THOUGHTS ON THE NORTH DAKOTA PUBLICLY TRADED CORPORATIONS ACT

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Given the topic of the day, and never having traveled to North Dakota, I thought it appropriate to find out a bit about the similarities and differences between our two states. My superficial internet-based inquiry led me to a conclusion all of you probably already know: Delaware is older, smaller, and lower than North Dakota. Delaware became a state on December 7, 1787, and is proudly known by Delawareans as "The First State." North Dakota became a state over 100 years later, on November 2, 1889. North Dakota is over thirty times the size of Delaware in total land area, but Delaware's population density is over thirty times greater than North Dakota's. The highest point in Delaware, known as the Ebright Azimuth, is nearly 300 feet lower than the lowest point in North Dakota, which is along the Red River. As some of you know, the state bird of Delaware, the Blue Hen chicken, is an animal close to my heart, and I was interested in the state bird of North Dakota, which I learned is the Western Meadowlark. That appears to be a fine animal, but with all due respect, no comparison to the mascot of my alma mater, the University of Delaware. While satisfying my curiosity about North Dakota's state bird, I discovered another similarity between our states that some of you may not know. North Dakota and Delaware share the same state beverage: milk.

More recently it appears that North Dakota and Delaware share an interest in corporate law and corporate governance. I guess it was natural, therefore, that my friend and former colleague, Dean Paul LeBel, invited me to deliver remarks about the new North Dakota Publicly Traded Corporations Act. I think Dean LeBel was hoping I would contrast it with the Delaware General Corporation Law, the corporate law of my jurisdiction, and offer criticisms of the NDPTCA. These remarks, however, will be far more modest in scope.

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A corporation, of course, is nothing more than an artificial structuring of the rights and responsibilities of a business' owners, the shareholders, as well as those chosen by the owners to act on their behalf, the directors and officers. To the extent that corporations excel over other business forms in the generation of wealth, they have become the dominant type of commercial organization. Similarly, to the extent that a particular allocation of rights and responsibilities within the strictures of the corporate form excels in the creation of wealth for its owners, that particular form will, again, prevail. This is the discipline of the market. I would like to speak to you today, then, about markets; how they affect corporate regulation, how they determine what forms corporations and corporate law may take, and how they determine the attractiveness of possible forums of incorporation.

To put the case, perhaps, with a crudity that does justice to the law of neither North Dakota nor Delaware, the North Dakota approach to issues of corporate governance is characterized by a belief that regulation of corporate rights and responsibilities can best be done by the state legislature, via statute, acting to protect the interests of shareholders as the owners of the corporation. The Delaware approach embodies the belief that the owners themselves are, through the flow of their capital, the best regulators of corporate governance, that the courts must vindicate the choices made by these corporate owners within a framework of common law fiduciary rights, and that the discipline of the market (that word again!) will ultimately provide the optimum level of shareholder rights.

It will not surprise you that I am a believer in the Delaware approach. As I mentioned, I have the feeling that I was invited here to criticize the North Dakota Act. But why would I do that? Any paltry criticism I or others might offer of an individual state's approach to corporate governance will be irrelevant: a flow of capital to or away from a jurisdiction will ratify or denigrate any statutory scheme far beyond our poor power to pass judgment. In any event, I am all for competition. I am all for different approaches to corporate governance being put to the test of real world conditions—in the "laboratory" of federalism I will discuss in a moment. I applaud the Legislature and the Governor of North Dakota for having the courage to put forth a novel approach to corporate law. I applaud as well the vision and entrepreneurial spirit of the "father" of this legislation, William Clark, who not only drafted the Act but attempted to see it implemented in his home state of Pennsylvania, then Vermont, and finally, successfully, here in North Dakota. Without his intellectual effort, and without his extraordinary perseverance, the North Dakota Act would never have come to be.

I have said I am in favor of different approaches to corporate regulation being given a real-world—that is, market-based—trial, and so I am, so long as it is at the state level. One of the destructive side effects of the current economic climate is that it has given Congress the impetus to intrude into the field of corporate governance, historically an area properly reserved for the states and governed by state law. The problem with regulation at the federal level is that it does not encourage various approaches, as represented by the statutes of North Dakota and Delaware, that we are discussing today. Just the opposite: regulation by Congress or the SEC stifles the kind of healthy experimentation that can lead to improvement in the law. We have seen the destructive effects of such "one-size-fits-all" legislative paroxysms arising during economic disruptions far less serious then the current one, Sarbanes-Oxley being the most obvious example of blunt and over-broad legislative populism driven by public anger inflamed by a sensationalizing press producing a cure worse than the illness. I spoke earlier of the flow of capital which may ratify either the North Dakota or the Delaware approach; overbearing federal regulation results in a similar flow—the market will not be denied—but unfortunately, having no domestic outlet due to the preemption of the arena by the federal legislation, the flow is from the United States, and to London and other foreign financial capitals.

