable departure point for analysing corporate law trends extending back more than a century. We do this in part by drawing upon a 14-point list of shareholder rights developed in 1929 to ascertain the extent to which these rights have eroded over time. We also identify key changes to state law occurring during the 20$^{th}$ century to ascertain whether reform displaced the protection of shareholders in fundamental ways not captured by our indices or by the 1929 14-point list. Our analysis suggests, corroborating what our indices reveal about trends concerning state law, that while there was erosion of some forms of shareholder protection arising under state law, there was no decisive curtailing of shareholder rights. It seems that if the rights corporate law provided to shareholders were

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ever compromised markedly, this occurred primarily as the 19th century drew to a close, rather than continuing during the 20th century.

Part V also links our findings to the "race to the bottom/race to the top" debate. Given that, at least with the ASDI and CBR SPI, aggregate scores increased over time, it would seem to follow that U.S. corporate law experienced a race to the top. Any such inference has to be drawn, however, with considerable care. Those who have argued that Delaware has led a race to the top do not necessarily assume that that race produced stronger shareholder protections. The point they emphasize instead is that regulating corporations by way of state law is beneficial because states are subject to market discipline – the loss of incorporation business to other states – not present at federal level. This state competition is more likely to produce a corporate law optimal for shareholders, not necessarily one that provides them maximum protection under the law. Those advocating this point of view typically assume that the costs associated with shareholder protection introduced through the federal side door exceed the benefits, meaning that shareholders are in fact likely to be net losers even if the effect of federal law has been to provide them additional protections.

## II. WHO MAKES CORPORATE LAW?

Leximetric analysis involves using a pre-defined protocol to assign numerical values to a particular legal regime based on the presence or absence of prescribed legal rules comprising an index. To determine what numerical values to assign to a component of an index it is necessary to identify who makes the laws that count for the purpose of coding. In the U.S., corporate law's federal dimension complicates to some degree the identification of the relevant players.

### A. The State/Federal Dimension

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At first glance, describing who makes corporate law in the United States should begin and end with state lawmakers because the states enact the corporate statutes pursuant to which companies are governed.[28] While proposals to provide for federal incorporation pre-date adoption of the U.S. Constitution,[29] Congress has consistently resisted calls to provide for federal incorporation, leaving the matter instead to the states.[30] Each state has in turn promulgated a general corporate statute which establishes the procedure for incorporating businesses and provides the ground rules governing the internal affairs of already incorporated companies.[31] When a corporation is incorporated under the laws of a particular state, that state's corporate law will be applicable notwithstanding where the principal place of business might be. The laws of the state of incorporation will be determinative due to a choice of law rule known as "the internal affairs doctrine" which does much to sustain Delaware's status as the leading supplier of corporate charters.[32]

The internal affairs doctrine, in addition to operating as a choice of law rule affecting states, has formed the basis of an understanding among federal and state lawmakers that has done much to shape U.S. corporate law. The key precept is that the internal affairs of corporations fall within the purview of state law and are not a proper subject for federal regulation.[33] Some judicial rulings imply that due to the nature of the federal system in the

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[28] Jill E. Fisch, *Leave it to Delaware: Why Congress Should Stay Out of Corporate Governance*, 37 DEL. J. CORP. L. 731, 732 (2013); Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, 26 REGULATION 26, 26 (2003) ("For over 200 years, corporate governance has been a matter for state law.")

[29] William W. Bratton and Joseph A. McCahery, *The Equilibrium Content of Federalism*, 41 WAKE FOREST L. REV. 619, 653 (2006) [hereinafter Bratton & McCahery, *Equilibrium*].

[30] Robert B. Thompson, *Delaware, the Feds, and the Stock Exchange: Challenges to the First State as First in Corporate Law*, 29 DEL. J. CORP. L. 779, 784 (2004) [hereinafter Thompson, *Delaware*]; Robert B. Thompson, *Delaware's Disclosure: Moving the Line of Federal-State Corporate Regulation*, [2009] U. ILL. L. REV. 167, 177.

[31] Wells, *Modernization*, *supra* note xx, at 573.

[32] Fredrick Tung, *Before Competition: Origins of the Internal Affairs Doctrine*, 32 J. CORP. L. 33, 39, 42-43 (2006).

[33] Renee M. Jones, *Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate*, 41 WAKE FOREST L. REV. 879, 882 (2006).

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U.S. the internal affairs doctrine is constitutionally mandated.[34] This in fact is not the case. The better view is that federal corporate law-making authority is very broad, with Congress being capable of federalizing corporate law largely without limit.[35]

With the federal government having refrained from enacting a federal corporation law despite having the necessary constitutional authority, there was no meaningful federal corporate law presence until the enactment of the Securities Act of 1933[36] and the Securities Exchange Act of 1934,[37] which established the federal Securities and Exchange Commission (SEC). Though these were important pieces of legislation in various respects, they ultimately constituted a tentative foray by Congress into the corporate law realm. The SEC would subsequently argue that key aspects of the 1934 Act authorized the SEC to create rules that directly affected the governance of corporations, such as regulation of shareholder voting conducted by proxy.[38] This, however, was not the consensus view when federal securities law reform was undertaken. The post-1934 regulatory pattern was generally assumed to be one where federal law targeted trading markets by way of disclosure and anti-fraud rules ("securities law"), thereby leaving "corporate law" relating to the internal affairs of companies to the states.[39] The legislative history relating to the enactment of the 1933 and

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34 Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 596 (2003) [hereinafter Roe, *Delaware's Competition*]; Greenwood, *supra* note xx, at 413; COX & HAZEN, *supra* note xx, at 172.

35 Roe, *Delaware's Competition*, *supra* note xx, at 597; Marcel Kahan and Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1585-86 (2005) [hereinafter Kahan and Rock, *Symbiotic Federalism*]. 1585-86; Fisch, *supra* note xx, at 737-38.

36 48 Stat. 74.

37 48 Stat. 881.

38 Arthur Fleisher, *'Federal Corporation Law': An Assessment*, 78 HARV. L. REV. 1146, 1151, 1158-59 (1965); Patrick Moyer, *The Regulation of Corporate Law by Securities Regulators: A Comparison of Ontario and the United States*, 55 U. TOR. FAC. L. 43, 49 (1997).

39 Bratton and McCahery, *Equilibrium*, *supra* note xx, at 624-25. A variety of tax provisions were enacted during this period that appeared to be motivated at least in part by the desire to affect corporate governance, but these were usually defended on tax policy grounds as well. *See* Steven A. Bank, *Tax, Corporate Governance, and Norms*, 61 WASH. & LEE L. REV. 1159, 1163-64 (2004).

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1934 Acts indeed indicates that Congress did not intend to authorize the SEC to interfere in the management of companies.[40]

Between the 1968 enactment of the Williams Act, which amended section 14 of the Securities and Exchange Act of 1934 to impose a range of obligations on parties making a tender offer,[41] and the close of the 20th century, there were various federal incursions in the corporate law realm. Examples of topics addressed included fostering disclosure in relation to transactions pursuant to which publicly traded companies were taken private, discouraging the listing of dual-class shares, the deregulation of proxy rules so as to facilitate institutional shareholder voice, and limits on the deductibility of executive compensation.[42] These incursions would soon be overshadowed, however, by the most ambitious federal corporate law-related initiative to date.

The game-changer was the Sarbanes-Oxley Act of 2002 (SOX),[43] which Congress enacted in response to high-profile corporate scandals involving companies such as WorldCom and Enron. As Mark Roe observed in a 2003 article where he emphasized the federal government's impact on competitive federalism,

> "With Sarbanes-Oxley in 2002, Congress did not even pretend to stay on the disclosure-and-trading side of rhetorically traditional federal-state division of power, not even offering perfunctory respect for state rules governing the corporation's internal affairs."[44]

Key changes SOX made included creating the possibility of executive pay "clawbacks" where there had been problematic restatements of earnings, prohibiting corporate loans to

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40 Moyer, *supra* note xx, at 49-50.

41 Pub. L. No. 90-439, 82 Stat. 454.

42 Roe, *Delaware's Competition*, *supra* note xx, at 616-22; Bank, *supra* note xx, at 1161.

43 Pub.L. 107-204, 116 Stat. 745.

44 Roe, *Delaware's Competition*, *supra* note xx, at 633.

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senior executives, requiring CEO certification of financial reports filed with the SEC, granting the SEC formal authority to regulate the structure and duties of board committees dealing with the audit function and giving the SEC explicit powers to formulate accounting standards.[45]

The nature and depth of the corporate law content in SOX was something of a shock to those who had assumed that the states were pre-eminent. William Bratton and Joseph McCahery said the "off-handed but emphatic revision of the internal affairs line drawn after 1934…upset settled expectations."[46] Joel Seligman observed similarly that SOX was the centerpiece of "a modest revolution in corporate governance" affecting "the rudimentary state law of corporate governance."[47]

The Dodd-Frank Act of 2010 constituted another substantial federal incursion into the corporate law realm.[48] While this post-financial crisis legislation focused primarily on the regulation of banks, it contained a sub-title entitled "Strengthening Corporate Governance" applicable to all issuers falling under the SEC's jurisdiction, not just financial companies.[49] This sub-title amended federal securities law to instruct the SEC to introduce rules requiring companies that had failed to split the chief executive officer and chairman of the board roles to explain why and to authorize the SEC to develop a "proxy access" rule permitting shareholders with significant stakes to nominate under prescribed circumstances directors on a company's own proxy card. Another sub-title of the Act dealt with executive

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45 Brown, *supra* note xx, at 358-71; Robert B. Ahdieh, *From "Federalization" to "Mixed Governance" in Corporate Law: A Defense of Sarbanes Oxley*, 53 BUFFALO L. REV. 721, 724-25 (2005); BRIAN R. CHEFFINS, THE HISTORY OF MODERN U.S. CORPORATE GOVERNANCE, vol. I, xxvi (2011).

46 Bratton and McCahery, *Equilibrium*, *supra* note xx, at 668.

47 Joel Seligman, *A Modest Revolution in Corporate Governance*, 80 NOTRE DAME L. Rev. 1159, 1159 (2005).

48 Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (hereinafter Dodd-Frank Act), Pub. L. 111-203.

49 Title IX, Sub-title G., encompassing §§ 971-72.

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compensation,[50] amending Federal securities laws to mandate an advisory "say on pay" vote and additional compensation disclosures for all publicly traded companies subject to SEC jurisdiction.[51]

B. The Relevant Players

While the fact that corporate law can be promulgated both at the state and federal level goes some distance towards explaining who makes corporate law in the United States, having a complete picture requires identifying the relevant players at both levels. The candidates at each level are: i) lawmakers enacting statutory measures that address corporate law issues, ii) courts developing the law through adjudication of cases, and iii) administrative agencies vested with subsidiary law-making powers pursuant to a general statutory mandate.[52] In the corporate law area, the states have historically refrained from vesting administrative agencies with rule-making powers, meaning the making of corporate law has fallen by default to the state legislature and the courts. By enacting statutory rules in the form of broad standards, state legislatures can provide courts with wide latitude to develop the law through the common law process.[53] This is what Delaware does. As one of us observed in a 2012 article,

> "Delaware's corporate law delegates regulatory power liberally to its judges, often favoring flexible, judicially adopted standards. Consequently, much of what matters in Delaware corporate law is a judicial construct, including the fiduciary duties of

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50 Title IX, Sub-title E., encompassing §§ 951-57.

51 Dodd-Frank Act, § 951 (shareholder voting on executive compensation); § 953 (disclosure). Of the provisions in Title IX, Sub-title E all govern all publicly traded companies subject to SEC jurisdiction save for § 956, which requires disclosure of executive pay arrangements to regulators, was an exception as it only applies to "covered financial institutions."

52 Kahan and Rock, *Symbiotic Federalism*, *supra* note xx, at 1580.

53 *Id*. at 1580.

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directors, officers, and controlling shareholders, and the prerequisites for bringing a derivative suit."[54]

The roster of players is longer at the federal level.[55] Congress is first. Although there is no federal incorporation legislation, Congress has periodically since the early 1930s enacted statutory measures as part of federal securities law that operate as *de facto* corporate law.[56] The SEC is second. As the administrative agency charged with administering federal securities law, it promulgates regulations and issues rulings pursuant to the statutory mandate under which it operates. Federal courts are third, as they interpret federal securities law and SEC regulations and rulings.[57]

Beyond the official governmental realm, private actors also participate in the rulemaking process at the federal level. For example, the New York Stock Exchange (NYSE) is a private body, not an agency of the federal government. Nevertheless, the Securities Exchange Act of 1934 requires the NYSE, operating as a national securities exchange and self-regulatory organization under the Act, to submit listing rules governing companies traded on the Exchange to the SEC for approval.[58] Also, the SEC can amend the NYSE's listing rules to further the purposes of the 1934 Act.[59] The SEC correspondingly has substantial power to ask – even direct – the NYSE to make rules that impinge on corporate law.[60] Indeed, Robert Thompson has said of NYSE listing rule amendments promulgated from the late 1970s onwards dealing with governance-related topics such as shareholder voting rights, board composition and shareholder approval of executive pay, "Without the

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54 Armour, Black and Cheffins, *supra* note xx, at 1349.

55 Roe, *Delaware's Competition*, *supra* note xx, 598-99; Mark J. Roe, *Delaware and Washington as Corporate Lawmakers*, 34 DEL. J. CORP. L. 1, 11 (2009) [hereinafter Roe, *Delaware and Washington*]..

56 *Supra* note xx and related discussion.

57 Roe, *Delaware and Washington*, *supra* note xx, at 11.

58 Securities and Exchange Act of 1934, § 19(b); 15 U.S.C. § 78(b).

59 Securities and Exchange Act of 1934, § 19(c); 15 U.S.C. § 78(c).

60 Roe, *Delaware and Washington*, *supra* note xx, at 11.

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SEC's leadership, the exchanges would not likely have entered into the arena of corporate governance."[61]

C. Sources of Controversy

The conventional wisdom concerning competitive federalism and shareholder protection has been that competition between the states has served to reduce shareholder rights. For instance, William Roy observed in his 1997 book on the rise of the industrial corporation, that "From the post-Civil War period onward stockholders and directors have gone to battle over many issues, and the directors have usually won."[62] Or as Julian Velasco said in a 2006 article on shareholder rights, "The history of corporate law has been one of increasing flexibility for directors and decreasing rights for shareholders." [63]

While the general consensus has been that the Delaware-led competition between the states in the corporate law realm prompted a substantial erosion of shareholder protection, there have been dissenting voices. Walter Werner argued in a 1977 article that over the previous four decades "[s]hareholders' legal rights within the corporation have been made meaningful."[64] Edward Herman suggested similarly in 1984 that "corporate standards of behavior and attention to the welfare of the shareholders are substantially greater than they were in 1925."[65]

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61 Thompson, *Delaware, supra* note xx, at 797.

62 ROY, *supra* note xx, at 158.

63 Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS. L. REV. 407, 409 (2006). *See also* Ahdieh, *Trapped*, *supra* note xx, at 263 (indicating that a leading critic of the "race to the bottom" view did not dispute the "observation of declining levels of shareholder protection"); Mary O'Sullivan, *The Expansion of the U.S. Stock Market, 1885-1930: Historical Facts and Theoretical Fashions*, 8 ENTERPRISE & SOC'Y 489, 529 (2007) ("…the statutory rights accorded to shareholders substantially diminished during the period 1885-1930").

64 Walter Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388, 398 (1977).

65 Edward S. Herman, *The Limits of the Market as a Discipline in Corporate Governance*, 9 DEL. J. CORP. L. 530, 538 (1984).

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Werner and Herman both drew attention to federal securities legislation, first introduced in the early 1930s,[66] to buttress their claims that shareholder protection had improved over the 20th century. Recognition of the federal dimension has more recently shifted fundamentally the terms of debate on the merits of regulatory competition in the corporate law realm. In particular, Mark Roe reframed the discourse when he argued in the mid-2000s that actions of the federal government on the corporate governance front had done more to shape Delaware corporate law than had potential competition from other states.[67]

Roe's contribution to the literature, while insightful and influential, raises at least two significant, and as yet unanswered, questions. First, has Washington's contribution to the shape of U.S. corporate law in fact been pivotal or only a side-show? Second, assuming that competition between states has over time diminished the rights corporate statutes provide to shareholders, has federal intervention bolstered shareholder protection sufficiently to cancel out moves in the other direction at state level?

With respect to the first question, Roe argues "There is a large federal presence in corporate law,"[68] but this claim has been contested. Roberta Romano challenged shortly after the enactment of SOX what she referred to as "the federal supremacy hypothesis", saying that the dynamics of corporate law in the United States can still be explained best by the working of competition between states.[69] Law professors Marcel Kahan and Ed Rock struck a middle ground in a 2005 article, suggesting the federal "threat" to Delaware is only potent at

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66 *Supra* notes xx to xx and related discussion.

67 Roe, *Delaware's Competition*, supra note xx, 588 (2003); Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491 (2005). On Roe's contribution to the discourse, see Note, *The Case for Federal Threats in Corporate Governance*, 118 HARV. L. REV. 2726, 2726 (2005) ("reframed (the) debate"); Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1767 (2006) ("pathbreaking observation").

68 Roe, *Delaware and Washington*, *supra* note xx, at, 33 (2009).

69 Roberta Romano, *Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?*, 21 OXFORD. REV. ECON. POL'Y 212, 213, 223 (2005) [hereinafter Romano, *Regulatory Competition*].

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moments when, due to the political climate, federal lawmakers can reap populist political dividends by supporting corporate governance reform.[70]

With the second question, again there is disagreement. According to some observers, the interaction of state law competition and federal intervention provides shareholders with ample and appropriate protection. Brett McDonnell has suggested the U.S.'s mixed system of corporate law produces under many circumstances results better than a pure state or pure national system would yield.[71] Leo Strine, Chief Justice of the Delaware Supreme Court, maintains that investors benefit from a combination of Delaware courts enforcing fiduciary duties expertly and the federal government vigorously policing laws mandating disclosure to investors.[72]

Others are less sanguine. Lucian Bebchuk and Assaf Hamdani argue that, even when federal intervention is taken into account, "regulatory competition tends to produce insufficient investor protection."[73] J. Robert Brown maintains similarly that "neither the states nor the federal government adequately regulates the behavior of officers and directors."[74] Likewise, Steven Ramirez has asserted that "Corporate governance in the United States suffers from a flawed legal structure that yields deeply suboptimal results."[75]

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70 Kahan and Rock, *Symbiotic Federalism supra* note xx, at 1576.

71 McDonnell, *supra* note xx, at 353. *See also* Kahan and Rock, *Symbiotic Federalism*, *supra* note xx, at 1622 ("[Federal] regulations help ward-off crises and thus provide a lightning rod for a populist backlash that could produce severe harm to Delaware's position as the creator of our de facto national corporate law").

72 Leo E. Strine, *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 686 (2005).

73 Bebchuk and Hamdani, *Federal Corporate Law*, *supra* note xx, at 1796.

74 Brown, *supra* note xx, at 320-21.

75 Steven A. Ramirez, *The End of Corporate Governance Law: Optimizing Regulatory Structures for a Race to the Top*, 24 YALE J. REG. 313, 358 (2007).

