

WHITHER FEDERALIZATION OF DELAWARE'S CORPORATE LAW?

By E. Norman Veasey

The question to be addressed is the extent to which there will be further intrusions by Congress into the international prominence of Delaware corporate law. That question should not be approached solely from a parochial and self-interested viewpoint. Rather, it requires a broad, rational and historic analysis.

James Madison, the “Father of the Constitution,” initially advocated at the 1787 Constitutional Convention that the new national government needed strong powers, including a veto power that could trump almost all state powers. But, as the historian, James Ellis, reminds us, “Madison and his colleagues lost the battle in the Constitutional Convention for their vision of a dominating national government, [eschewing] . . . even a sharp line delineating federal and state powers. It left that line blurred, as we know.” Madison, being very nimble, then went to the state ratifying conventions and trumpeted the blurred line between federal and state powers as a good thing. So, the unclear, but limited national government power carried the day.

Federal and state laws have coexisted reasonably well in managing the division of authority between federal disclosure regulation and state primacy over internal corporate affairs. As a result, Delaware has adopted a wide range of corporate innovations—most notably the establishment of a neutral body of experts to review and recommend changes to its corporation law and the cultivation of a cadre of judges and lawyers with special expertise in business law. This phenomenon has led to more than 60% of the Fortune 500 being incorporated in Delaware.

The United States Supreme Court has made it quite clear that Congress did not legislate a federal corporate law, and that federal courts, as well as the SEC, are not at liberty to fashion a kind of federal common law of corporations or otherwise to trump Delaware corporate law unless Congress expressly so provides. And Congress has not so provided. Yet, Congress has the constitutional power to take over Delaware corporate law to the extent it chooses.

Now the blurred line dividing national and state lanes of authority is being continually tested by Congress and sometimes federal agencies in an ad hoc, hasty, and random manner. These efforts are driven by political expediency and perceptions of problems, crises, vacuums, scandals, or other spasms thought by some to be in need of federal resolution.

In 2001 a wave of highly publicized scandals broke at prominent public corporations such as Enron, WorldCom, and Tyco. This catastrophe led to the passage of the Sarbanes-Oxley Act of 2002, a loose package of federal legislation, ostensibly intended to rein in corporate executives run amok, and to restore investor confidence.

Sarbanes-Oxley established some mandatory rules governing the internal affairs of publicly traded corporations. Not only were these rules arguably unrelated to the corporate scandals they were supposed to address, but also they represented a perceptible (albeit partial) shift in the established federal-state division of authority. Was this just the first step of federalization by Congress—the “camel’s nose in the tent?” Moreover, there are a number of other efforts pending in Congress to extend the federalization effort into

internal corporate affairs, such as “Say on Pay” legislation for corporate executives and a bill that would mandate disclosures of beneficial owners of stock.

In the corporate area, the policy question is whether the federal government is better equipped than the states, particularly Delaware, with its decades of experience and its ongoing expertise. Madison wrote presciently in *Federalist No. 46* that the federal-state balance should be changed only for manifest improvements:

[The] Federal and State governments are ... constituted with different powers and designed for different purposes. [The] ultimate authority ... will not depend merely on the comparative ambition ... of the different governments ... to enlarge its sphere of jurisdiction at the expense of the other Change can only result from such manifest and irresistible proofs of a better administration.

My speculation is that Congress may chip away at state corporate sovereignty, depending on the scandal or perceived need du jour. I think it is unlikely that Congress will totally preempt state corporation law—but it might! In my opinion, that outcome would make no sense for business, directors, stockholders, or foreign investment. Many leading scholars agree, including Federal Circuit Judge Ralph Winter, who has written that “state corporate legal systems do protect shareholders and that state regulation is generally preferable to federal regulation.”

Although I am mindful of the admonition to “be careful what you ask for,” I think we should not always be waiting for the next scandal to stimulate Congress into an unwise paroxysm of federalization. I think there should be a comprehensive, general analysis of federalism vs. federalization beginning with the corporate area.

* Ed. Note: This paper is a brief excerpt from an address by E. Norman Veasey, former Delaware Chief Justice, at the American Law Institute, May 20, 2008. A copy of the complete paper, entitled, “What Would Madison Think? The Irony of the Twists and Turns of Federalism” can be obtained from the author at e.normanveasey@weil.com.