But enough of federal misadventures. What of differing state approaches like the two before us? North Dakota now allows an incorporating entity to accept an entire slate of regulations designed to enhance shareholder control of the corporation; Delaware allows the entity to adopt such internal constraints in favor of shareholder control up to, but only up to, the extent the entity finds it in its interest to do so. In other words, what North Dakota coercively imposes, Delaware permits. Both our states' laws regulate only firms incorporating in our respective states, so corporations are insulated from the problem of having to follow conflicting rules. Because our federal system allows both the North Dakota and the Delaware approach to exist, the two statutes will be exposed to a marketplace of many individual actors, including corporate decision-makers as well as investors directing capital flow to these corporations. The market will eventually reveal which approach is a superior wealth-producer for investors.

This is the beauty of the federal system, what Yale Law School Professor Roberta Romano calls the "genius" of federalism. This facet of federalism embodies neatly the kind of self-organizing structures that economic philosophers like F. A. Hayek point out far exceed the ability of any group of individuals, acting deliberately, to allocate assets for the production of wealth. In an earlier time of financial crisis, in *New State Ice Co. v. Liebmann*[1], Justice Brandeis (otherwise no particular fan of free markets) stated that: "It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."[2] With the enactment of the Publicly Traded Corporations Act, in the arena of corporate governance and shareholders' rights, North Dakota has become the embodiment of Justice Brandeis' "single courageous state," and I salute you for it!

How do I think the marketplace will respond to these two models? Again, it will not surprise you to learn that I suspect the Delaware approach will ultimately prevail. Why? As I have already mentioned, where the North Dakota law is prescriptive, the Delaware statute is permissive. The many shareholder-friendly provisions of the North Dakota Act are available to Delaware corporations as well, should they choose them. Delaware's approach to the corporate charter and by-laws is contractual in nature; the incorporators can choose the basket of shareholder rights that they believe will strike the right balance between corporate stability and governability, on one hand, and shareholder rights on the other. How will they know if they have it right? By the same mechanism that will ultimately pass judgment on the different statutory approaches of North Dakota and Delaware: by the flow of capital into the corporation.

For instance, Delaware permits, but does not require, shareholders or directors to adopt by-laws that require that directors be elected by majority, rather than plurality, vote, and that such provision may not be repealed by the directors. Although our statute does not coerce, a majority of Fortune 500 companies incorporated in Delaware have implemented this option. Similarly, Delaware law permits, but does not require, corporations to provide that the election of the board of directors be unified, rather than staggered. North Dakota imposes this requirement by statute. Despite Delaware's permissive approach, staggered boards are disappearing in Delaware as shareholders demand their elimination. Because shareholders control the flow of capital, the elimination of staggered boards is brought about by the private ordering of actors participating in the activities of the firm—that is, by market mechanisms—and not by the prescriptive power of the legislature. The same phenomenon is occurring with respect to poison pill provisions: Delaware allows private ordering of the relationship between managers and stockholders, and as the absence of a poison pill

1. 285 U.S. 262 (1932).
2. *New State Ice Co.*, 285 U.S. at 311.

becomes important to shareholders, corporate by-laws increasingly eliminate them. Thus, I see the privately-ordered charters and by-laws of Delaware as every bit as "shareholder friendly" as the regime imposed on corporations under the North Dakota law. More so, in fact, to the extent that the market insures that eventually the corporation will "get it right," that is, come up with that combination of streamlined governance and shareholder rights which best leads to the formation of wealth. After all, there is no "right" of shareholders more valuable than to be among the owners of a corporation that generates wealth!

Under what set of assumptions would North Dakota's prescriptive approach be superior to what I see as the wealth-enhancing privately-ordered Delaware approach? If the assumption is that the full panoply of shareholder rights mandated by North Dakota is superior to any sub-set of those rights, a corporation can, and would have an incentive to, simply choose all those rights from the Delaware menu. If the assumption is that shareholders are powerless vis-à-vis managers, then the managers will simply choose to incorporate in Delaware without the shareholder protections, so as to keep the shareholders at heel. In this "race to the bottom" scenario, Delaware would once again come out ahead. Even if such an overbearing set of managers wished to incorporate in North Dakota, they could choose to opt out of the new statute entirely.

The assumption, therefore, must be that shareholders have enough power to ensure the selection of a full set of regulations if offered ready-made, a la North Dakota, but not sufficient power to negotiate a private ordering of rights under the Delaware market-based system. In that case, only under the prescriptive system offered by North Dakota will shareholders be able to impose a regime that will maximize their rights and at the same time their wealth. Of this proposition, I must say, I am skeptical.