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Or as Martin Gelter has suggested, U.S. corporate and securities law is "highly unusual in the extent to which it disenfranchises shareholders from both explicit and implicit influence."[76]

Empirical analysis of the development of U.S. corporate law over time could help to resolve the foregoing controversies. As Todd Henderson has suggested, empirical research could bring "the debate down to the level of the real-world merits and applicability of…conflicting visions of corporate law."[77] Nevertheless, until now there have only been a tiny handful of studies which have attempted to measure quantitatively changes in U.S. corporate law across time and those studies have typically sought to measure the pace of change rather than to quantify the level of protection afforded to shareholders.[78] Correspondingly we now undertake a pioneering historically-oriented leximetric analysis of U.S. corporate law to provide insights concerning the evolution of shareholder rights over time.

## III. METHODOLOGY

### A. Selecting the Indices

Now that we know the relevant players and controversies to consider when "scoring" U.S. corporate law, we turn to the indices we have selected to measure the protection U.S. corporate law has afforded to shareholders over time. Coinciding in the mid-1990s with the emergence of corporate governance as a topic of international interest,[79] academics of that era began to develop indices to quantify the protection the corporate laws of various countries

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[76] Martin Gelter, *The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance*, 50 HARV. INT'L L.J. 129, 134 (2009).

[77] Henderson, *supra* note xx, at 713.

[78] See Brian R. Cheffins, Steven A. Bank, and Harwell Wells, *Law and History by Numbers: Use, But With Care*, U. ILL. L. REV. 4-5 (forthcoming) [hereinafter Cheffins, Bank, and Wells, *Law by Numbers*], available at http://ssrn.com/abstract=2348654, discussing William J. Carney, *The Production of Corporate Law*, 71 SO. CAL. L. REV. 715 (1998); Romano, *States as a Laboratory*, supra note xx.

[79] On the relevant chronology, see Brian R. Cheffins, *The History of Corporate Governance* in THE OXFORD HANDBOOK OF CORPORATE GOVERNANCE 56-68 (Mike Wright, Donald Siegel, Kevin Keasey and Igor Filatotchev, eds., 2013).

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offered investors. These efforts have continued to the present day. Here we deploy three different indices originally developed for cross-country comparison to examine the development of U.S. corporate law over time.

The first of these is the six element anti-director rights index (ADRI). It was constructed in the mid-1990s by financial economists Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer, and Robert Vishny, generally referred to as "LLSV."[80] The second is the "anti-self-dealing index" (ASDI), which La Porta, López-de-Silanes, and Shleifer developed in the mid-2000s with Simeon Djankov (DLLS). It focuses on regulation of transactions between a company and those who control it.[81] The third is a 10 variable shareholder protection index Mathias Siems constructed in the late 2000s in tandem with an academic team associated with the Cambridge, U.K.-based Centre for Business Research (CBR SPI).[82]

In isolation, the ADRI, ASDI and CBR SPI each have drawbacks as a mechanism for measuring the historical development of U.S. corporate law. However, in combination they should provide a reasonably representative picture of the level of protection afforded to shareholders over time, at least by reference to present-day norms. This may well be the best that can be achieved given the tools at hand. A more exhaustive empirical analysis of corporate law developments impacting upon shareholder rights is unlikely to be feasible since evaluating fully "the substance of state corporation law [is] a daunting task."[83]

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80 The ADRI was initially fully deployed in a published paper in Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer and Robert Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998) but a working paper version was distributed in 1996 as part of the NBER Working Paper Series: http://www.nber.org/papers/w5661.pdf.

81 Simeon Djankov, Rafael La Porta, Florencio López-de-Silanes and Andrei Shleifer, *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430, 442, 454 (2008) [hereinafter Djankov et al., *Law and Economics*]; a working paper version was distributed in 2005 as part of the NBER Working Paper Series: http://www.nber.org/papers/w11883.

82 *See generally* Siems, *Shareholder Protection*, supra note xx.

83 Wells M. Engledow, *Handicapping the Corporate Law Race*, 28 J. CORP. L. 143, 153 (2002).

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Why did we choose each index? With the ADRI, its wide acceptance strongly influenced us. There is a rapidly burgeoning law and finance literature oriented around quantitative comparative analysis which aims to trace the relationship between nations' laws and legal institutions, on the one hand, and corporate governance outcomes, on the other.[84] In the law and finance realm, the ADRI has achieved the greatest prominence with respect to the measurement of corporate law.[85] As of 2010, over a hundred academic papers had used the ADRI to test theories concerning the interaction between law and markets.[86] Correspondingly, with our quantitative analysis of the historical development of U.S. corporate law the ADRI was an obvious metric to deploy.

Focusing solely on the ADRI could, however, yield a seriously incomplete picture. One difficulty is that the ADRI fails to take into account various key corporate law topics, including powers shareholders have to remove directors, the scope shareholders have to exercise managerial powers and the legality of takeover defences.[87] It is hardly surprising that the ADRI is not comprehensive, given that it is comprised of only six components. The problem is compounded, however, because of the manner in which the components were selected. La Porta, López-de-Silanes, and Shleifer, writing in tandem with Simeon Djankov, conceded in the paper where they deployed the ASDI that the ADRI was "based on an ad hoc collection of variables."[88] Correspondingly, the ADRI is in isolation unlikely to constitute a

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84 For an overview of the literature and its popularity, see John Armour, Simon Deakin, Priya Lele and Mathias Siems, *How Do Legal Rules Evolve? Evidence from a Cross-Country Comparison of Shareholder, Creditor and Worker Protection*, 58 AM. J. COMP. L. 579, 582-85 (2009).

85 Lucian Bebchuk and Assaf Hamdani, *The Elusive Quest for Global Corporate Governance Standards*, 157 U. PA. L. REV. 1263, 1276 (2009) (saying of the ADRI "[a]mong academic researchers the most influential metric for evaluating governance arrangements worldwide.")

86 Holger Spamann, *The "Antidirector Rights Index" Revisited*, 23 REV. FIN. STUD. 467, 468 (2010) [hereinafter Spamman, *Antidirector*].

87 Lele and Siems, *Shareholder Protection I*, *supra* note xx, 20-21; Detlev Vagts, *Comparative Company Law – The New Wave* in FESTSCHRIFT FÜR JEAN NICOLAS DRUEY 595, 601 (Rainer J. Schweizer, Herbert Burkert and Urs Gasser, eds., 2002).

88 Djankov *et al.*, *Law and Economics*, *supra* note xx, at 432.

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suitable proxy for the level of protection corporate law has provided for shareholders over time.

With the ASDI, there are various reasons why it should be part of a project to code historically the development of U.S. corporate law.[89] First, DLLS explicitly proffered the ASDI as a superior alternative to the ADRI, saying that the ASDI dealt "with corporate self-dealing in a more theoretically grounded way."[90] Second, in empirical tests DLLS ran on the relationship between stock market development and corporate law the ASDI delivered more robust results than the ADRI.[91] Third, the ASDI has proven popular in its own right among those carrying out empirical law and finance research and could indeed be supplanting the ADRI as the primary numerical measure of the quality of corporate law.[92]

While the ASDI might be displacing the ADRI as an empirical measure of corporate law for cross-border analysis, its narrow focus means that it too in isolation is not a sufficient mechanism for ascertaining historical trends. The ASDI focuses on a single legal topic, the regulation of related party transactions involving a company and its dominant shareholder, who is also a director. The scenario is a classic example of a conflict of interest scenario affecting corporations.[93] Nevertheless, it is unrealistic to be confident that regulation of this particular topic will be broadly representative of the level of protection corporation law affords to shareholders.

While the narrow scope of the ASDI partly compromises its utility, breadth of coverage provides a compelling rationale for treating the CBR SPI as part of our inquiry.

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89 For a more detailed analysis, see Cheffins, Bank and Wells, *Law by Numbers*, *supra* note xx, at 17-19.

90 Djankov *et al.*, *Law and Economics*, *supra* note xx, at 432.

91 *Id*. at 456.

92 Cheffins, Bank, and Wells, *Law by Numbers*, *supra* note xx, at 18-19.

93 Mary A. Jacobson, *Interested Director Transactions and the (Equivocal) Effects of Shareholder Ratification*, 21 DEL. J. CORP. L. 981, 986-87 (1996); Eric G. Orlinsky, *Corporate Opportunity Doctrine and Interested Director Transactions: A Framework for Analysis in an Attempt to Restore Predictability*, 24 DEL. J. CORP. L. 451, 453 (1999).

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The CBR SPI we deploy encompasses 10 variables, selected by the index's creators partly on the basis that the variables were representative of the full range of shareholder protection used in the countries coded.[94] The variables were also selected to encompass rules thought to form the core of international corporate governance "best practice" during the period covered by the study (1995 to 2005).[95] Correspondingly, the CBR SPI is potentially a more reliable proxy for the level of shareholder protection a particular jurisdiction provides than either the ADRI or the ASDI.

While the range of issues the CBR SPI addresses is wider than the ADRI or ASDI it would be imprudent for us to use the CBR SPI as the exclusive measure of corporate law for our historically-related leximetric exercise. One consideration is that, whatever the CBR SPI's merits might be as a corporate law index, it is not as well-known and has not been as influential as the ADRI and ASDI.[96] Also, those constructing the CBR SPI intentionally biased the selection of variables in favor of ones they expected would exhibit a relatively high degree of change during the period they focused on (again 1995 to 2005).[97] No explicit equivalent present-day bias affects the ADRI and ASDI, meaning that for a historically oriented study such as ours they provide a useful cross-check against this feature of the CBR SPI.

Minimal overlap between the ADRI, the ASDI and the CBR SPI reinforce the utility of each as a cross-check against the others. Neither the ADRI nor the CBR SPI covers the

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94 John Armour, Simon Deakin, Prabirjit Sarkar, Mathias Siems and Ajit Singh, *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis*, 6 J. EMPIRICAL LEGAL STUD. 343, 355 (2009) [hereinafter Armour *et al.*, *Shareholder*]. The initial CBR SPI was a highly detailed 60 variable index coded for five countries: Lele and Siems, *Shareholder Protection I*, *supra* note xx, at 45-49.

95 Armour *et al.*, *Shareholder*, *supra* note xx, at 355, 374.

96 The number of citations on Google as of July 30, 2014 for each of the papers where the indices were initially deployed provides an admittedly crude measure of this point: La Porta, López-de-Silanes, Shleifer and Vishny, *supra* note xx (13,225 citations); Djankov *et al.*, *Law and Economics*, *supra* note xx (1543 citations); Siems, *Shareholder Protection*, *supra* note xx (53 citations).

97 Armour *et al.*, *Shareholder*, *supra* note xx, 355.

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same ground as the ASDI as neither explicitly addresses rules governing transactions between a corporation and one of its directors or dominant shareholders. Both the ADRI and the CBR SPI, however, take into account the extent to which corporate law facilitates shareholder voting by way of proxies and protects against minority shareholder oppression, defined largely in terms of the procedure governing derivative suits.[98] However, a majority of the six topics the ADRI addresses are not components of the CBR SPI.[99] Similarly, the bulk of CBR SPI elements lack an ADRI counterpart.[100] The upshot is that taken together the ADRI, ASDI and the CBR SPI canvass a wide range of mechanisms that afford protection to shareholders and correspondingly should offer collectively a sufficiently representative picture of shareholder protection to execute a fruitful analysis of the historical development of corporate law in the United States.

B. Coding Protocol – In General

For each of the three indices we deploy the same coding protocol to score U.S. corporate law going back through time. Our departure point with all three indices was the present-day score for each of the three corporate law regimes we are focusing on, namely Delaware, the MBCA and Illinois. Having ascertained their present-day scores, we worked backwards to identify changes to the law that would have caused the score for any of the relevant variables to move up or down.

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98 The variables comprising both indices are identified individually in Part III.C, *infra*. The regulation of multiple voting rights attached to shares, which is an element of the CBR SPI, was taken account of empirically by LLSV. They did not treat this form of regulation, however, as part of the ADRI: La Porta, López-de-Silanes, Shleifer and Vishny, *supra* note xx, at 1126-27.

99 The elements of the ADRI are set out *infra* note xx and related discussion. The components of the ADRI which are not addressed in the CBR SPI are the rights individual shareholders have to call shareholder meetings, the ability of companies to block share transfers immediately prior to shareholder meetings, the fostering of a director election system known as cumulative voting and "pre-emptive" rights shareholders can be vested with in relation to the issuance of shares

100 The CBR SPI components are discussed *infra* note xx and accompanying text. Among these CBR SPI components which are not part of the ADRI are the regulation of shares with multiple voting rights attached, requirements concerning the appointment of independent directors and rules forcing shareholders to make a takeover offer after they have acquired a large minority stake ("mandatory bid").

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With the ADRI recoding efforts complicate the ascertainment of present-day scores, at least for Delaware. While the ADRI was originally promulgated by LLSV in their 1998 article, it was significantly rescored not once but twice, by DLLS in a 2008 article and, in a separate project, by Holger Spamann in a 2009 article.[101] These three scoring approaches diverge at points. The rationale for recoding and key differences in ADRI scoring methodology, are discussed in subsections III.C and III.D.[102] It suffices for present purposes, to say that we use ADRI scoring by DLLS and Spamann as our departure point. Thus, when appropriate, we refer to the ADRI as being scored using the DLLS approach and the Spamann approach.

With determining present-day scores for the ADRI, ASDI and CBR SPI Delaware was the obvious place to start because all three indices were scored for that jurisdiction. DLLS and Spamann, as with LLSV, focused on Delaware when generating ADRI scores for the U.S.[103] DLLS and Siems and his Center for Business Research co-authors ("Siems/CBR") did likewise for the ASDI and the CBR SPI, each taking Delaware's corporate law as the closest thing to "U.S." corporate law.[104] Correspondingly, when we coded Delaware we borrowed verbatim from the scoring by DLLS, Spamann, and Siems/CBR. Since we adopted the scoring from each source without variation, even if we had queries about a score awarded in relation to a particular variable we refrained from recoding. We scored Illinois and the MBCA ourselves, although whenever the applicable rule in these jurisdictions was similar to Delaware's the Delaware coding of DLLS, Spamann and Siems/CBR was used to promote consistency.

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101 Djankov et al., *Law and Economics*, supra note xx; Spamann, *Antidirector*, supra note xx.

102 *Infra* notes xx to xx and related discussion.

103 La Porta, López-de-Silanes, Shleifer and Vishny, *supra* note xx, at 1119; Djankov *et al.*, *Law and Economics*, *supra* note xx, 454; Spamann, *Antidirector*, *supra* note xx, at 472, n. 12.

104 Djankov *et al.*, *Law and Economics*, *supra* note xx, at 442 (ASDI); Siems, *Shareholder Protection*, *supra* note xx, at 120 (CBR SPI).

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It might be assumed that, given the extent to which we borrowed from DLLS, Spamann, and Siems/CBR, ascertaining present-day scores would be a straightforward exercise. In fact identifying the suitable scores posed various challenges that influenced the approach we took with historical scoring. The remaining sections of this Part illustrate the point by summarizing the key elements of the ADRI, the ASDI and the CBR SPI and by identifying the sources of law that need to be taken into account to code corporate law using these indices.

C. ADRI, ASDI and CBR SPI Variables

Our departure point in ascertaining appropriate present-day coding for the three indices we focus on was to identify the variables comprising each index and the basic scoring regime used for each variable. The ADRI, which was constructed and initially deployed by LLSV in a 1998 *Journal of Political Economy* article to compare the protection afforded by corporate law to shareholders in 49 countries,[105] is comprised of six variables:

1) the ability to mail in a proxy vote

2) the absence of a requirement that shareholders intending to vote their shares at a shareholder meeting deposit those shares before the meeting, rendering them non-transferable ("no block")

3) the availability of cumulative voting, which permits minority shareholders to "bundle" their votes and thereby increases the likelihood they can elect their representatives to the board of directors

4) mechanisms offering relief to minority shareholders who have been oppressed or unfairly prejudiced

[105] La Porta, López-de-Silanes, Shleifer and Vishny, *supra* note xx.

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5) rules obliging a company to give existing shareholders a right of first refusal when new shares are issued ("pre-emptive" rights)

6) the ability of shareholders owning 10 per cent or more of a company's shares to call an extraordinary shareholders' meeting.

For the purposes of their cross-country study, LLSV awarded jurisdictions either "0" or "1" with respect to each variable, with a higher cumulative score for a country signalling a more shareholder-friendly legal regime. The maximum score any country could receive was "6", though "5" in fact was the highest score LLSV awarded in their 1998 paper.[106] DLLS recoded the ADRI for the 49 countries in the 2008 article in which they deployed the ASDI, focusing on the law as of 2003 as opposed to 1993.[107] The highest score they awarded remained "5."[108] The DLLS recoding, however, changed quite often the scores awarded to individual countries for particular variables, with the correlation with the original LLSV coding being 0.60.[109] Also, while scoring for each ADRI variable was "0" or "1" with the original version, DLLS were prepared with the oppressed minority shareholder variable to award a score of 0.5 where this was necessary to improve the accuracy of coding.[110]

With the ASDI, for which DLLS assessed the law of 72 countries,[111] the departure point for coding was a hypothetical transaction that implicated self-dealing. The transaction involved Buyer Co., a publicly traded food manufacturer of which a Mr. James was a director and 60% shareholder.[112] Following a proposal by Mr. James, Buyer Co. agreed to purchase

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106 La Porta, López-de-Silanes, Shleifer and Vishny, *supra* note xx, at 1128.

107 Djankov *et al.*, *Law and Economics*, *supra* note xx, at 455.

108 On the data, see Andrei Shleifer: http://scholar.harvard.edu/shleifer/publications/law-and-economics-self-dealing Revised Antidir tab (last visited July 1, 2014) (nine countries were awarded a score of "5") [hereinafter Shleifer, *Data*].

109 Djankov *et al.*, *Law and Economics*, *supra* note xx, at 455.

110 *Id*. at 455, Table 9.

111 *Id.* at 432

112 *Id*. at 433.

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an unused fleet of trucks from Seller Co., a privately held retailer of which Mr. James was a 90% shareholder. Though all required approvals were obtained and all required disclosures were made, Buyer Co. shareholders sued the interested parties and the body that approved the transaction on its behalf.[113]

DLLS, to measure the law governing their hypothetical self-dealing transaction, compiled two anti-self-dealing indices, one measuring public enforcement (fines and other criminal sanctions) and the other private enforcement (civil remedies). They evaluated public enforcement by assessing whether Mr. James and the approving parties could be fined and/or imprisoned as a result of what had occurred.[114] The private enforcement index was composed of two sub-indices, one addressing *ex ante* private control and the other *ex post*.[115] The *ex ante* index, which focused on regulation of the process by which the sale of the trucks could be validated, dealt with requirements for advance disclosure of the proposed transaction by Mr. James and Buyer Co. and for independent review of the transaction. The *ex post* index, which was designed to measure the ease with which minority shareholders of Buyer Co. could establish potential wrongdoing in the courts after the transaction had been entered into, dealt with requirements Buyer Co. would face to disclose the transaction, standing to sue, burden of proof and access to evidence.[116]

Following the pattern with the ADRI, with most of the variables in the ASDI scoring ranged between "0" and "1." The only exception was for prison term variables in the public enforcement index, where the maximum length of the sentence was recorded. In some of the instances where the score had to be between "0" and "1", such as with a requirement in the *ex ante* private index for an independent review by a financial expert or an auditor and the

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113 *Id.*

114 *Id.* at 435.

115 *Id.* at 434-35.

116 *Id.* at 435.

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possibility of imposing fines in the public enforcement index, "0" and "1" were the only possible scores. More often allowance was made for the possibility of intermediate scores, with the range usually being "0", "0.5" and "1."[117] For instance, with disclosures Mr. James had to make in advance for validation of the hypothetical transaction to be possible, a country would score "0" if no disclosure was required, ½ if the conflict of interest only had to be disclosed and "1" if all material facts had to be divulged.

With the CBR SPI, Siems/CBR used their 10 element index to score corporate law in 20 countries.[118] The CBR SPI's 10 variables were selected partly so as to provide a representative mixture of legal rules.[119] The index accordingly addresses five basic themes, each associated with two of the ten variables:[120]

1) shareholder meetings (powers of shareholders; the scope shareholders have to set the agenda)

2) shareholder voting (fostering voting by the use of proxy/mailing; regulation of shares with multiple voting rights)

3) shareholders as a priority for directors (independence of directors; enabling shareholder dismissal of directors)

4) legal actions shareholders can file (derivative suits; challenging shareholder resolutions)

5) shareholder protection in relation to corporate control transactions ("mandatory bid" rule for tender offers; compelling disclosure of major share ownership stakes)

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117 With the *ex post* private index, the range for the "access to evidence" variable was 0, ¼, ½, ¾ and 1.

118 Siems, *Shareholder Protection II*, *supra* note xx, at 116. Siems and others associated with the CBR are currently updating their research and extending the coding to a wider range of countries: http://www.cbr.cam.ac.uk/research/projects/project3-19.htm.

119 Siems, *Shareholder Protection II*, *supra* note xx, at 119.

120 *Id.* The ten variables are specified *id.* at 116-19.

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Consistent with the predominant approach with the ADRI and ASDI, the CBR SPI scored each variable in a range between "0" and "1." Unlike with the original ADRI and akin to the revised ADRI and the ASDI, the CBR SPI forsakes strict binary "0" and "1" coding. The CBR SPI indeed goes further to accommodate intermediate scoring so as to provide an accurate picture of the law.[121] For instance, although the revised ADRI and the ASDI permitted non-binary options only when explicitly identified (such as "0", "0.5" and "1"), those coding the CBR SPI were prepared to give a wide range of intermediate scores.[122] For instance, while the description of the CBR SPI variable dealing with independent directors indicated that the scoring options were "1" if at least half of the board had to be independent directors, "0.5" if 25% of the board had to be independent and "0" otherwise,[123] Siems and his CBR affiliates awarded China 0.4 for 2002 and 0.6 for 2003 to 2005.[124]

D. Which Rules?

As part of our exercise of determining present-day coding before working backwards, we needed to determine which sources of law to take into account. We already know the potentially relevant players, namely the legislature, the courts, administrative agencies and stock exchanges.[125] LLSV's original ADRI did not take all of these into account. The ADRI was instead scored purely by reference to company and bankruptcy/organization law and excluded securities law and stock exchange listing rules.[126] This meant that when we scored the ADRI going back through time, following LLSV we did not take into account federal securities legislation, SEC regulations or any exchange-imposed restrictions. We did take

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121 Siems, *Shareholder Protection II*, *supra* note xx, at 120.

122 Mathias Siems et al., CBR Extended Shareholder Protection Index, (2009), 4, available at http://www.cbr.cam.ac.uk/pdf/Shareholder%20protection%20index%20references%2025%20countries.pdf (accessed May 29, 2014) [hereinafter Siems et al., *CBR Extended*].

123 Siems, *Shareholder Protection II*, *supra* note xx, at 117.

124 Siems et al., *CBR Extended*, *supra* note xx, at 34.

125 See Part II.B., *supra* note xx.

126 La Porta, López-de-Silanes, Shleifer and Vishny, *supra* note xx, at 1120.

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account, however, of case law relating to corporate law, as LLSV were clearly prepared themselves to factor in judicial rulings when scoring jurisdictions.[127] For instance, they explicitly drew attention to the American derivative suit as an example of a legal mechanism that afforded shareholders protection against perceived oppression and its contours are defined primarily by case law.[128]

Those coding the ASDI and the CBR SPI took into account a wider range of players than LLSV and we follow the same pattern with these indices. With the ADRI, coding was done by reference to "stock market act(s) and regulations" (i.e. securities law) and stock exchange listing rules as well as corporate legislation and judicial precedent.[129] With the CBR SPI those responsible for coding similarly took into account securities law and stock exchange listing rules in addition to statutory rules and case law.[130]

Finally, when deciding which rules to focus on for our coding, we had to ascertain not only who had promulgated particular rules but also the form those rules took. Corporate law rules can take several basic forms: mandatory, default/presumptive (applicable unless specifically waived or "opted out"), or enabling/permissive (inapplicable unless specifically chosen or "opted in").[131] LLSV, when they coded the original ADRI, failed to distinguish explicitly between these different kinds of rules.[132] In contrast, DLLS, in what they indicated was the key difference between LLSV's original ADRI and their revised ADRI, ignored enabling rules when they recoded.[133] Correspondingly, a country would only be awarded a "1" when its corporate law had a default or mandatory rule providing the relevant protection

127 *Id*. at 1126.

128 Armour, Black and Cheffins, *supra* note xx, at 1349 (describing the prerequisites for bringing a derivative suit in Delaware as a "judicial construct").

129 Djankov *et al., Law and Economics*, *supra* note xx, at 433.

130 Siems, *Shareholder Protection II*, *supra* note xx, at 120.

131 BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE AND OPERATION 217-20 (1997).

132 Djankov *et al., Law and Economics*, *supra* note xx, at 454.

133 *Id*. at 454.

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to shareholders. With the CBR SPI the focus similarly was on mandatory and default rules.[134] DLLS did not indicate specifically which rules they focused on with the ASDI, but because they were seeking to measure "hurdles" that had to be jumped[135] due to their permissive nature enabling rules should not have qualified.

With the ADRI the choice we made concerning the types of rules to take into account potentially had a significant impact on our coding. LLSV awarded the United States "5" overall in their 1998 article, with the only "0" occurring because shareholders lack pre-emptive rights under Delaware law, which LLSV again focused on when coding the United States.[136] In Delaware, a corporation can only provide for cumulative shareholder voting and for rights for shareholders to call an extraordinary meeting by "opting in." LLSV gave the United States a "1" for both variables but, due to the enabling nature of Delaware law governing each point, DLLS coded both as "0."[137] This meant the aggregate score for the United States dropped from a "5" for LLSV to a "3" for DLLS, thereby transforming the United States from a top rank corporate law country to a jurisdiction that provided below average protection.[138] Since DLLS themselves treated the revised ADRI as superior to the original, we decided to adopt the same approach to enabling rules as they did and excluded laws of this type from consideration when coding the ADRI going back through time.

Given DLLS' ADRI scoring for the United States, it might seem that "3" would be the obvious present-day baseline for historical research on Delaware. There is, however, an additional wrinkle, namely Holger Spamann's ADRI recoding. DLLS generated their revised

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134 Siems et al., *CBR Extended*, *supra* note xx, at 3-4 (indicating as well that with respect to rules precluding shares with multiple voting rights and requiring a takeover bid for all shares upon acquiring a specified percentage of shares only mandatory rules were counted).

135 Djankov *et al.*, *Law and Economics*, *supra* note xx, at 432.

136 *Supra* note xx and related discussion.

137 Cheffins, Bank and Wells, *Questioning*, *supra* note xx, at 606.

138 *Id.*

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ADRI in response to a then ongoing effort by Spamann to recode the original LLSV.[139] Spamann's methodology was more rigorous and transparent than LLSV's in various ways and he coded the United States (i.e. Delaware)[140] markedly differently than LLSV. Like DLLS, he awarded the United States "0"s for cumulative voting and for the calling of shareholder meetings. Spamann, however, awarded the United States a "2" rather than a "3" overall because he adopted a tougher standard than DLLS for awarding a "1" for proxy voting, a standard that Delaware failed to meet.[141] Spamann specifically acknowledged that the U.S. score went from "5" to "2,"[142] which was well below the average for the 46 countries dealt with in the original ADRI that Spamann re-coded.[143] Spamann's careful coding of Delaware law provides as credible a departure point for our analysis as does DLLS's so we correspondingly decided to rely on both.

## IV. HYPOTHESES AND FINDINGS

Our historically-oriented leximetric investigation of U.S. corporate law allows us to analyze numerous aspects of corporate law federalism. To ensure our empirical research directly addressed the key issues, before compiling our historical indices we formulated a series of testable hypotheses. We identify these here before turning to our findings.

### A. Hypotheses

Among the hypotheses that can be tested by using the ADRI, ASDI and CBR SPI to measure historically Delaware law, Illinois law and the MBCA, perhaps the most obvious is that scores should decline over time, at least with state corporate law. The corporate law

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139 Spamann, *Antidirector*, *supra* note xx, at 474.

140 *Supra* note xx and accompanying text.

141 On the differing approaches to proxy voting, see *infra* notes xx to xx and related discussion. Spamann, *Antidirector*, *supra* note xx, does not provide for the United States or any other country an element-by-element breakdown of ADRI scores. For this data, see http://rfs.oxfordjournals.org/content/23/2/467/suppl/DC1 [hereinafter Spamann, *Data*], (last visited January 28, 2014), link to Supplementary Data #2.

142 Spamann, *Antidirector*, *supra* note xx, at 474.

143 Cheffins, Bank and Wells, *Questioning*, *supra* note xx, at 606-7.

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"race" rhetoric used to characterize the evolution of the law, whether to the top or bottom, connotes movement.[144] Moreover, given the general consensus that the competition among states for incorporation business occurring in the 20th century served to erode shareholder rights while enhancing managerial flexibility,[145] the trend should have been downwards.

*Hypothesis 1: Corporate law index scores, to the extent they reflect state law, should decline over time.*

While the standard narrative has been that shareholder rights have been eroded over time, various observers have cited reform at the federal level to argue that shareholder protection in fact was bolstered from the 1930s onwards.[146] Assuming these observers are correct, one would expect that:

*Hypothesis 2: Corporate law index scores, to the extent they reflect federal law, should increase over time.*

Due to growing recognition of the role the federal government has played going back through time conventional wisdom concerning the United States' system of corporate law federalism has been shifting over the past decade.[147] The extent of federal influence is, however, open to debate.[148] If this influence was substantial and if federal intervention was typically intended to fortify the rights of shareholders the effect may have been enough to more than offset any race to the bottom at the state level, meaning the overall level of protection afforded to shareholders would have increased. It follows that:

144 *Id*. at 606.

145 *Supra* note xx and related discussion.

146 *Supra* note xx and accompanying text.

147 *Supra* note xx and accompanying text.

148 *Supra* note xx and related discussion.

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*Hypothesis 3: If changes to federal law heavily influenced the scoring of individual components of the corporate law indices, these indices' aggregate scores should have increased over time.*

Hypotheses 2 and 3 should only be relevant for the ASDI and the CBR SPI, given that these are the only two of our indices affected by securities law and rules developed by key players at the federal level, namely the SEC and stock exchanges. The ADRI, in contrast, does not measure these sources of law.[149] Assuming hypotheses 1, 2 and 3 are verified, it follows that:

*Hypothesis 4: Changes to the ADRI will be negatively correlated with changes to the ASDI and the CBR SPI.*

B. ADRI Findings

Given our methodology, which involves determining present-day coding before working backwards, with each of the three indices we begin by considering the current scoring for each of our three jurisdictions. With the ADRI, as mentioned, DLLS gave the United States (i.e. Delaware) a "3" overall, while Spamann gave Delaware an aggregate score of "2" rather than "3" (Fig. 1), with the discrepancy relating to the proxy voting element of the ADRI (Fig. 1). DLLS gave Delaware a "1" for proxy voting because the Delaware General Corporation Law ("DGCL") explicitly authorizes voting by proxy.[150] Spamann only gave countries a "1" with this variable if the law required that proxies provide for "yes or no" "two way" voting.[151] Delaware corporate law does not do this, so he scored this element "0."

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149 *Supra* note xx and accompanying text.

150 Djankov *et al.*, *Law and Economics*, at 454 (indicating it would suffice if "shareholders can vote by mail on each of the items on the agenda through a ballot or proxy form"), 455 (Table 9, describing elements in their revised ADRI).

151 Holger Spamann, *On the Insignificance and/or Endogeneity of La Porta et al.'s "Anti-Director Rights Index" Under Consistent Coding*, HARVARD OLIN CENTER FOR LAW, ECONOMICS AND BUSINESS FELLOWS'

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Figure 1: Delaware's Present-Day ADRI Scores

| **ADRI element** | **DLLS** | **Spamann** | **Justification for present day score** |
|---|---|---|---|
| Vote by Proxy Allowed | 1 | 0 | DGCL § 212(b) (gives shareholders the right to vote by proxy but does not provide for, as Spamann requires, two way voting). |
| No Block | 1 | 1 | Spamann (2008) (at 183): "Under the default regime, firms cannot require deposit of shares…" |
| Cumulative Voting | 0 | 0 | DGCL § 214 (providing for an enabling rule, not a default rule) |
| Oppressed Minority | 1 | 1 | Spamann (2008, p. 184): Minority shareholders can challenge breaches of duty by a derivative suit and can challenge shareholder amendments to the corporate charter on grounds of "unfairness." |
| Pre-emptive Rights | 0 | 0 | Spamann (2008, p. 184): "Preemptive rights exist only to the extent expressly granted in the (certificate of incorporation) (DGCL §102(3))." |
| Ability to Call General Meeting | 0 | 0 | Spamann (2008, p. 184): "shareholders can call a special meeting only if allowed by, and under the conditions specified in, the (certificate of incorporation), DGCL §211(d)....)" |
| **Total** | **3** | **2** | |

Source: Spamann (2008).[152]

Given that in recent years Delaware law has not been amended in a way that would affect the scoring of any ADRI variables, the coding by DLLS and Spamann should determine Delaware's present-day score. This means that under the ADRI Delaware corporate law is not "shareholder friendly", at least in comparison with other countries scored using the ADRI. DLLS's U.S. score of "3" was substantially below the average score of 4.29 DLLS awarded to common law countries and was similar to the average for civil law

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DISCUSSION PAPER NO. 7, 27 (2006). "Yes or no" or "two way" voting refers to a proxy form that gives shareholders the ability to vote for and against, rather than only to affirm, a board's decision.

[152] Spamann, *Data*, *supra* note xx.

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countries (2.88).[153] According to Spamann's coding, Delaware's aggregate ADRI score trailed well behind the overall average for common law countries (4.06) and civil law countries (3.93). Indeed, no country was given a lower overall score than Delaware's "2."[154]

For Illinois and the MBCA, using DLLS's approach, "4" appears to be the appropriate present day aggregate score for each jurisdiction (Fig. 2, Fig. 3). This aligns these jurisdictions more closely with the DLLS average for common law countries and means they have significantly higher aggregate scores than the typical civil law country. The situation is somewhat different if Spamann's methodology is used. Given that neither the MBCA nor Illinois mandate the use of two way proxies, under Spamann's methodology their aggregate present day scores become "3" rather than "4." This is below the overall average for common law countries and civil law countries but the discrepancy is not as dramatic as is the case with Delaware.

Figure 2: Illinois Present-Day ADRI Scores

| **ADRI element** | **DLLS** | **Spamann** | **Justification for present day score** |
|---|---|---|---|
| Vote by Proxy Allowed | 1 | 0 | Illinois Business Corporation Act (IBCA) § 7.50; reasoning for scoring is the same as Delaware. |
| No Block | 1 | 1 | IBCA §7.25 (provides for the concept of record ownership of shares, which means companies can identify who is entitled to vote without blocking share transfers prior to shareholder meetings). |
| Cumulative Voting | 1 | 1 | IBCA §7.40 (requires cumulative voting unless the articles of incorporation say otherwise). |
| Oppressed Minority | 1 | 1 | Brown v. Tenney, 532 N.E.2d 230, 232-33 (Ill. 1988); Kalabogias v. Georgou, 254 Ill. App. 3d 740, 747 |

[153] On the common law average, see Djankov *et al.*, *Law and Economics*, *supra* note xx, at 456. The civil law average is not discussed in this article but was set out in Table XII of a working paper version available at http://ssrn.com/abstract=864645. Spamann, in his 2010 article, provides different averages for the DLLS ADRI, namely 4.22 for common law countries and 3.11 for civil law countries. Spamann, *Antidirector*, *supra* note xx, at 475. Djankov *et al*. and Spaman provided aggregate data for civil law and common law countries because an important feature of the "law and finance" literature has been determining whether legal protection relevant to investors differs among different legal families, such as civil or common law.

[154] Spamann, *Antidirector*, *supra* note xx, at 475.

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| | | | |
|---|---|---|---|
| | | | (1993); IBCA §7.80 (governing the procedure for derivative litigation). |
| Pre-emptive Rights | 0 | 0 | IBCA §6.50; which merely permits pre-emptive rights to be created in the certificate of incorporation. |
| Ability to Call General Meeting | 0 | 0 | IBCA §7.05 (shareholders owning 20% of the shares can call a meeting, which exceeds 10% maximum required for a "1"). |
| **Total** | **4** | **3** | |

Figure 3: MBCA Present-Day ADRI Scores

| **ADRI element** | **DLLS** | **Spamann** | **Justification for present day score** |
|---|---|---|---|
| Vote by Proxy Allowed | 1 | 0 | MBCA § 7.22; reasoning for scoring is the same as Delaware. |
| No Block | 1 | 1 | Spamann (2008) (p. 184), citing MBCA §7.07. |
| Cumulative Voting | 0 | 0 | MBCA §7.28(b) (providing for an enabling rule, not a default rule) |
| Oppressed Minority | 1 | 1 | Spamann (2008, p. 184), citing MBCA §§8.31, 8.61, 13.02, and Chapter 7 Subchapter D. |
| Pre-emptive Rights | 0 | 0 | MBCA §6.30; reasoning similar to that for Illinois; see also Spamann (2008, p. 184). |
| Ability to Call General Meeting | 1 | 1 | MBCA §7.02(a) (10% threshold). |
| **Total** | **4** | **3** | |

Turning from the present day to historical trends, with four of the six ADRI variables it appears that going back through time – to 1899 in the case of Delaware and Illinois and to 1950 for the MBCA -- the scores remained unchanged. First, with voting by proxy, just as is the case today, Delaware and Illinois corporate legislation authorized shareholders to vote in this manner in 1899.[155] The MBCA has done likewise since 1950.[156]

Second, our searches failed to reveal any historical evidence of statutory provisions in Delaware or Illinois corporate legislation or the MBCA designed to block the transfer of

[155] Delaware General Corporation Law (1899), § 20; Illinois General Corporation Law of 1874, §3.