But I am, of course, biased. Not alone by being a Delawarean, but by being a common-law judge, as well. As a common-law jurist, I tend to believe that the organic growth of a body of law is superior to the strictures of a Code Napoleon, with its overweening specification, definition, categorization, and prescription of every imaginable act. To my admittedly-prejudiced eye, the North Dakota statute has that look: the look of a field of action so thoroughly occupied by legislative fiat that creativity is crowded out. It is the genius—if I may use that phrase again—of the common law that legislative pronouncement is replaced by considerations of the duty of one actor to the other. This idea of duty forms the basis of the American model of common law: managers owing fiduciary duties of loyalty, good faith, candor, and care to their shareholder-principals. Unlike the positivist North Dakota statute—chock-full of mandatory terms specifying how corporations must go about their business—under Delaware's equitable principles corporate decision-makers are free to act as they find best, within the strictures of their fiduciary duties. This maximizes freedom and creativity while protecting shareholder interest by requiring that that freedom and creativity be conducted for the benefit of the shareholders. That is what I refer to as the genius of the common law.

Such a system, of course, depends heavily on the exercise of independent judgment by the judiciary. Where the limitations on management actions are defined by a judicial interpretation of fiduciary duty—rather than by an exhaustive list of "dos" and "don'ts" prescribed by the Legislature—the system will operate only as well as the judges are skillful. Delaware was fortunate that, when it first enacted its equitably-based general corporate law over a century ago, it had in place a specialized court—the Court of Chancery—that was something of an anachronism, a court specializing in equity law. The existence of a court of specialists in trusts and equitable relations gave Delaware an advantage then and, in all modesty, continues to give it an edge in corporate law today. No matter how brilliant its drafters, no matter haw far-sighted its legislators, no code-based system can offer the flexibility and nuance of a common law court, aided by able counsel, reacting to each individual question of corporate governance put before it by interested parities with a stake in the outcome. Next to this system, legislative action is a blunt tool indeed.

The beauty of a decisional-law system like that of the Court of Chancery is that it allows protection of shareholder rights in a way that encourages shareholder confidence, through an incremental legal development using specific factual situations, while still encouraging broad action and innovation by corporate officers and directors, protected under our law by the business judgment rule. The judge-made law created by the Court of Chancery and by the Delaware Supreme Court is a much finer instrument, for good or for ill, than bright-line statutory pronouncements—a scalpel as opposed to the legislative axe.

It appears to be among the intentions of the North Dakota law to blunt the advantage that Delaware receives, as a locus of incorporation, from its well-regarded court system, by enacting a detailed code that makes legislators, not judges, the prime actors in the system. Mr. Clark, I believe, has made this argument explicitly. I have two reasons to doubt the success of this project. First, I doubt any regulations can be comprehensive enough and tightly-drafted enough to be free of ambiguities that require interpretation by judges. Second, assuming that is possible, it would so restrict corporate action that companies operating under those requirements would be at a significant competitive disadvantage. But if I am wrong, the experiment you have started here will soon demonstrate it!

Note that the system of corporate governance in a common law system as I have described it—where corporate managers are free to act as they see fit, bound by the strictures of their fiduciary duties owed to their shareholders—is the direct analog of how freedom works in a market system. In this system, participants are free to retain, sell, and use their property as they see fit, constrained by certain legal requirements (individual ownership of property, the binding nature of contracts, the requirement that representations not be fraudulent, etc.). In fact, the common-law approach to corporate governance is simply another kind of market, in which corporate managers are free to make decisions to use resources, conduct business, and, if they can, create wealth, constrained by broad fiduciary duties rather than by rigid and narrow prescriptive law. If they succeed, they will attract capital and prosper. If they fail, capital will flow elsewhere.

Thus we have come full circle. The federal system is a marketplace of ideas expressed through state legislation. I applaud North Dakota for having entered with a novel approach to corporate law, thus expanding the range of choices available and improving the market. That is one market. A second market is created by the methodology of the Delaware General Corporation Law, in which Delaware permits corporations to choose from among a wide array of possible combinations of shareholder powers in the realm of corporate governance, a marketplace in which those combinations perceived best at producing wealth for shareholders prevail over other forms. A third is the marketplace created by the wide sphere within which managers may make decisions in a common-law jurisdiction where shareholder protections are defined by fiduciary duties, rather than a rigid code, and in which firms prosper or fail accordingly.

As I have made clear, I favor a market approach over the alternative, because, after all, we are dealing here with corporations, and if a market approach is not optimal, then we have problems more fundamental than determining how best to advance shareholder rights! In any event, the differences between our two approaches are material enough that, if I am wrong, we will soon know it. Let the contest begin, let the marketplace of federalism do its work, and let the best system prevail![*]

[*]I would like to thank Sam Glasscock (who serves with me on the Court of Chancery as the Master in Chancery) and James M. Belger (who served as my Law Clerk for the 2008-2009 term) for their invaluable suggestions for and assistance with this speech. All errors are mine, however.