[156] Model Business Corporation Act, 1950, §31.

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shares prior to shareholder meetings.[157] Third, with the oppressed minority variable even though the right of shareholders to file derivative suits against directors was only first confirmed specifically by Delaware courts in the early 1920s, it was clearly available in Illinois in the nineteenth century.[158] More generally the derivative suit's origins can be traced back in the U.S. at least as far as 1831,[159] and it was widely understood to be a general feature of U.S. corporate law by the late nineteenth century.[160] Correspondingly, a "1" is the appropriate score for Delaware and Illinois from the present day back to 1899 and for the MBCA back to 1950.

Finally, with rights shareholders have to call a shareholder meeting, Delaware has only regulated this topic by statute since 1967 and has never specifically authorized shareholders owning a designated percentage of shares to take this step.[161] While Illinois has empowered shareholders to call shareholder meetings since 1872 and the ownership threshold was reduced from two-thirds to 20% in 1919, the relevant figure has always exceeded the 10% threshold required for a "1."[162] The MBCA, in contrast, has since 1950 authorized shareholders owning 10% or more of a corporation's shares to call a meeting, thus meriting a "1."[163]

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157 There were at various points in time statutory provisions that gave a corporation's directors the power to close the stock transfer books prior to a shareholder meeting to fix who was permitted to vote. See, for example, Delaware General Corporation Law 1925 § 17; Model Business Corporations Act 1950, §28. These measures, however, did not authorize the directors to preclude dealing in the shares.

158 Allied Chemical & Dye Corp. v. Steel & Tube Corp. of America, 120 A. 486, 491 (Del. 1923); Fleer v. Frank H. Fleer Corp., 125 A. 411, 415 (Del. Ch. 1924); Wheeler v Pullman Iron & Steel Co., 32 N.E. 420, 422-23 (Ill. 1892); City of Chicago v. Cameron, 11 N.E. 899, 903 (Ill. 1887).

159 Taylor v. Miami Exporting Co., 5 Ohio 162 (1831). The U.S. Supreme Court recognized the derivative suit in Dodge v Woolsey, 59 U.S. 331 (1855), which subsequently became the leading case. See Cheffins, Bank, and Wells, *Law by Numbers*, *supra* note xx, at 13-14.

160 *See*, *e.g.*, VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS 236 (1886).

161 Delaware General Corporation Law 1967, §211(d); Cheffins, Bank and Wells, *Questioning*, *supra* note xx, at 609.

162 Illinois Revised Statutes, 32 § 22, 702 (Harvey Hurd and B. Bradwell Helmer eds., 1917) Illinois General Corporation Act 1919, §40.

163 Model Business Corporation Act, 1950, §26.

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Cumulative voting and pre-emptive rights are the two ADRI variables where change has occurred, with the moves being from "1" to "0" in each case. With cumulative voting, the MBCA is the only jurisdiction affected, with the score falling from "1" to "0" in 1969.[164] Delaware specifically authorized companies to "opt in" to this method of director selection in 1919 but never established cumulative voting as a default rule, meaning its cumulative voting score was "0" from 1899 to the present day.[165] While Illinois displaced a long-standing mandatory cumulative voting rule in favor of a presumptive rule in 1984,[166] a "1" remains the appropriate score throughout because default rules are taken into account when scoring with the ADRI.

With pre-emptive rights all three jurisdictions experienced a change, with the score dropping from "1" to "0" in each instance. At common law, shareholders had pre-emptive rights,[167] meaning that as of 1899 Delaware and Illinois both scored "1"with this variable and the MBCA did likewise with its inception in 1950. The inaugural version of the MBCA expressly permitted shareholders to waive their pre-emptive rights,[168] as Delaware and Illinois had done since 1927 and 1933 respectively.[169] These enabling measures were insufficient to displace a score of "1." This occurred with Delaware, Illinois and the MBCA in 1967, 1982 and 1984 respectively when pre-emptive rights were eliminated unless the articles of incorporation provided otherwise.[170]

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164 On the chronology, see Cheffins, Bank, and Wells, *Law by Numbers*, *supra* note xx, at 16-17.

165 29 Del. Laws c. 113, § 9; Cheffins, Bank and Wells, *Questioning*, *supra* note xx, at 609.

166 Illinois General Corporation Law of 1874, §3; Illinois Business Corporations Act 1984, §7.40.

167 Wells, *Modernization*, *supra* note xx, at 610-11; ADOLF BERLE AND GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 133-34 (1932).

168 Model Business Corporation Act, 1950, §24.

169 DGCL 1927 § 5, para. 10; Illinois Business Corporations Act 1933, § 24.

170 Delaware General Corporation Law 1967, §102(b)(3); Business Corporations Act – Shareholder Rights, Pub. Act 82-650 (Ill.), § 1; Model Business Corporations Act, §6.30, Annotation, Historical Background, 2. Model Act (indicating as well that a provision was added to the MBCA in 1961 providing for abolition of pre-emptive rights that was set out as an alternative to the 1950 "opt out" approach).

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With all changes affecting the ADRI over time being from "1" to "0", it was inevitable that the time trend with the ADRI would be downwards. Moreover, with changes only affecting two of the ADRI variables, it was likely that changes would be modest. This indeed was the case with Delaware, where the only change was from "4" to "3" ("3" to "2" using Spamann's methodology) due to the 1967 displacement of pre-emptive rights (Fig. 4). Illinois was the same, with the aggregate score falling from "5" to "4" ("4" to "3" using Spamann's methodology) in 1982 due to the same change.

Figure 4: Aggregate ADRI Scores, Delaware, Illinois and MBCA, 1899-Present Day

| | **1899** | **1950** | **1967** | **1969** | **1982** | **1984** | **Present day** |
|---|---|---|---|---|---|---|---|
| Delaware (DLLS/Spamann) | 4/3 | 4/3 | **3/2** | 3/2 | 3/2 | 3/2 | 3/2 |
| Illinois (DLLS/Spamann) | 5/4 | 5/4 | 5/4 | 5/4 | **4/3** | 4/3 | 4/3 |
| MBCA (DLLS/Spamann) | X | 6/5 | 6/5 | **5/4** | 5/4 | **4/3** | 4/3 |

Note: Scoring changes are identified in **bold**.

With the MBCA, because the 1984 displacement of pre-emptive rights was preceded by the 1969 side-lining of cumulative voting, the downwards trend was more pronounced. However, with the MBCA the drop occurred from a very high initial starting point. The MBCA's DLLS ADRI aggregate score of "6" for 1950 to 1969 exceeded the score of each country DLLS considered when revising the ADRI.[171] With Spamann's recoding, the MBCA's "5" was exceeded by only two countries, South Korea and Spain, which both had scores of "6."[172]

C. ASDI Findings

[171] *Supra* note xx and related discussion.

[172] Spamann, *Antidirector*, *supra* note xx, at 475.

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The ASDI, which is premised on a hypothetical self-dealing transaction between a public and a private company, consists of two indices oriented around private and public enforcement. The former is comprised of two sub-indices relating respectively to ex-ante and ex-post control.[173] For the most part, for each of these the present-day scores for Delaware, Illinois and the MBCA are identical. With the MBCA, this is partly because we have drawn upon Delaware and Illinois scoring where coding was problematic because the MBCA is a model act not anchored to the law of a particular state.

The ASDI element where we drew on Delaware and Illinois law to code the MBCA was a component of the ex-post control of self-dealing index dealing with "access to evidence." With "access to evidence", the possible overall score ranges from "0" to "1." A jurisdiction is awarded one-quarter point each when a plaintiff shareholder challenging the hypothetical transaction who owns 10% or more of the shares can request the court to investigate the self-dealing transaction, when the plaintiff shareholder can request documents relevant to the case from the defendant, when the plaintiff shareholder can ask the defendant questions prior to trial without prior judicial approval of the questions and when the plaintiff shareholder can do the same with non-parties.[174] These are issues that are governed by civil procedure rules of the state in which the litigation would occur, rather than by corporation law itself. Given that Djankov *et al.* awarded the United States (i.e. Delaware) 0.75 for access to evidence and given that this in all likelihood is the appropriate score for Illinois[175] we have given the same score to the MBCA.

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173 *Supra* note xx and accompanying text.

174 Djankov *et al.*, *Law and Economics*, *supra* note xx, at 432 (Table 1).

175 On Delaware, see Shleifer, *Data*, *supra* note xx, Ex-Ante Control tab, columns D and E. Illinois should be given one-quarter point each because the plaintiff shareholder could request documents, could ask the defendant questions prior to trial and could do the same with non-parties. See ILCS Supreme Court Rules, R. 206 (right to conduct oral depositions, parties and non-parties), R. 210 (right to conduct written depositions, parties and non-parties), R. 213 (right to conduct interrogatories), R. 214 (right to demand document production). The overall score should not be 1.00 because Illinois, like Delaware, lacks procedural or corporate law rules permitting a shareholder to request a court investigation.

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There is one area where ASDI scores diverge as between Delaware and the MBCA on the one hand and Illinois on the other, this being the treatment of disclosure by the Buyer Co. and disclosure by Mr. James under the ex-ante private control of self-dealing index. Djankov *et al.* awarded the U.S. (i.e. Delaware) "1" for both these variables.[176] They did not do so because an explicit statutory duty is imposed; there are no provisions of the relevant type in the Delaware General Corporation Law.[177] Instead, it appears that Delaware was awarded "1"s for disclosure by Buyer Co. and by Mr. James because the relevant disclosures would have to occur in order for the parties in Djankov *et al.*'s hypothetical to be able to rely on a statutory "safe harbor" provision in the DGCL designed to help shield a related party transaction from challenge and protect the directors involved from liability.[178]

The MBCA's related party transaction "safe harbor" provision is worded similarly to Delaware's,[179] meaning the MBCA similarly should be given "1"s for the rules governing disclosure by the Buyer Co. and Mr. James (Fig. 5). In contrast, Illinois's "safe harbor" provision is drafted explicitly to ensure that a transaction can be insulated from challenge if it was "fair," regardless of whether ex ante disclosure occurred or not. The relevant measure provides that the absence of full disclosure merely shifts the burden of proof on to those asserting the related party transaction should be treated as valid on the grounds of its fairness.[180] Correspondingly, Illinois should be given a "0" both for rules governing disclosure by the Buyer Co. and by Mr. James. Illinois' present day scores for the ASDI ex-

176 Shleifer, *Data*, *supra* note xx, Ex-Post Control tab, column H.

177 Cheffins, Bank, and Wells, *Law by Numbers*, *supra* note xx, at 25.

178 *Id.* at 26-27.

179 Model Business Corporations Act, §8.61.

180 805 ILCS 5/8.60; *see* Janice M. Church, Note, *Director Conflict of Interest Under the 1983 B.C.A.; A Standard of Fairness*, [1985] U. ILL. L. REV. 741 ("Section 8.60 supports such an approach because it relegates factors relevant to procedural fairness --disclosure and approval -- to the issue of shifting the burden of proof.") [hereinafter Church, *Director Conflict of Interest*]

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ante private control of self-dealing correspondingly are appreciably lower than those for Delaware and the MBCA (Fig. 5).

Figure 5: Present Day ASDI Ex-ante Private Control of Self-Dealing -- Delaware, Illinois and the MBCA

| ASDI Element | Delaware | Illinois | MBCA | Justification for present day score |
|---|---|---|---|---|
| Approval by disinterested shareholders | 0 | 0 | 0 | None of the jurisdictions have rules in place requiring that related party transactions be voted on by shareholders. The UK is an example of a jurisdiction where such approval is required (Companies Act 2006, c. 46, §§ 190-96). |
| Disclosure by Buyer Co. | 1 | 0 | 1 | See *supra* notes xx to xx and related text. |
| Disclosure by Mr. James | 1 | 0 | 1 | *Id.* |
| Independent Review | 0 | 0 | 0 | None of the jurisdictions require that a related party transaction be scrutinized by an independent auditor or financial expert. |
| Ex ante disclosure | 0.67 | 0 | 0.67 | Average of previous three variables. |
| **Ex-ante Private Control of Self-Dealing** | **0.33** | **0** | **0.33** | Average of approval by disinterested shareholders and ex ante disclosure. |

The ex ante private control of self-dealing scores for the jurisdictions we focus on are mediocre at best. The Delaware and MBCA scores of 0.33 were below the average of 0.36 for the 72 countries Djankov *et al.* focused on.[181] Only three of the countries – Austria, Hungary and Tunisia – scored as poorly as Illinois with its 0.00.[182]

With ex post private control of self-dealing the story was much different. The overall Delaware, Illinois and MBCA scores of 0.98 (Fig. 6) were inferior to only one jurisdiction,

[181] Cheffins, Bank, and Wells, *Law by Numbers*, *supra* note xx, at 23.

[182] Shleifer, *Data*, *supra* note xx, Ex-Ante Control tab, column H.

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this being Singapore with 1.00.[183] Unlike with ex ante private control of self-dealing, with the ex post index there was no variation with any of the elements between Delaware, Illinois and the MBCA.

Figure 6: Present Day ASDI Ex-post Private Control of Self-Dealing -- Delaware, Illinois and the MBCA

| ASDI Element | Delaware | Illinois | MBCA | Justification for present day score |
|---|---|---|---|---|
| Disclosure in periodic filings | 1 | 1 | 1 | Federal regulation: 17 CFR §229.404, Form 10-K, 17 CFR §240.15D-1, 17 CFR §240.14A |
| Standing to sue (equals 1 if a derivative suit can be brought against Mr. James and bodies approving the transaction) | 1 | 1 | 1 | See discussion of derivative action in relation to the oppressed minority variable in Figs. 1, 2 and 3. |
| Rescission (equals 1 if rescission is available if the transaction is unfair or involves a conflict of interest) | 1 | 1 | 1 | At common law, a related party transaction was void or at least voidable.[184] Delaware, Illinois and the MBCA each have statutory safe harbor provisions that can shelter transactions from challenge[185] but they would not operate if a transaction was unfair or had not been approved by the board or the shareholders. |
| Ease of holding Mr. James liable (equals 1 if the interested director is liable if the transaction is unfair, oppressive, or prejudicial). | 1 | 1 | 1 | The MBCA specifically recognizes that damages will be recoverable when a related party transaction cannot be saved under a statutory safe harbor.[186] The remedy should also be available at common law.[187] |
| Ease of holding approving body | 1 | 1 | 1 | Unclear. Relevant Delaware case law[188] indicates that, in a related party |

183 Cheffins, Bank, and Wells, *Law by Numbers*, *supra* note xx, at 23-24.

184 Model Business Corporations Act, Subchapter F. Directors' Conflicting Interest Transactions, Introductory Comment, Part 1.

185 *Supra* notes xx to xx and accompanying text.

186 Model Business Corporations Act, §8.61(a).

187 Model Business Corporations Act, §8.61, Selected Cases, 2.G Conflicts of Interest/Damages.

188 See, e.g., *In re Loral Space and Communications, Inc*., 2008 WL 4293781, *33 (Sept. 19, 2008) ("[B]eing a non-independent director who approved a conflict transaction found unfair does not make one, without more, personally liable for harm caused. Rather, the court must examine that director's behavior in

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| | | | | |
|---|---|---|---|---|
| liable (equals 1 if the members of the approving body are liable if the transaction is unfair, oppressive, or prejudicial). | | | | transaction context, directors who approve a one-sided transactions will be held liable only if they have breached duties of loyalty and care (i.e. gross negligence). Under DLLS' coding scheme, this means the United States should have been given "0". Consistent, however, with our policy of deferring to original coding,[189] we will assume that all three jurisdictions should be scored "1". |
| Access to evidence | 0.75 | 0.75 | 0.75 | *Supra* notes xx to xx and related discussion. |
| Ease of proving wrongdoing | 0.95 | 0.95 | 0.95 | Average of previous five variables |
| **Ex-post Private Control of Self-dealing** | **0.98** | **0.98** | **0.98** | Average of disclosure and ease of private wrongdoing |
| **Anti-self-dealing index** | **0.65** | **0.49** | **0.65** | Average of Ex-ante Private Control of Self-Dealing and Ex-post Private Control of Self-dealing |

For Delaware and the MBCA, the combination of the very high ex post private control of self-dealing score with the mediocre score of 0.33 for ex ante private control yields an overall present-day score of 0.65 for private control of self-dealing (Fig. 5). This score of 0.65 placed Delaware (i.e. the United States) 10th highest among the 72 countries DLLS coded and well above the global average of 0.44.[190] Illinois' overall private control of self-dealing score of 0.49 – despite being driven downwards by the score of 0 with ex ante private control – would have still placed Illinois 24th out of the 72 countries.[191]

Delaware, Illinois and the MBCA were less robust with public enforcement than with private enforcement, particularly from an ex post perspective. The 25 year prison term which Mr. James could receive in the U.S. under federal law for failing to disclose his conflict of

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order to assess whether the director breached her fiduciary duties…"); *ATR-Kim Eng Financial Corp. v. Araneta*, 2006 WL 3783520 (Del. Ch. 2006).

189 *Supra* notes xx to xx and related discussion.

190 Cheffins, Bank, and Wells, *Law by Numbers*, *supra* note xx, at 24.

191 Derived from analysis of Shleifer, *Data*, *supra* note xx, Ex-Post Control tab, column K.

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interest was the longest of any of the 72 countries Djankov *et al.* considered.[192] On the other hand, neither federal nor state law provides for fines and prison terms for parties such as Mr. James or the directors of Buyer Co. in circumstances where all relevant disclosure and approval requirements had been met. Correspondingly, the United States (i.e. Delaware) received a score of 0.00 on Djankov et al.'s public enforcement index and Illinois and MBCA would do likewise. While nearly half of the countries in Djankov et al.'s dataset were in the same position (34 of 72), 0.00 was nevertheless well below the 72-country average of 0.41.[193]

With Delaware, Illinois and the MBCA there has been little historical change in the ASDI. An exception was the prison sentence Mr. James would face for failing to disclose his interest in the related party transaction. A sentence of this sort could only have been imposed as early as 1935, when disclosure of material contracts between the company and any of its directors or officers was first mandated and false or misleading disclosures were made punishable by way of a prison sentence under the Securities Exchange Act of 1934.[194] The maximum sentence that could be imposed for false or misleading disclosure was increased in 1977, 1988 and 2002.[195]

With the ex ante private control of self-dealing index, statutory provisions mandating shareholder approval or independent review of related party transactions have never been a feature of state corporate law in the United States Correspondingly, scores with these variables would be "0" going back through time (Fig. 7). Where change did occur was with respect to disclosure by Mr. James and Buyer Co. The Illinois "safe harbor" provision with wording that ensures ex ante disclosure is not even implicitly required began to govern in

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192 Shleifer, *Data*, *supra* note xx, Public Enforcement tab, column G; 15 USC §78ff(a) (maximum 20 year sentence for false and misleading statements, which would occur if there had not been disclosure of the relevant transaction in periodic filings); 18 USC §371 (adding an additional five years for conspiracy to commit a crime against the United States).

193 Derived from Shleifer, *Data*, *supra* note xx, Public Enforcement tab, column F.

194 Cheffins, Bank, and Wells, *Law by Numbers*, *supra* note xx, at 27-28.

195 15 USC §78ff, History; Ancillary Law and Directives (2014).

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1984 when the Illinois Business Corporation Act of 1983 (IBCA) came into force.[196] Prior to this the common law would have governed and full disclosure likely was required for a court to exercise discretion it had to relieve parties of the adverse consequences potentially associated with related party transactions.[197] Hence, the only change to the ex ante private control of self-dealing index going back to 1899 was that Illinois' ex ante disclosure score fell from 0.67 to 0 in 1984, which in turn reduced Illinois' ex ante private control of self-dealing index from 0.33 to 0 (Fig. 7).

Figure 7: ASDI Ex-ante Private Control of Self-Dealing -- Delaware, Illinois and the MBCA, 1899-Present

| **ASDI Element** | 1899 -- Delaware/Illinois/MBCA | 1950 – Delaware/ Illinois/MBCA | 1984 – Delaware/ Illinois/MBCA | Present day – Delaware/Illinois/MBCA (see Figure 6) |
|---|---|---|---|---|
| Approval by disinterested shareholders | 0/0/x | 0/0/0 | 0/0/0 | 0/0/0 |
| Disclosure by Buyer Co. | 1/1/x | 1/1/1 | 1/**0**[198]/1 | 1/0/1 |
| Disclosure by Mr. James | 1/1/x | 1/1/1 | 1/**0**/1 | 1/0/1 |
| Independent | 0/0/x | 0/0/0 | 0/0/0 | 0/0/0 |

196 805 ILCS 5/8.60 (safe harbor provision); Ill. Rev. Stat. ch. 32 ¶¶ 1.01-16.10 (IBCA). On when the Illinois Business Corporation Act of 1983 came into force, see James M. Van Vliet, *The New Illinois Business Corporation Act Needs More Work*, 61 CHI. KENT. L. REV. 1, 2 (1985).

197 On the necessity for disclosure under the common law, *see Corporations – Directors – Transactions Involving Conflicts of Interest*, 42 ORE. L. REV. 61, 64 (1962) ("A finding of nondisclosure will make a consideration of other facets of a transaction unnecessary in most cases. Nondisclosure of an interest by a director may constitute unfairness per se under the fairness test and thus make the transactions voidable."); Note, *The Fairness Test of Corporate Contracts with Interested Directors*, 61 HARV. L. REV. 335, 338 (1948) ("The courts usually require of the interested director full disclosure of his interest and of those facts, such as his own purchase price, which would affect the board's decision to buy.") With respect to Illinois, pre-1984 there was conflicting case law concerning related party transactions but in Shlensky v. South Parkway Bldg. Corp., 19 Ill. 2d 268, 283 (1960) full disclosure was identified as a factor that would determine the outcome of a fairness test. *See* Church, *Director Conflict of Interest*, *supra* note xx, at 746, 749-50.

198 Illinois initially had a statutory provision governing related party transactions in 1981 – Illinois Business Corporations Act 1933, §40a. The enactment of this provision would not have reduced Illinois' Disclosure by Buyer Co. and Disclosure by Mr. James scores in the same way as the 1984 provision because the 1981 provision specifically required disclosure of the transaction to the board before a court could save the transaction. On the nature of the 1981 provision, see Church, *Director Conflict of Interest*, *supra* note xx, at 746-47.

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| | | | | |
|---|---|---|---|---|
| Review | | | | |
| Ex ante disclosure | 0.67/0.67/x | 0.67/0.67/0.67 | 0.67/**0**/0.67 | 0.67/0/0.67 |
| **Ex-ante Private Control of Self-Dealing** | 0.33/0.33/x | 0.33/0.33/0.33 | 0.33/**0**/0.33 | 0.33/0/0.33 |

Note: Scoring changes are identified in **bold**.

As with the ex ante private control of self-dealing index, with the ex post private control of self-dealing index the scoring only changed for one variable going back through time, though the change was not restricted to one jurisdiction. The variable affected was disclosure in public filings, with the relevant change occurring in 1935 when disclosure of material contracts between the company and any of its directors or officers became compulsory under federal securities law.[199] The change more than doubled Delaware and Illinois' ex-post private control of self-dealing score and increased the overall anti-self-dealing index score for both jurisdictions from 0.41 to 0.65 (Fig. 8).

Figure 8: ASDI Ex-post Private Control of Self-Dealing -- Delaware, Illinois and the MBCA, 1899-Present

| **ASDI Element** | 1899 -- Delaware/Ill./ MBCA | 1935 -- Delaware/Ill./ MBCA | 1950 – Delaware/ Ill./MBCA | 1984 – Delaware/ Ill./MBCA | Present Day – Delaware/ Ill./MBCA |
|---|---|---|---|---|---|
| Disclosure in periodic filings | 0/0/x | **1/1**/x | 1/1/1 | 1/1/1 | 1/1/1 |
| Standing to sue | 1/1/x | 1/1/x | 1/1/1 | 1/1/1 | 1/1/1 |
| Rescission | 1/1/x | 1/1/x | 1/1/1 | 1/1/1 | 1/1/1 |
| Ease of holding Mr. James liable | 1/1/x | 1/1/x | 1/1/1 | 1/1/1 | 1/1/1 |
| Ease of holding approving body liable | 1/1/x | 1/1/x | 1/1/1 | 1/1/1 | 1/1/1 |

[199] Cheffins, Bank, and Wells, *Law by Numbers*, *supra* note xx, at 27-28.

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| | | | | | |
|---|---|---|---|---|---|
| Access to evidence | 0.75/0.75/x | 0.75/0.75/x | 0.75/0.75/0.75 | 0.75/0.75/0.75 | 0.75/0.75/0.75 |
| Ease of proving wrongdoing | 0.95/0.95/x | 0.95/0.95/x | 0.95/0.95/0.95 | 0.95/0.95/0.95 | 0.95/0.95/0.95 |
| **Ex-post Private Control of Self-dealing** | 0.48/0.48/x | **0.98/0.98**/x | 0.98/0.98/0.98 | 0.98/0.98/0.98 | 0.98/0.98/0.98 |
| **Anti-self-dealing index** | 0.41/0.41/x | **0.65**/**0.65**/x | 0.65/0.65/0.65 | 0.65/**0.49**/0.65 | 0.65/0.49/0.65 |

Note: Scoring changes are identified in **bold**.

Scores for "Access to evidence" have remained unchanged over time because Delaware and Illinois civil procedure rules provided as far back as 1899 for the same core litigant rights that justify the present-day score of 0.75.[200] With standing to sue, rescission and the ease of holding Mr. James and the approving body (i.e. the board) liable, at present common law principles provide the justification for the "1"s awarded to Delaware, Illinois and the MBCA (Fig. 6). The same common law principles should have been applicable back to 1899. Verifying this point definitively admittedly is not feasible. For instance, Delaware lacked any case law directly focusing related party transactions until the early 1920s.[201] Still, the trend of authority from other states should, in the absence of Delaware jurisprudence, provide a reasonably accurate characterization of what the law would have been in Delaware prior to that point.[202]

## D. CBR SPI Findings

[200] On the right to request documents relevant to the case from the defendant, see Rules of the Revised Statutes of the State of Delaware (1893), Ch. 30, vol. 13, § 13; Ill. Rev. Stat., ch. 51 §9 (1874). On the right to examine the defendant without a court approving the questions, see Rules of Equity Practice in the Court of Chancery (1868), R. 40, §§24-28 (setting out rules for witnesses), §1 (indicating parties were not excluded from being witnesses). On the right to examine non-parties without a court approving the questions, see Rules of Equity Practice in the Court of Chancery (1868), R. 48; Ill. Rev. Stat., ch. 51 §§24-28 (1874).

[201] Cheffins, Bank, and Wells, *Law by Numbers*, *supra* note xx, 32.

[202] There was pre-1920s case law from New York which indicated that individual shareholders might lack standing to challenge related party transactions. Even if this was in fact the law, the doctrine was subject to sufficiently wide exceptions to suggest a "1" was the appropriate score for standing to sue. See Cheffins, Bank, and Wells, *Law by Numbers*, *supra* note xx, at 30-31.

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With the CBR SPI, Mathias Siems and his CBR co-authors gave the United States (again, meaning Delaware) a score of 7.25 out of a possible score of 10 for 2005.[203] With Delaware there have been no relevant changes to the law in the years since, so given our methodological choice not to depart from scores generated by those initially constructing an index for our purposes Delaware's present day score is 7.25 (Fig. 9). In comparative terms this implies that shareholders are well-protected. Among the 20 countries in the Siems/CBR dataset, the United States tied for second best with France with a score of 7.25, trailing slightly behind the UK at 7.375 and well above the average score of 5.2.[204]

Figure 9: Delaware Present-Day CBR SPI Scores

| **CBR SPI Element** | **Delaware/U.S. score (2005/present day)** | **Justification for present day score[205]** |
|---|---|---|
| Powers of the general meeting for de facto changes. (The score is governed by the level of shareholder approval required for a sale of the company's assets). | 0.75 | DGCL § 271 requires shareholder approval for "sale, lease, or exchange" of "substantially all" of the assets. The case law indicates that 50% does not automatically constitute "substantially all," which was the threshold specified for awarding a "1". |
| Agenda setting power. (The score is based on the ability of shareholders owning specified percentages of shares to put a matter to a shareholder vote). | 1 | SEC Rule 14a-7 (requiring a public company to provide a shareholder list to shareholders who ask); SEC Rule 14a-8 (allows shareholders owning a modest number of shares to circulate resolutions in proxy material their company circulates). |
| Anticipation of shareholder decision facilitated. (Score = 0.5 if postal voting possible and 1 if postal voting possible and companies soliciting proxies must use "two-way"-- "yes" and "no" -- proxy forms.) | 1 | NYSE Manual, § 402.04 (requiring listed companies to solicit proxies to facilitate shareholder voting); SEC Rule 14a-4(b)(1) (mandating use of two way proxies). |
| Prohibition of multiple voting rights. | 0.5 | NYSE Manual, §§ 313.00 (Voting rights cannot be disparately reduced or restricted but companies with non-voting shares are permitted to continue to list and issue such shares). |

203 Armour *et al.*, *Shareholder*, *supra* note xx, 357, Table 2.

204 *Id.*; average calculated from figures provided in the table.

205 Siems et al., *CBR Extended*, *supra* note xx, at 103-5.

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|---|---|---|
| Independent board members. (Score = 1 if at least half of the board members must be independent; 0.5 if 25% of them must be independent.) | 1 | NYSE Manual, § 303A.01 (half of the board members must be independent). |
| Feasibility of director's dismissal. (Score = 0.5 if a dismissed director can claim for contractual compensation if dismissed without good reason.) [206] | 0.5 | There can be compensation agreements with dismissed directors (*cf.* DGCL § 141(k)). |
| Private enforcement of director duties. (The score is based on the ease with which a minority shareholder can bring a derivative suit.) | 0.75 | Siems et al. acknowledged that derivative actions are feasible in the United States but did not award a "1" because various restrictions apply, such as the need typically to make "demand" (asking the board to sue), deference to screening by special litigation committees and a contemporaneous ownership requirement (the plaintiff must have owned shares at the time the alleged breach of duty occurred). |
| Shareholder action against resolutions of the general meeting. (Score = 1 if every shareholder is eligible to challenge a shareholder resolution.) | 1 | Siems et al relied upon Delaware case law to justify awarding "1". The cases cited indicate the powers of the majority are "always subject to the historical processes of a court of equity to gauge whether there has been an oppressive exercise of the power granted."[207] |
| Mandatory bid. The score is determined by the presence of rules requiring a shareholder who buys a designated percentage of shares to make an offer to buy the shares of all remaining shareholders. | 0 | Neither Delaware nor federal law requires an investor who acquires a large stake in a company to make a bid for all of the shares of the company. |
| Disclosure of major shareholder ownership. (Score = 0.75 if shareholders who acquire at least 5% of a company's shares have to disclose this.) | 0.75 | Securities Exchange Act 1934, § 13(d) and Schedule 13D of the Act combine to require those acquiring a stake of 5% or more to disclose their interest. |
| **Total** | **7.25** | |

Source: Siems et al., (2009), *supra* note xx.

While with the ADRI the Illinois and MBCA present-day aggregate scores diverge from Delaware's (Figs. 1-3) and the same occurs with Illinois with the ASDI (Figs. 5, 6),

[206] Those constructing the CBR SPI apparently inaccurately conflated dismissal as a director with dismissal as an executive. The analysis of the 0.5 scoring for the United States cited MBCA §8.08(a), which specifically permits a corporation's shareholders to dismiss a director without cause and means a director will not have compensation available. Despite §8.08(a), an individual who is an executive in addition to being a director who is fired as an executive without cause will be able to sue for damages for wrongful termination. It appears that the possibility of this occurring was sufficient to reduce the U.S. (i.e. Delaware) score to 0.5.

[207] Siems et al., *CBR Extended*, *supra* note xx, at 103-5 (citing Barrett v. Denver Tramway Corp., 53 F. Supp. 198, 202 (D. Del. 1943), aff'd, 146 F.2d 701 (3d Cir.1944), citing Goldman v. Postal Tel., Inc., 52 F. Supp. 763 (D. Del. 1943)).

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with the CBR SPI Illinois and MBCA have present-day scores which are identical element-by-element to Delaware's (Fig. 10). The fact that with five of the variables federal law determined the relevant score contributed substantially to this uniformity.

Figure 10: Illinois/MBCA Present-Day CBR SPI Scores

| **CBR SPI Element** | **Illinois/MBCA score (present day)** | **Justification for present day score** |
|---|---|---|
| Powers of the general meeting for de facto changes. | 0.75/0.75 | Illinois -- IBCA, §11.60 (same standard as Delaware).<br>MBCA §12.02(a) (in effect requiring a shareholder vote if less than 25% of assets will remain after a disposition.) |
| Agenda setting power. | 1/1 | Federal securities law (see Fig. 9). |
| Anticipation of shareholder decision facilitated. | 1/1 | NYSE listing rules/federal securities law (see Fig. 9). |
| Prohibition of multiple voting rights. | 0.5/0.5 | NYSE listing rules (see Fig. 9). |
| Independent board members. | 1/1 | NYSE listing rules (see Fig. 9). |
| Feasibility of director's dismissal. | 0.5/0.5 | IBCA (§ 8.35) and MBCA (§ 8.08) both permit shareholders to dismiss directors without cause but executives dismissed without cause could still sue for compensation (see *supra* note xx). |
| Private enforcement of director duties. | 0.75/0.75 | As is the case with Delaware (see Fig. 9) derivative actions are feasible under the IBCA and the MBCA but the requirements that mean that a "1" is not justified also apply. On demand, see IBCA § 7.80(b), MBCA § 7.42(1). On special litigation committees, see Weiland v. Illinois Power Co. 1990 WL 267364 (accepting the use of a special litigation committee) ; MBCA §§ 1.43, 7.44 (indicating that a derivative suit can be dismissed by "qualified" directors, these being directors lacking a material interest in the challenged transaction). On contemporaneous ownership see IBCA § 7.80(a), MBCA § 7.41(1). |
| Shareholder action against resolutions of the general meeting. | 1/1 | Cases cited to justify a "1" for Delaware are consistent with general common law trends.[208] |

[208] See Rutherford B. Campbell, *Corporate Fiduciary Principles for the Post-Contractarian Era*, 23 FLA. ST. UNIV. L. REV. 561, 573 (1996) (treating the cases cited as authoritative jurisprudence concerning recapitalizations involving preferred shareholders).

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| | | |
|---|---|---|
| Mandatory bid. | 0/0 | See Fig. 9; the position is the same under Illinois law and the MBCA. |
| Disclosure of major shareholder ownership. | 0.75/0.75 | Federal securities law (see Fig. 9). |
| **Total** | **7.25/7.25** | |

While with both the ADRI and the ASDI there were relatively few changes to scores attributable to Delaware, Illinois and the MBCA over time (Figs. 4, 7, 8) and while, the ASDI disclosure in periodic filings variable aside, those changes all moved scores downwards, the situation was different with the CBR SPI. There were changes at the state level as far back as 1903, with the pace of change increasing starting in 1950, but with one exception, each change moved scores upward (Fig. 12). This was reflected in an upward trend of aggregate scores (Fig. 11), which was primarily due to changes to federal securities law and NYSE listing rules (Fig. 13), the content of which the S.E.C. strongly influences.[209]

Figure 11: CBR SPI Aggregate Scores for Delaware, Illinois and the MBCA, 1899-Present Day

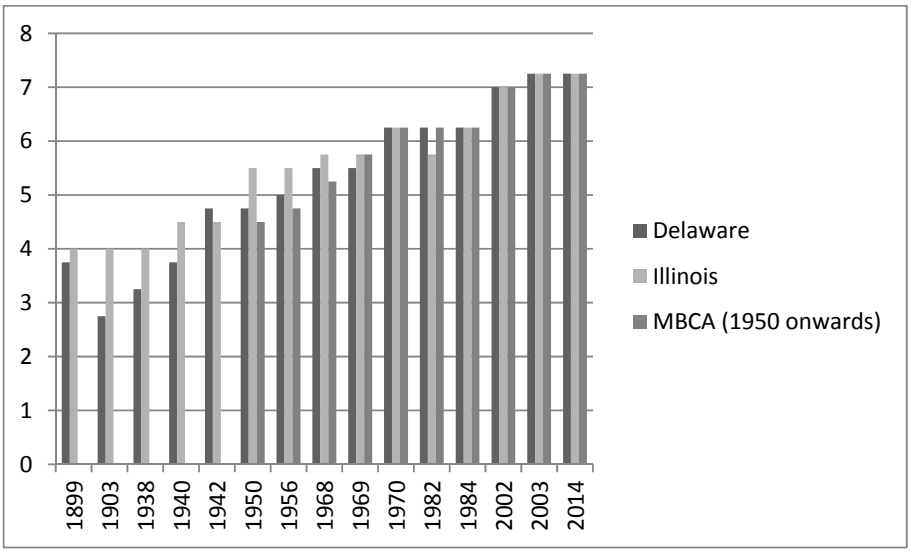



Figure 12: Changes to CBR SPI Scores for Individual Variables Generated by State Law -- Delaware, Illinois and the MBCA, 1899-Present Day

[209] *Supra* note xx and related discussion.

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| Year | CBR SPI Variable | Jurisdiction(s) Affected | Score Change | Explanation |
|---|---|---|---|---|
| 1903 | Prohibition of multiple voting rights | Delaware | 1 to 0 | The Delaware General Corporation Law of 1899 authorized the issuance of share classes with different voting rights but it only took full effect with the repeal of a provision in the Delaware Constitution of 1897 which stated that "in all elections for directors or managers of stock corporations, each shareholder shall be entitled to one vote for each share of stock he may hold."[210] |
| 1950 | x | MBCA | x | MBCA first introduced. |
| 1969 | Feasibility of director's dismissal. | MBCA | 0 to 0.5 | In 1960, the forerunner to the current MBCA § 8.08 was introduced as an "optional" provision and in 1969 the optional designation was removed.[211] This displaced the common law rule, which was that shareholders could only remove directors for cause, reflecting the fact that the directors had a statutory entitlement to their office.[212] This would be a "0" under the CBR SPI coding protocol.[213] |
| 1970 | Feasibility of director's dismissal. | Delaware | 0.25 to 0.5 | DGCL § 141(k) enacted,[214] which the CBR SPI coders rely upon to give Delaware/U.S. a 0.5.[215] |
| 1982 | Prohibition of multiple voting rights | Illinois | 1 to 0.5 | IBCA § 28 amended to allow corporations formed after December 31, 1981, to eliminate cumulative or other voting rights.[216] |

[210] *Brooks v. State ex rel. Richards*, 79 A. 790, 800 (Del. 1910).

[211] Model Business Corporations Act, §8.08(a), Annotation, History – Historical Background, 2. The Model Act.

[212] COX & HAZEN, *supra* note xx, §9.14; MBCA, §8.08, Official Comment.

[213] Under the "feasibility of director's dismissal" the CBR coders gave jurisdictions a "0" if "good reason (was) required for the dismissal of directors": Armour *et al.*, *Shareholder*, *supra* note xx, 354, Table 1.

[214] Laws of 1970, ch. 437, http://delcode.delaware.gov/sessionlaws/ga127/chp437.shtml.

[215] Siems et al., *CBR Extended*, *supra* note xx, at 104. Prior to the enactment of § 141(k), the Delaware General Corporation Law contained a provision indicating that directors could be removed but it was unclear whether this had to be for cause. *See* Charles H. Nida, *Note: The New Delaware Corporation Law*, 5 HARV. J. LEGISL. 413, 427-28 (1968). Delaware had a provision of this sort going back to 1899. Katharina Pistor et al., *The Evolution of Corporate Law: A Cross-Country Comparison*, 23 U. PA. J. INT'L. ECON. L. 791, 815 (2002). A pre-1970 score of 0.25 appears to be appropriate, which the CBR coders award when it is clear that a director can be dismissed but would always be compensated: Armour *et al.*, *Shareholder*, *supra* note xx, at 354, Table 1.

[216] *See* Roanoke Agency v Edgar, 461 N.E.2d 1365, 1368 (Ill. 1984)

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| | | | | |
|---|---|---|---|---|
| 1984 | Feasibility of director's dismissal. | Illinois | 0 to 0.5 | IBCA § 8.35 enacted, displacing the common law rules which offered shareholders little, if any, scope to dismiss directors.[217] |
| 2003 | Private enforcement of director duties. | Delaware, Illinois, MBCA[218] | 0.5 to 0.75 | Case law developments "evidenc(ing) a heightening of judicial scrutiny on directors in the wake of the corporate governance scandals."[219] |

Figure 13: Changes to CBR SPI Scores for Individual Variables Generated by Changes to Federal Law-- Delaware, Illinois and the MBCA, 1899-Present Day

| Year | CBR SPI Variable | Jurisdiction(s) Affected | Score Change | Explanation |
|---|---|---|---|---|
| 1938 | Anticipation of shareholder decision facilitated. | Delaware, Illinois | 0.5 to 1 | SEC Rule X-14A-2, forerunner to SEC Rule 14a-4(b)(1), adopted.[220] |
| 1940 | Prohibition of | Delaware[221] | 0 to 0.5 | The NYSE introduced a rule precluding the |

[217] See, for example, Van Vliet, *supra* note xx, 34 ("New BCA section 8.35 reflects a basic public policy change, granting statutory authority for the removal of directors with or without cause, by shareholder action. There was no counterpart to this in the old BCA so that, prior to the New BCA, only the common law right to remove a director for cause existed".) The common law rule generally applicable in U.S. states was that directors could only be removed before the end of their terms "for cause," but this rule was gradually displaced by statute beginning in the 1930s. *See* BALLANTINE ON CORPORATIONS (2d ed. 1946) 433-34. The law may have been even more restrictive in Illinois, as prior to the adoption of the 1983 Illinois Business Corporation Act "there was no statutory provision for removal of directors" (Voss Engineering Inc. v Voss Industries Inc., 481 N.E.2d 63, 66 (Ill. App. 1985)). At least one Illinois court suggested that allowing shareholders to remove a director would allow an end-run around cumulative voting requirements of the Illinois constitution, see Laughlin v Geer, 121 Ill. App. 534, 538-39 (1905) See generally CHARLES MURDOCK, 7 ILL. PRAC. BUS. REORGANIZATIONS § 11.18 (2nd ed. 2010).

[218] With this case law driven change in scoring, each case cited was from Delaware. Given, however, our policy of deferring to coding by those who constructed the original indices (see *supra* note xx and related discussion) and given the influential nature of Delaware case law, we have assumed the private enforcement of director duties score would increase with Illinois and the MBCA as well as with Delaware.

[219] Siems et al., *CBR Extended*, *supra* note xx, at 105.

[220] Sheldon E. Bernstein and Henry G. Fischer, *The Regulation of the Solicitation of Proxies: Some Reflections on Corporate Democracy*, 7 U. CHI. L. REV. 226, 229 (1940). The CBR coders cite a 1959 NYSE listing rule compelling companies to solicit proxies to justify the "1" they give the United States with the "Anticipation of shareholder decision facilitated" – Fig. 10. On the fact that the relevant listing rule was not introduced until 1959, see Douglas C. Michael, *The Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 BUS. LAW. 1461, 1469 (1992); Thompson, *Delaware, supra* note xx, at 795. However, because according to the CBR protocol a "0.5" is justified if postal/proxy voting is merely authorized, state laws that justify a coding of "1" for Delaware and Illinois for the ADRI proxy voting variable back to 1899 (*supra* note xx and related discussion) should suffice.

[221] Illinois' score for this variable did not increase in 1940 because it was already "1" due to a provision in the Illinois constitution prohibiting the use of share classes with different voting rights for directors' elections. ILL. CONST. art XI, § 3 (1870) (replaced 1970) ("in all elections for directors or managers of incorporated companies, every stockholder shall have the right to vote . . . for the number of shares owned by him . . . or to

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| | | | | |
|---|---|---|---|---|
| | multiple voting rights. | | | listing of non-voting common stock.[222] |
| 1942 | Agenda setting power. | Delaware, Illinois | 0 to 1 | Shareholder proposal mechanism that is now SEC Rule 14A-8 introduced as rule X-14A-7.[223] |
| 1956 | Independent board members. | Delaware, Illinois, MBCA | 0 to 0.25 | Companies listed on the NYSE were required to have at least two independent directors.[224] |
| 1968 | Disclosure of major shareholder ownership. | Delaware, Illinois, MBCA | 0 to 0.5 | The Williams Act[225] introduced Securities Exchange Act 1934, § 13(d) and Schedule 13D of the Act, which required shareholders owning 10% or more of the shares of an issuer governed by the Act to disclose its stake. |
| 1970 | Disclosure of major shareholder ownership. | Delaware, Illinois, MBCA | 0.5 to 1 | Ownership disclosure threshold applicable to Securities Exchange Act 1934, § 13(d) and Schedule 13D reduced to 5%.[226] |
| 2002 | Independent board members. | Delaware, Illinois, MBCA | 0.25 to 1 | NYSE Manual, § 303A.01 (2002) adopted. |

## E. Our Hypotheses Revisited

To distil our findings we return to the four hypotheses we sought to test with historical analysis of the ADRI, ASDI and CBR SPI.[227] Our first hypothesis (H1) is our

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cumulate said shares, and give one candidate as many votes as the number of directors multiplied by the number of his stock shall equal"). *See also* H. W. Ballantine, *A Critical Survey of the Illinois Business Corporation Act*, 1 U. CHI. L. REV. 357, 386 (1934).

222 Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19C-4*, 69 WASH. U.L.Q. 565, 569 (1991). The NYSE had refused to list corporations with dual-class capitalizations beginning in 1926, but did not adopt a formal rule forbidding such listings until 1940. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN FINANCE 585-86 (3d ed. 2003).

223 George W. Dent, *SEC Rule 14a-8: A Study in Regulatory Failure*, 30 N.Y.L. SCHOOL REV. 1, 3-4 (1985). *See also* Susan W. Liebeler, *A Proposal to Rescind the Shareholder Proposal Rule*, 18 GEO. L. REV. 425, 427-28 (1984); Mortimer M. Caplin, *Proxies, Annual Meetings and Corporate Democracy: The Lawyer's Role*, 37 VA. L. REV. 653, 669 (1951) (indicating that prior to 1942 the SEC had indicated companies should set shareholder proposals forth in proxy soliciting materials but only specifically permitted a shareholder to submit a proposal at that point).

224 Michael, *supra* note xx, 1469; Thompson, *Delaware, supra* note xx, 795.

225 Pub. L. 90-439, 82 Stat. 454 (1968).

226 Pub. L. No. 91-567, 84 Stat. 1497 (1970).

227 *Supra* note xx to xx and accompanying text.

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state-driven race to the bottom hypothesis and would be verified if scores fell in relation to those elements of corporate law indices determined by state law. Our findings on balance confirm H1, but the trend was hardly robust. With the ADRI, the aggregate scores for Delaware and Illinois did drop, but only did so by one out of six when those jurisdictions displaced pre-emptive rights. The MBCA ADRI score fell by one in 1969 and again by one in 1984 but the decline was from a very high starting point.[228]

With the ASDI there again was, with its state law elements, a downwards trend but continuity was the main theme. Between 1899 and the present day on only one occasion was there state law-driven change to the index and it affected only one jurisdiction, this being the 1984 amendment to Illinois law that meant that advance disclosure of related party transactions was no longer implicitly required.[229] Finally, while with the ADRI and the ASDI changes to state law reduced aggregate scores, with the CBR SPI, the trend was mixed. State-law driven changes to the index affecting the use of share classes with multiple voting rights caused the scores of Delaware and Illinois to decline while those related to director dismissal and enforcement of directors' duties pushed the scores of Delaware, Illinois and the MBCA up (Fig. 12). The upshot is that H1 is confirmed, but the trend was neither robust nor uniform.

Our second and third hypotheses (H2 and H3) relate to the impact of federal law on shareholder protection over time. H2 presupposes that changes to federal law should bolster shareholder protection. The assumption underlying H3 is that changes to federal law were significant, and significant enough to outweigh whatever downward pressure a state-driven "race to the bottom" had on shareholder rights.

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228 *Supra* note xx and related discussion.

229 *Supra* note xx and accompanying text.

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H2 and H3 are strongly confirmed. Federal law was not taken into account with the coding of the ADRI. Each of the changes to this index that decreased Delaware, Illinois and the MBCA's aggregate score correspondingly occurred at state, not federal, level. While federal law was taken into account with the ASDI, scoring for private control of self-dealing was dictated primarily by state law (Fig. 5, 6). Still, with the one element determined by federal law -- disclosure in periodic filings – federal reform drove scores upwards in what was otherwise a very stable environment over time.[230]

The impact of federal law was considerably more pronounced with the CBR SPI. Unlike with the ADRI and the ASDI, federal law (defined to include NYSE listing rules)[231] had a major impact on the scoring for Delaware, Illinois and the MBCA, with federal rules accounting for the scoring of five of the ten elements.[232] Overall, the aggregate CBR SPI scores for each jurisdiction increased markedly between 1938 and 2003 (Fig. 11), with changes to federal law accounting for most of the upward movement (Fig. 13). CBR SPI trends correspondingly indicate that federal developments substantially bolstered shareholder protection (H2) and more than cancelled out whatever movement downwards was associated with changes to state law (H3).

Our final hypothesis (H4)—that ADRI trends would be negatively correlated with ASDI and CBR SPI trends—combines the presuppositions underlying H1, H2 and H3 with the knowledge that ADRI scoring was driven solely by state law whereas ASDI and CBR SPI scoring could be influenced by federal law developments. Since H1 was confirmed, albeit

230 *Supra* note xx and related discussion.

231 On why, see *supra* note xx and accompanying text.

232 The variables were Agenda setting power, Anticipation of shareholder decision facilitated, Prohibition of multiple voting rights, Independent board members and Disclosure of major shareholder ownership. See Figures 9 and 10. With anticipation of shareholder decision facilitated, state law was potentially relevant as well. See *supra* note xx.

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somewhat weakly, and since H2 and H3 were strongly confirmed, it follows that H4 should be confirmed as well. This was true, but with a caveat.

Changes to the ADRI were indeed negatively correlated with changes to the CBR SPI, with ADRI scores declining modestly over time whereas CBR SPI scores increased substantially. H4, however, was not confirmed with respect to the ASDI. Given that changes to federal law only had a modest impact in practice on ASDI scoring and given that the scoring relating to variables determined by state law was very stable, aggregate ASDI scores changed little over time despite the 1935 introduction of federal securities law rules mandating ex post disclosure of the hypothetical related party transaction.

## V. "PRESENT DAY" BIAS?

The fact that our second and third hypotheses were strongly confirmed affirms the significance of a theme that has moved to the forefront quite recently in the competitive federalism literature, namely that the federal government is an important player. The weak confirmation of H1 combined with the strong confirmation of H2 and H3 runs contrary to a much better established element of the received wisdom, this being that competition between states served to erode shareholder protection substantially over time. Federal intervention more than outweighed a relatively weak trend in favor of erosion of shareholder protection at the state level, meaning that on a net basis shareholder rights became more robust over time.

While our historical findings cast doubt on the received wisdom that jurisdictional competition substantially eroded shareholder rights, and confirm the accuracy of the more recent theory that federal intervention has done much to shape shareholder protection, this presupposes that our indices measure what was really occurring. This cannot be taken for granted. A source of particular concern is that the indices are, for two reasons, afflicted by a "present day" bias. First, the indices we rely on potentially incorporate elements that

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lawmakers would not have considered important for shareholder protection decades ago and therefore would not have been regulated at that time. Second, the indices could fail to reflect substantial protection formerly afforded by now defunct legal rules.

This Part explains initially why present day bias is potentially a source of concern. We then carry out cross-checks which indicate that whatever bias exists is insufficient to compromise our findings materially. We ultimately show that our historical analysis of corporate law indices provide reliable evidence that whatever erosion of shareholder protection has occurred under state law since 1900 has been modest and has been more than cancelled out by a federally-prompted surge in shareholder rights.

A. Reasons for Concern

Mathias Siems, often together with co-authors, has on various occasions suggested that when LLSV constructed the ADRI they fell into a trap that comparative lawyers seek to avoid, namely imposing one's own pre-conceptions on foreign legal systems.[233] Siems maintains that the fact that cumulative voting was included in the ADRI -- a topic historically widely debated in the United States but not elsewhere – and the law on removal of directors was not -- legal rules in the United States that can entrench boards have been heavily criticized as being shareholder-unfriendly – betray a pro-U.S. bias in the ADRI.[234] Though plausible, Siems' conjectures do not fit the facts comfortably. If the ADRI was, as Siems alleges, affected by a pro-U.S. bias, one might have expected that this would translate into high scores for the supposedly favoured country. It is true that under the original LLSV ADRI the United States did score "5" out of "6."[235] However, with DLLS' recoded ADRI

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233 Lele and Siems, *Shareholder Protection I*, *supra* note xx, at 20-21; Armour *et al.*, *Shareholder*, *supra* note xx, at 349; Mathias M. Siems, *What Does Not Work in Comparing Securities Law: A Critique on La Porta et al.'s Methodology*, [2005] INT. COMPANY COMM. L. REV. 300, 301.

234 Lele and Siems, *supra* note xx, at 20-21.

235 *Supra* note xx and related discussion.

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and Spamann's coding the U.S. aggregate score ("3" and "2" respectively) was substantially below the average for countries coded.[236]

Given that our leximetric analysis of corporate law focuses exclusively on the United States throughout it is largely immaterial to us if the indices we deploy betray an implicit partiality for U.S. corporate law. There is, however, another type of bias that potentially affects the indices we rely upon that could compromise our results, namely a tilt in the direction of scores increasing as time progressed. Bias of this sort is a source of concern partly because there are some variables in the indices we use where for substantial periods of time contemporaries would have been unaware that regulating the topic in question might have been beneficial for investors. Under such circumstances, the law governing U.S. corporations could not realistically generate positive scores for the variables in question. This could only change when lawmakers recognized the value of the rules in question, which in turn would tend to bias upwards scores from recent decades.

Those constructing the CBR SPI have indeed explicitly acknowledged that they focused on a period (1995 to 2005) when change, in the form of proposals to strengthen shareholder protection, were on the policy agenda in numerous countries.[237] Given this, it should not be surprising that, consistent with the 1995-2005 trend for most of the 20 countries Siems and his CBR associates coded,[238] the CBR SPI scores for Delaware, Illinois and the MBCA increased by a full point out of ten between 2001 and 2003 (Figs. 11, 12, 13).

The CBR SPI variable concerning the mandating of a designated proportion of independent directors on the board is an example of an index element where a present-day bias exists. It appears that William Douglas in a 1934 Harvard Law Review article was the

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236 Cheffins, Bank and Wells, *Questioning*, *supra* note xx, at 606, 608.

237 Armour *et al.*, *Shareholder*, *supra* note xx, at 353.

238 Siems, *Shareholder Protection*, *supra* note xx, at 122-23.

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first to advocate that a majority of board seats be occupied by individuals not affiliated with management.[239] Under such circumstances, it would be unrealistic to expect that the law governing U.S. corporations would have scored positively with the independent director component of the CBR SPI prior to that point in time. Similarly, given that laws mandating public filing of annual and quarterly reports by publicly traded companies were not introduced until the Securities Exchange Act of 1934,[240] with the ASDI it is difficult to see how a "1" could have been awarded for the disclosure of related party transactions in public filings variable prior to that point in time.

Present-day bias, in the form of index components with a strongly modern orientation, is, however, by no means an endemic feature with variables in the indices we focus on. With many of the variables in the indices we focus on it was theoretically possible for scores to be positive back to 1900. The "5" that Illinois had as early as 1899 using DLLS's ADRI scoring method and the very high scores the MBCA had when it was introduced in 1950 (Fig. 4) indicate that "1"s have been for decades more than a theoretical possibility.

An additional potential source of an upwards present-day bias is that shareholders may have had in the past protections available to them that are not part of contemporary shareholder rights discourse. Due to their outdated nature, legal protections of this nature would be unlikely candidates for inclusion in the ADRI, ASDI and CBR SPI. Shareholders therefore may have had in 1900, 1910 or 1920 significant protections largely unknown today, which in turn would be unlikely candidates for inclusion in the ADRI, ASDI and CBR SPI.

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239 William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1314-15 (1934) (advocating the introduction of legislation mandating that stockholders independent of management should make up half of the board). On Douglas' pioneer status, see Bratton and McCahery, *Equilibrium, supra* note xx at 661 (2006) ("Douglas' article set out the basic terms of the governance agenda that has guided corporate law reforms ever since.") Robert Gordon was another early advocate of mandating the appointment of independent directors: ROBERT A. GORDON, BUSINESS LEADERSHIP IN THE LARGE CORPORATION 347-50 (1945).

240 Bratton and McCahery, *Equilibrium, supra* note xx, at 650 (noting, though, that NYSE listing rules did require disclosure of prescribed financial information prior to the mid-1930s); SELIGMAN, *supra* note xx at 99. Requirements that companies file reports to state agencies have been essentially non-existent under state corporate law: Cary, *supra* note xx, 667.

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Correspondingly, reforms that compromised, eroded or abolished such rights would have occurred and diminished shareholder protection without reducing historical scores for Delaware, Illinois or the MBCA. These indices could in turn fail to capture going back through time the abrogation or abolition of potentially significant shareholder rights. We account for this aspect of present-day bias next.

B. What Shareholder Rights Mattered in 1929?

A plausible cross-check against present-day bias in the indices we use to measure historical shareholder protection trends is to identify what shareholder rights were thought to matter in the past and ascertain whether these have been eroded over time. Conducting such an exercise is not straightforward because those writing about corporate law in the opening decades of the 20th century were not constructing indices in the same way as LLSV, DLLS and those responsible for the CBR SPI. However, a 1929 book by John Sears, *The New Place of the Stockholder*,[241] provides a helpful substitute.

Sears indicated that with his book "the aim and purpose [was] to consider methods and practices proposed to *protect the stockholder, use the stockholder, and help the stockholder*."[242] He identified as a departure point "an understanding of the deeply fundamental character of the stockholder's legal rights"[243] and composed a 14-point "list of strict legal rights, powers and remedies" so "[t]hat we may more clearly understand where we stand."[244] This 14-point list can be used as the departure point in capturing a historically sensitive sense of trends concerning shareholder protection.

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241 JOHN SEARS, THE NEW PLACE OF THE STOCKHOLDER (1929).

242 *Id*. at 9. Emphasis in original.

243 *Id.* at 8.

244 *Id.* at 198.

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If it transpired that there had been in the decades following the 1929 publication of Sears' book a substantial erosion of the protections Sears identified, this would suggest that the indices we have relied upon are seriously compromised by present-day bias. Our findings correspondingly would have to be discounted considerably. As we will see, the legal rights on Sears' list in fact remain largely intact today. It follows that that the trends we have identified in fact are robust.

Sears' book, as with various others published during the same era that drew attention to the fact that recent and substantial growth in the number of individuals owning shares had significant legal and economic implications, would subsequently be overshadowed by Adolf Berle and Gardiner Means' landmark 1932 book *The Modern Corporation and Private Property*.[245] Sears, though, was not simply a precursor of Berle and Means. Instead, he had a more sanguine view of management and a more skeptical take on the need for further legal changes to protect shareholders.[246] Nevertheless, as Lawrence Mitchell has observed, Sears' views "were taken seriously" at the time of publication.[247] The *Wall Street Journal* referred to *The New Place of the Stockholder* as "One of the most timely books of recent date…."[248] At least one reviewer of *The Modern Corporation and Private Property* explicitly acknowledged Sears' book as a forerunner of Berle and Means' work[249] and Gardiner Means cited *The New Place of the Stockholder* in a 1930 *Quarterly Journal of Economics* article

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245 BERLE & MEANS , *supra* note xx; Robert Hessen, *The Modern Corporation and Private Property: A Reappraisal*, 36 J.L. ECON. 273, 279-80 (1983) (citing THOMAS NIXON CARVER, THE PRESENT ECONOMIC REVOLUTION IN THE UNITED STATES (1925); WILLIAM Z. RIPLEY, MAIN STREET AND WALL STREET (1927); I. MAURICE WORMSER, FRANKENSTEIN INCORPORATED (1931)).

246 *See*, for example, SEARS, *supra* note xx, at 6 ("I don't think Main Street has the right to criticize Wall Street in matters of corporate finance").

247 Lawrence E. Mitchell, *The "Innocent Shareholder": An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits*, [2009] WISC. L. REV. 243, 273.

248 *New Publications: The New Place of the Stockholder*, WALL ST. J., Sept. 18, 1929, 20.

249 *Book Review: The Modern Corporation and Private Property*, 18 CORNELL L.Q. 634, 634 (1933).

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Berle and Means drew upon heavily in *The Modern Corporation and Private Property*.[250] Sears' catalog of protections available to shareholders in 1929 thus can serve as a fair measure of the rights shareholders enjoyed at that moment.

With two items on Sears' 14-point list – cumulative voting and pre-emptive rights -- shareholder protections available in 1929 were eroded in subsequent decades. In both instances, however, we have already taken the topics in question into account for the purposes of this Article because they were ADRI components (Fig. 14). With each item on Sears' list that was not dealt with by the ADRI, the rights Sears cited remain currently available to shareholders (Fig. 15). This suggests that even if there is some element of present-day bias in the indices we use, our findings concerning shareholder protection trends remain valid.

Figure 14: Elements of Sears' 14-Point List of Shareholder Rights That Were Also ADRI Components – ADRI Trends

| **Shareholder Right, Identified by Number of Sears' List** | **Sears' Description** | **ADRI Component** | **ADRI Trend** |
|---|---|---|---|
| Right to vote (# 7) – proxy voting. | "The right to…vote by proxy…is provided by statute and court decisions (at p. 202)" | Vote by Proxy Allowed. | DLLS: Delaware "1" (1899-present); Illinois "1" (1899-present); MBCA "1" (1950-present)<br>Spamann: DLLS: Delaware "0" (1899-present); Illinois "0" (1899-present); MBCA "0" (1950-present)[251] |
| Cumulative voting (# 8) | "To accumulate his votes in the election of directors, when statute or state constitution make this right compulsory, and to do so where such right is | Cumulative Voting | Delaware "0" (1899-present); Illinois "1" (1899-present); MBCA "1" (1950-69), "0" (1969-present)[252] |

250 Gardiner C. Means, The *Diffusion of Stock Ownership in the United States*, 44 Q.J. ECON. 561, 561 (1930). On Berle and Means' reliance on this research, see the preface to the 1932 edition of BERLE AND MEANS, *supra* note xx.

251 Figures 1 to 3, *supra* notes xx to xx and related discussion.

252 *Supra* note xx and accompanying text.

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| | | | |
|---|---|---|---|
| | permissive and the certificate of incorporation etc. provides therefor (at p. 202). | | |
| Pre-emptive rights (#11) | "Preemptive right to participate in new issue upon increase of capital stock (at p. 202)" | Pre-emptive Rights | Delaware "1" (1899-1967), "0" (1967-present); Illinois "1" (1899-1982), "0" (1982-present); MBCA "1" (1950-84), "0" (1984-present).[253] |
| Derivative action (#12) | "To bring legal actions, in a representative capacity for all the stockholders, in the event the directors are acting fraudulently in withholding suit…(at p. 202). | Oppressed Minority | Delaware "1" (1899-present); Illinois "1" (1899-present); MBCA "1" (1950-present).[254] |

Figure 15: Additional Elements of Sears' 14-Point List of Shareholder Rights – Present Day Situation

| **Shareholder Right, Identified by Number of Sears' List** | **Sears' Description** | **Present Day Situation (Delaware, Illinois, MBCA)** |
|---|---|---|
| Ultra vires (#1) | "Every stockholder, however small, has the right to insist that the purposes of the corporation be confined to those stated in the charter (at p. 198)." | Individual shareholders have standing to challenge *ultra vires* transactions if it would be equitable to do so.[255] |
| Shareholder voting on charter amendments (#2) | "To make amendments, to alter the charter, the statutes require the vote of holders of various proportions of stock (at p. 200)."[256] | Shareholder approval is generally required for corporations to amend their articles of incorporation – DGCL § 242(b)(1); 805 Ill. Comp. State. 5/10.20; MBCA § 10.03(b). |
| Calling stockholder meetings (#3) | "Power in the stockholders to call meetings, in the event the regularly constituted officers fail to do so, is | Where corporate legislation requires that an annual shareholder meeting be held (e.g. DGCL § 211(b); 805 Ill. Comp. |

253 *Supra* notes xx to xx and related discussion.

254 *Supra* note xx and accompanying text.

255 See Delaware General Corporation Law §124(1); 805 Ill. Comp. State. 5/3.15; Model Business Corporations Act § 3.04(b)(1); COX & HAZEN, *supra* note xx, § 4.8. With the rise of general incorporation and broad corporate purpose clauses, ultra vires was in fact largely a vestigial doctrine even in the 1920s and there is no evidence that it decreased markedly in strength subsequently. *See* HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW 1836-1937, at 60-62 (1991).

256 Procedurally amending the articles required the directors to submit a proposal to the shareholders. See SMITH-HURD, ILLINOIS REVISED STATUTES 1929, chapter 32, § 62; 1915 Revised Statutes of the State of Delaware, ch. 65 1940 §26.

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| | usually provided by statute (at p. 200)." | State. 5/7.05; MBCA § 7.01) individual shareholders have the right to have an annual meeting held.[257] |
| Power to dissolve (#4) | "Stockholders, usually by a two-thirds vote at a meeting…may dissolve the corporation….(at p. 200-1)."[258] | "Every state provides for the voluntary dissolution of a corporation when authorized by a vote of the shareholders."[259] See, for example, DGCL § 275; 805 Ill. Comp. State. 5/12.15; MBCA § 14.02. |
| Right to assets on dissolution (#5) | "After the payment of corporate debts, the stockholder becomes entitled to his proportionate share of the assets of the company (at p. 201)." | A key duty of directors during the winding up process is "to distribute the remaining assets to the shareholders after provision has been made for creditors."[260] |
| Right to sell stock (#6) | "The right of alienation is an inseparable incident to the ownership of stock as it is of other property (at p. 201)." | "In publicly held corporations, free alienation of shares is a distinct advantage of the corporate form of doing business."[261] |
| Right to vote (#7) | "The stockholder is normally entitled to one vote for each share of stock….(at p. 201)." | "Generally…each outstanding share of stock is entitled to one vote…."[262] |
| Right to dividends (#9) | "A well-known law writer [I.M. Wormser, footnote omitted] believes that where it appears that dividends have erroneously and unfairly been detained from distribution to the stockholders for a long period of years, a point will be reached where a court of equity should unhesitatingly intervene….(at p. 134)." | With dividends, "[t]he shareholders are usually entitled to the amounts credited to them….In most cases where dividends have been compelled, it has been shown that the directors wilfully abused their discretion….."[263] |
| Defend suits on behalf of the corporation (#13) | If the board's power to defend suits against the corporation is "fraudulently neglected, a stockholder might conceivably act on behalf of and in defense of the corporation (at p. 202)" | "…refusal to defend (by the board), where it partakes more of disregard of duty than of an error of judgment, or is a breach of trust although not involving intentional moral delinquency, warrants relief to complaining shareholders."[264] |

257 COX & HAZEN, *supra* note xx, § 13.13.

258 At the time of publication of Sears' book the procedure for the dissolution of a corporation in both Illinois and Delaware called for the board to present a dissolution proposal to their shareholders. The proposal, however, could be made at the request of shareholders. See 1929 Illinois Revised Statutes 32 § 75; 1915 Revised Code of Delaware, 1953, § 39.

259 COX & HAZEN, *supra* note xx, § 26.2.

260 *Id*. § 26.13.

261 *Id*. § 1.5.

262 ROBERT C. CLARK, CORPORATE LAW 361 (1986).

263 COX & HAZEN, *supra* note xx, §§ 20.1, 20.2.

264 12B FLETCHER CYC. CORP. § 5853 (2013)

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| Remedy against misconduct by majority shareholders (#14) | "A *bona fide* minority stockholder who has not…ratified fraudulent acts of the majority…may sue and will be given appropriate remedies against an offending majority….(at p. 202)." | "In broad overview, transactions shown to produce disproportionate gains to the controlling stockholders are typically judged by a standard of fairness….(T)he burden of establishing the fairness of the transaction is placed upon the controlling stockholder…."[265] |

C. What Shareholder Protections Were Displaced?

While the ADRI, ASDI and CBR SPI scores for Delaware, Illinois and the MBCA imply that there was only a modest erosion of protection afforded to shareholders under state corporate law from 1899 onwards, and while the shareholder rights identified by Sears in 1929 as important remain largely intact today, anecdotally changes to state law did compromise shareholder rights markedly. Perhaps, then, neither our leximetric investigation nor our historical cross-check has captured fully what in fact was a prevalent trend in U.S. corporate law. Correspondingly, we identify now changes to the law emphasized by those saying shareholder protection afforded by state law diminished considerably and assess whether the changes in question were of sufficient importance to undermine our ADRI, ASDI and CBR SPI findings.

Throughout the 20th century there were numerous assertions that competition by states was placing shareholder rights in jeopardy. In 1927 Adolf Berle, co-author of *The Modern Corporation and Private Property*, said that unless managerial power was subject to equitable control by the courts "the interest of anyone who purchases or contracts in respect of shares of a Delaware corporation is so hazardous from a legal point of view that no well informed person would care to run the risk."[266] John Flynn, in a 1930 *Atlantic Monthly* article explaining "Why Corporations Leave Home" for Delaware, said the state's laws were

[265] COX & HAZEN, *supra* note xx, § 11.11.

[266] A.A. Berle, *Investors and the Revised Delaware Corporation Act*, 29 COLUM. L. REV. 563, 581 (1929).

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liberal "to the point of glaring laxity."[267] Wiley Rutledge observed in 1937 that numerous states were following "the lead of Delaware", meaning

> "The individual shareholder now has largely a 'pig-in-a-poke.' His old vested rights are gone or are going. He is made more dependent with each new statute upon the desires of the management…."[268]

Ernest Folk, who played a leading role in the revision of Delaware corporate law that led to the enactment of the Delaware General Corporation Law of 1967, said in 1968 of the approach taken "We do not seek to protect shareholders, creditors or others; rather we limit their rights and remedies. We constantly enlarge the rights and freedom of management."[269] Cary, in his landmark 1974 article on regulatory competition's impact on corporate law, indicated that the "race for the bottom" had "watered the rights of shareholders vis-à-vis management to a thin gruel."[270]

What forms of shareholder protection were abrogated or compromised to elicit such forceful rhetoric? There were throughout the 20th century various changes to the law both in Delaware and elsewhere that bolstered managerial freedom of action. Did these compromise shareholder rights in the robust manner implied by the "race" rhetoric used in relation to regulatory competition by states?

Within two years of Delaware's 1899 enactment of a new general incorporation statute designed to attract incorporation business,[271] Delaware was revising the legislation to enhance managerial flexibility, adding a new section permitting a corporation's certificate of

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267 John T. Flynn, *Why Corporations Leave Home*, ATLANTIC MONTHLY, Sept., 1932, 268, 272.

268 Wiley B. Rutledge, *Significant Trends in Modern Corporation Statutes*, 22 WASH. U.LQ. 305, 337 (1937).

269 Ernest L. Folk, *Some Reflections of a Corporation Law Draftsman*, 42 CONN. B.J. 409, 415 (1968). On Folk's role in the lawmaking process, see Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861, 865-68 (1969) [hereinafter Comment, *Law for Sale*].

270 Cary, *supra* note xx, at 666.

271 *Supra* note xx and related discussion.

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incorporation to contain any provision not demonstrably in violation of the statute.[272] The process continued in 1917, when directors of a Delaware corporation were explicitly authorized to sell all or substantially all of the corporation's assets so long as such action had been approved on a majority vote by the shareholders.[273] Also, following a precedent set by New York in 1912,[274] in 1917 Delaware allowed corporations to issue shares with no par value.[275] Berle claimed in 1928 that the institution of no-par stock probably was "the greatest single step in transferring control of property rights from stockholders to corporate managements…."[276] This change to the law did theoretically make it easier for managers to benefit favored investors inappropriately by issuing new shares cheaply.[277] Still, the beneficial flexibility of no par value shares quickly became apparent,[278] and by the time the 20th century drew to a close par value was an anachronism.[279]

Otherwise, few amendments were made to Delaware's corporation statute until the late 1920s, when major changes were made to provisions governing corporation finance.[280] Delaware corporations were then explicitly authorized to issue stock options and to create large blocks of authorized but unissued "blank stock" for which managers could tailor the

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272 S. Samuel Arsht, *A History of Delaware Corporation Law*, 1 DEL. J. CORP. L. 1, 9 (1976) (discussing Act of March 7, 1901, ch. 167, § 5).

273 *Id*. at 10 (discussing Act of April 9, 1917, ch. 114, § 20). This amendment was made in response to a court decision throwing doubt on whether a company could sell all its assets with less than unanimous shareholder approval. *Id*.

274 Wells, *Modernization*, *supra* note xx, at 606.

275 Del. Laws 1917, c. 113, § 3.

276 ADOLF A. BERLE, STUDIES IN THE LAW OF CORPORATION FINANCE 64 (1928).

277 For an overview of the perceived risks created by the creation on non-par stock, see Wells, *Modernization*, *supra* note xx, 607.

278 See, for example, HENRY W. BALLANTINE, BALLANTINE ON CORPORATIONS 473 (2d ed.1946) ("The great feature of no-par shares is price flexibility….").

279 Venture Stores, Inc. v. Ryan 678 N.E. 2d 300, 303 (Ill. Ct. App., 1997); see also COX & HAZEN, *supra* note xx, § 16.15 ("'Par value' is a rapidly vanishing feature of corporate law.") *Cf*. BAYLESS MANNING AND JAMES J. HANKS, LEGAL CAPITAL 30 (3rd ed., 1990) (…par stock continues to be in majority use.")

280 Arsht, *supra* note xx, at 11.

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rights and preferences to meet market conditions at the time of issuance.[281] Berle characterized these and related changes to the Delaware legislation as "dangerous" and "unworkable."[282]

The 1933 Illinois Business Corporations Act did not bolster managerial discretion or erode shareholder rights dramatically as compared with other legislation of the time, which is not surprising given that it had been promised that the new law would protect shareholders from ongoing abuses.[283] As we have seen, for instance, the 1933 Illinois Act preserved pre-emptive rights even though the California General Corporation Law of 1931 had set a precedent for abolition of such rights[284] and retained mandatory cumulative voting even though Delaware never went further than authorizing companies to "opt in" to this method of director selection in 1919.[285] Also, while Delaware explicitly authorized the issuance of share options in the 1920s, the 1933 Illinois Act did not do so and also provided directors with less scope to carry out share buy-backs and declare dividends than Delaware was offering.[286] Illinois then refrained from revising its incorporation statute substantially until the enactment of the Illinois Business Corporations Act of 1983.[287]

Delaware periodically tweaked its corporate law statute between 1929 and 1967, but did not disturb the basic structure until concerns arose in the mid-1960s that its dominant position might be under threat from other states seeking to compete for incorporations by

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281 *Id*.; Berle, *supra* note xx, at 565-73 (discussing Act of March 2, 1927, ch. 85; Act of March 22, 1929, ch. 135, § 6).

282 Berle, *supra* note xx, at 579.

283 *Supra* note xx and related discussion.

284 Ballantine, supra note xx, at 362-63.

285 *Supra* note xx and related discussion; Illinois Business Corporations Act 1933, § 28.

286 Ballantine, *supra* note xx, at 363, 365, 369.

287 Van Vliet, *supra* note xx, 2-3.

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changing their laws to "out-Delaware Delaware."[288] Delaware enacted a revised statute in 1967 referred to by one critic as "a modern round of state charter-mongering" [289] and by another as "a prime exemplar of the trend away from shareholder control."[290] Whether such forceful rhetoric is justified is open to question. We have already considered some changes made by the 1967 legislation, these being the displacement of the presumptive rule concerning the existence of pre-emptive rights and, in the related party transaction context, the deeming by statute of approval by informed, disinterested directors to have the same insulating effect as a good faith shareholder vote.[291] Other changes cited by commentators arguing the 1967 Act diluted shareholder rights substantially were hardly radical, as they compromised in some respects the scope for appraisal rights in companies registered on a national stock exchange or having more than 2,000 shareholders[292] and empowered corporations to purchase directors' and officers' insurance.[293]

Delaware has not engaged in a wholesale revision of its corporation statute since 1967. In the years since, the 1986 enactment of § 102(b)(7) of the Delaware General Corporation Law has been the manager-friendly change to Delaware law that has attracted by far the most attention.[294] This provision, which authorizes Delaware corporations to include

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288 Arsht, *supra* note xx, at 11; Joel Seligman, *A Brief History of Delaware's General Corporation Law*, 1 DEL. J. CORP. L. 249, 279-82 (1976) (quoting "out Delaware Delaware" from Tom Downs, *Michigan to Have a New Corporation Code*, 18 WAYNE L. REV. 913, 914 (1972)).

289 Seligman, *supra* note xx, at 279.

290 Comment, *Vestiges of Shareholder Rights Under the New Delaware Corporation Law*, 57 GEO. L.J. 599, 599 (1969) [hereinafter Comment, *Vestiges*].

291 *Supra* notes xx, yy and related discussion.

292 Comment, *Law for Sale*, *supra* note xx, at 872-73; Comment, *Vestiges*, *supra* note xx, at 608-9; see now Del. Code Ann., tit. 8, § 262(b)(1). These commentators used sweeping language to characterize the change ("effectively eliminate appraisal rights": Comment, *Law for Sale*, supra note xx, at 873; "abolition": Comment, *Vestiges*, *supra* note xx, at 609). In so doing they glossed over the fact that appraisal rights were preserved in a stock-for-stock merger: Delaware General Corporation Law § 262(b)(2).

293 Comment, *Law for Sale*, *supra* note xx, at 884-85; Comment, *Vestiges*, *supra* note xx, at 603.

294 Brown, *supra* note xx, at 331-32 (treating the provision as manager-friendly); Edward P. Welch and Robert S. Saunders, *Freedom and its Limits in the Delaware General Corporation Law*, 33 DEL. J. CORP. L. 845, 854 (2008) ("the most significant post-1967 amendment").

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a provision in their certificates of incorporation that limits or eliminates for directors personal liability arising from breaches of the duty of care, was enacted in response to concerns that escalating directors' and officers' insurance costs could result in honest directors being exposed to a substantial and unjustified risk of having to pay damages out of their own pocket.[295]

One other area where the ADRI, ASDI and CBR SPI might not capture significant changes in shareholder protection concerns states' antitakeover statutes. Following an unprecedented burst of hostile takeover activity in the 1980s, a majority of states adopted statutes that empowered boards to impede unwelcome takeover bids by, for instance, allowing boards to take into account "other constituents" beyond shareholders in making business decisions and removing for a period of time would-be acquirors' voting rights.[296] Anti-takeover statutes seemingly reduced shareholder value,[297] and several commentators concluded their rapid adoption was evidence for a race to the bottom.[298] The indices deployed here therefore may have missed an area where shareholder protection was significantly weakened over time. On the other hand, the antitakeover measures adopted in the 1980s arguably did not mark a fundamental departure from historical trends but rather confirmed that boards had substantial discretion to thwart takeover attempts. In Delaware, for instance—admittedly a state which belatedly adopted a weak antitakeover statute and one

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295 *Id.*

296 For reviews of these laws, see Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1828 (2002); Michal Barzuza, *The State of State Antitakeover Law*, 95 VA. L. REV. 1973, 2040-42 (2009).

297 *See, e.g.*, Subramanian, supra note xx, at 1800 ("Econometric analysis of these statutes consistently find that they reduce shareholder wealth"); *Amanda Acquisitions Corp. v. Universal Foods Corp.*, 877 F.2d 496, 500 (7th Cir. 1989) ("[W]e believe that antitakeover legislation injures shareholders") (Easterbrook, J.).

298 The effects of antitakeover laws have attracted great scholarly attention. See Ahdieh, *Trapped*, supra note xx, at 299 ("Among the most significant sources of contention in the 'race debate' of the last three decades have been state antitakeover statutes."). Important works addressing antitakeover statutes and state competition include ROMANO, GENIUS OF AMERICAN CORPORATE LAW, supra note xx, at 52-84; Romano, *States as a Laboratory*, supra note xx, at __; and Lucian Bebchuk, Alma Cohen, and Allan Ferrell, *Does the Evidence Favor State Competition in Corporate Law?* 90 CAL. L. REV. 1777, 1781-83 (2002).

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where takeover law was largely made by the courts—takeover doctrine developed during the 1980s may have circumscribed rather than enhanced board discretion.[299]

The foregoing synopsis indicates that while some significant shareholder protections have been eroded, the changes have not been dramatic compared to changes to the legal rules we have already taken into account by way of our historical analysis of the ADRI, the ASDI, the CBR SPI and Sears' 14-point list. Correspondingly, it appears that while changes to state law did erode shareholder protection to some degree, at least from 1900 onwards the "race" terminology applied to trends concerning state corporate law is somewhat hyperbolic.

Focusing on changes to the law occurring in the 20th century may in fact not be the appropriate way to ascertain why there was a general consensus that competition between states for incorporation business had caused a substantial erosion of shareholder rights. The key point instead may have been that affirmative statutory shareholder protection was never a prominent feature of 20th century state corporate law. The two pivotal themes in the New Jersey corporation law of 1896—from which Delaware's 1899 statute was derived—were to remove limits formerly imposed on corporations and to increase dramatically the scope that those incorporating and acting as directors of companies had, relative to shareholders, to dictate the internal structure and operation of corporations.[300] As far back as 1899, then, Delaware's general incorporation statute failed to govern in any material way the responsibilities of management to shareholders or afford substantial rights and remedies to

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[299] Compare, e.g., *Cheff v. Mathes*, 199 A.2d 548, 556 (Del. 1964) (effectively applying the business judgment rule in the context of takeover defenses) with *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955-56 (applying two-prong, more searching test for determining board use of defensive tactics in takeover attempt); *see also* COX & HAZEN § 23.6. It is true that "first generation" takeover statutes adopted prior to the 1980s may have provided protection against takeovers exceeding that available previously but these typically failed to pass constitutional muster. See Edgar v. MITE Corp. 457 U.S. 624 (1982); Ahdieh, *Trapped*, supra note xx, at 300 ("Enthusiasts of federalism . . . have pointed to reduction in the levels of resistance condoned by successive generations of state antitakeover statutes").

[300] Wells, *Modernization*, *supra* note xx, at 584.

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dissident shareholders.[301] Correspondingly, the "race" that has ostensibly characterized the development of state corporate law in the United States may well have been largely over just as it started.

This revised characterization of the chronology of U.S. corporate law is not novel. Bill Bratton and Joe McCahery have said "Legislative innovation at the state level never again reached the intensity experienced in the wake of New Jersey's competitive initiative."[302] They have observed similarly "the structure of state [corporate] law showed remarkable stability between 1896 and the takeover wars of the 1980s, and that structure was determined in a manifestly competitive environment," referring with respect to the 1980s to the introduction of anti-takeover legislation in that decade.[303] Cary has similarly suggested that that Delaware had a "modern and 'liberal' act" by 1915.[304]

These observations accord with our ADRI, ASDI and CBR SPI findings, at least with respect to state law – there was no dramatic erosion of shareholder rights during the period we focus on. As we have just seen, some statutory amendments occurring in the 20th century elicited strong reactions. Nevertheless, Bratton and McCahery's characterization of 20th century rounds of innovation as "minor adjustments to a stable legal regime"[305] appears to be on the mark. As our shareholder protection indices indicate, shareholder rights were not fundamentally compromised by changes to state law after 1899.

If a substantial erosion of shareholder protection in fact was not a hallmark of state corporate law in the United States from 1899 onwards, was there ever a robust race to the

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301 Kenneth K. Luce, *Trends in Modern Corporation Legislation*, 50 MICH. L. REV. 1291, 1298 (1952); Arsht, supra note xx, at 8 ("…the 1899 Act was largely silent with respect to the standards to be adhered to by officers and directors in the performance of their duties….)"

302 Bratton and McCahery, *Equilibrium*, *supra* note xx, at 631.

303 *Id.* at 646.

304 Cary, *supra* note xx, at 665.

305 Bratton and McCahery, *Equilibrium*, *supra* note xx, at 635.

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bottom? To the extent it did happen, the closing decades of the 19th century stand out as the crucial period. It has been said that "American corporate law lost a substantial part of its regulatory content from the 1880s"[306] and that "the position of minority shareholders if anything became weaker" as the 19th century drew to a close.[307] We leave it to others to verify by way of leximetrics and otherwise these claims. From 1899 onwards, however, general trends concerning state corporate law in the United States appear to accord with our empirical findings that a "race" did not compromise fundamentally shareholder rights under state corporate law.

## VI. A RACE TO THE TOP?

Our leximetric analysis of trends concerning U.S. corporate law not only indicates that the erosion of shareholder rights under state corporate law was not as pronounced as is commonly supposed but also shows that once the federal dimension is taken into account the level of protection afforded to shareholders increased appreciably over time. One might correspondingly suppose that our findings show that there was a federally-led "race to the top." Any such contention would, however, disregard important contours of the debate concerning the United States' system of corporate law federalism. Considering why reveals that the meaning of a "race to the top" is not as straightforward as might be anticipated.

Given that the "race to the bottom" with state corporate law presupposes a sacrificing of shareholder rights to cater to managers desiring increased flexibility, it might seem to follow that a "race to the top" would imply fortification of shareholder rights. To the extent that this is correct, those who have characterized the development of corporate law as a race to the top should have treated federal intervention that pushed upwards scores in our ASDI

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306 P.M. Vasudev, *Corporate Law and Its Efficiency: A Review of History*, 50 AM. J. LEGAL HIST. 237, 260 (2008-10).

307 Naomi Lamoreaux, *Scylla or Charybdis? Historical Reflections on Two Basic Problems of Corporate Governance*, 83 BUS. HIST. REV. 9, 21 (2009).

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and CBR SPI indices as a welcome vindication of their stance. The reaction of "toppers" has in fact been largely the opposite.[308]

Roberta Romano, a noted corporate law academic, exemplifies the perceived disconnect between a "race to the top" and federal intervention. As the author of a 1993 book on corporate law and competitive federalism entitled *The Genius of American Corporate Law*, she stands out as perhaps the most prominent advocate of the "race to the top" narrative.[309] She is also a prominent critic of federal intervention in the corporate law realm. For instance, she argued that with each of the corporate governance initiatives the Sarbanes Oxley Act of 2002 introduced for which a substantial scholarly literature existed the available evidence indicated the changes were unlikely to improve shareholder returns.[310]

Romano's stance is by no means an isolated one. As far back as 1982 Daniel Fischel was simultaneously denouncing the race to the bottom thesis and attacking proposals to use federal law to bolster the decision-making power of shareholders and require independent directors to constitute a majority on boards of publicly traded companies.[311] Judge Frank Easterbrook, a frequent co-author of Fischel,[312] suggested nearly 30 years later that SOX, with its promotion of independent directors and other mandated changes to corporate governance, might be reversing the direction of what had been a state-led race to the top.[313] Larry Ribstein, an expert on the forum shopping phenomenon that underpins Delaware's

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308 On the "topper" terminology, see Henderson, *supra* note xx, at 711, 716.

309 ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 148 (1993) ("The best available evidence indicates that, for the most part, the race is for the top and not the bottom in the production of corporate laws.")

310 Romano, *Regulatory Competition*, *supra* note xx, at 215; Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1529-43 (2005) (canvassing the empirical evidence relating to four key changes SOX made).

311 Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 919-23 (1982).

312 See, for example, FRANK H. EASTERBROOK AND DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

313 Frank H. Easterbrook, *The Race for the Bottom in Corporate Governance*, 95 VA. L. REV. 685, 691-99 (2009).

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success[314] and another advocate of the benefits of state-led corporate law, was also a critic of SOX generally and its promotion of independent directors particularly.[315]

Given the scepticism of federal intervention among advocates of the race to the top and given that changes initiated at the federal level, including reforms from the SOX era, boosted CBR SPI and ASDI scores for Delaware, Illinois and the MBCA, it is clear that the federally-led bolstering of shareholder protection is not the sort of race that "toppers" find attractive. Indeed, as we have seen, "race to the top" advocates have typically conceded that state-oriented competition for corporate charters eroded shareholder rights.[316] Why, then are "toppers" favourably disposed towards state oriented jurisdictional competition?

The admiration that race to the top advocates have for state corporate law is not a product of shareholder rights provided or not provided, which is what our indices seek to capture. Instead, for toppers the priority is that the law-making style associated with state-driven corporate law is superior to that of a federally-dominated process.[317] They believe that by virtue of the superior law-making process the outcomes will be better with state-driven corporate law regardless of the extensiveness of rights allocated to shareholders. As Ahdieh has argued when summarizing the logic underlying the "genius" of U.S. corporate law admired by race to the top advocates, "It is not, as such, about shareholders' versus managers' share of the corporate pie, but about the size of the pie in its entirety."[318]

Why is the style of law-making at state level so attractive to toppers? Some emphasize the nature of rules that states such as Delaware adopt. Federal intervention in the

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314 ERIN A. O'HARA AND LARRY E. RIBSTEIN, THE LAW MARKET (2009).

315 Larry E. Ribstein, *Markets vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 11-18 (2002) (critiquing key SOX provisions), 57-61 (advocating state-led corporate law) (2002).

316 *Supra* note xx and related discussion.

317 Ahdieh, *Trapped*, *supra* note xx, at 283-85, 294; Henderson, *supra* note xx, at 711-12, 725-26.

318 Ahdieh, *Trapped*, *supra* note xx, 285.

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corporate law realm is said to occur in the form of mandatory rules that limit choice and thus inhibit potentially beneficial private ordering. States, in contrast, reputedly take a business-friendly approach characterized by a bias in favor of incremental change and resistance to regulatory prescription.[319]

Why, though, do states choose to enact laws with these beneficial features? The decisive consideration, toppers tend to say, is that states face market discipline that the federal government does not. Fischel has argued, for example,

> "In the context of the market for corporate charters…only states (such as Delaware) which have corporation law that enable parties to maximize their joint welfare without undue regulatory interference will attract a high percentage of incorporations.
>
> Federal regulation for corporations would destroy the salutary effect of the market for corporate charters."[320]

Easterbrook has observed similarly "States can't harm investors...—if they make bad laws, capital migrates elsewhere…If Congress makes a mistake, it is not automatically undercut by market forces."[321] Or as Romano has said

> "In short, regulatory competition offers a distinct advantage over a single regulator in the corporate law setting: it better aligns the incentives of issuers, and of regulators, with the perspective of investors, and has thereby an increased likelihood of promulgating rules that investors prefer….(T)he feedback mechanism of firm

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319 See, for example, Hamermesh, *supra* note xx, at 1772-86; Romano, *Regulatory Competition*, *supra* note xx, at 216-17; Fisch, *supra* note xx, at 740-44; Sean J. Griffith and Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 BUS. LAW. 1, 8-9 (2005).

320 Fischel, *supra* note xx, at 921-22.

321 Easterbrook, *supra* note xx, at 698.

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movement across competing regimes spurs regulators to respond to the investor-derived preferences of firms."[322]

The ADRI, ASDI and CBR SPI do not purport to measure regulatory style. Instead, the focus is on the presence or absence of rules that can offer protection to shareholders. Indeed, given that enabling rules are typically ignored for the purpose of coding the three indices,[323] there might well be a bias against the sort of laws "toppers" favor. Correspondingly, our historically-oriented leximetric analysis does not provide an appropriate basis for evaluating whether the sort of race that advocates of this interpretation of state corporate law favor has been a dominant feature of U.S. corporate law over time. What our analysis does demonstrate conclusively is that a feature of the U.S. system of corporate law federalism which "toppers" dislike increased markedly in prominence, namely federal intervention. It also throws into sharp relief the fact that this trend ironically fostered what at first glance might be thought to be the result of a race to the top in the context of the literature on U.S. corporate law, namely a substantial bolstering of shareholder rights.

## VII. CONCLUSION

For decades, scholars and commentators have devoted a great deal of attention to perhaps the central and distinctive feature of U.S. corporate law, namely the ability of a corporation to choose which state to incorporate in and thus which state's law to be organized under. In so doing, they have argued bitterly over whether the choice this regime offers has led to competition between states for charters and, if so, whether such competition has produced a legal regime disproportionately disempowering shareholders to managers' benefit (and so been a "race to the bottom"), or instead has prodded states to develop corporate law that maximizes shareholder wealth (and so been a "race to the top"). These robust debates

322 Romano, *Regulatory Competition*, *supra* note xx, at 216.

323 *Supra* note xx and related discussion.

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have too often ended in stalemate, partly because there has been no clear way to establish whether one state's law was "better" than another's, nor to show whether a state law was becoming better or worse over time.

This Article makes at least three major contributions to these vital but too often stymied debates concerning jurisdictional competition in the corporate law realm. First, it presents a fresh way to track quantitatively the development of U.S. corporation law over time. Using indices originally developed to compare shareholder protections across nations, the Article charts the development of three vital bodies of U.S. corporate law, those of Delaware and Illinois and the Model Business Corporation Act, since the turn of the twentieth century. The insights this Article has provided indicate the sort of quantitative analysis engaged in may help to facilitate further fruitful research on the development of corporate law over time.

The Article's second contribution is to use quantitative analysis to cast new light on one of the fundamental issues of corporate law, namely the nature of jurisdictional competition between states. Our deployment of leximetric analysis indicates, for instance, there has been erosion of shareholder protections offered by state law over the past century. This erosion was generally modest, however, suggesting that if there was a meaningful race to the bottom, it did not occur during the twentieth century.

The Article's third and final significant contribution has been to put into context the federal role in corporate law. We demonstrate quantitatively that federally-oriented reform has bolstered considerably shareholder protection over time and indeed has more than off-set whatever diminution occurred due to state law changes. Today, shareholders, at least those in public corporations, are better protected by the amalgam of state and federal "corporation law" than were shareholders of a century or even a half-century ago. Our study

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correspondingly shows that there was not a debilitating race to the bottom in the period under scrutiny, at least once the significant effect of federal interventions is taken into account.

This does not mean there was a race to the top. While this Article indicates that corporate law offered shareholders greater protection overall over time, it is possible the costs of such protection may have outweighed the benefits. Proponents of the race to the top do not contend that state competition will produce substantial shareholder protection. Instead, they acknowledge that laws affording substantial autonomy to managers can yield positive outcomes for shareholders in terms of higher stock value. Clarification of this point illustrates how the leximetric analysis of corporate law in which we have engaged can facilitate our understanding of jurisdictional competition and the historical development of corporate law more generally.

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