

Capitalist Punishment

By John Gapper
Financial Times
January 29, 2005

A quirk of history means a court in the small state of Delaware has a large role to play in keeping corporate America in line. The five chancery judges once had a reputation for being soft on big business but that all changed with Enron and Conrad Black

The red tail-lights shine on Interstate 95 as the November afternoon fades. Judge Leo Strine, 40-year-old Wunderkind of US corporate law, is heading north towards Philadelphia to teach a class at the University of Pennsylvania. He is at the wheel of a Ford Explorer that has two child seats fitted in the middle row and soccer balls and equipment strewn across the rear.

Strine is a vice-chancellor of the Delaware Court of Chancery, which has jurisdiction over most US companies, and he is not afraid to speak his mind. One Delaware lawyer says: "Leo writes too much and talks too much. He does everything too much." Strine concedes the point. "My opinions are too long. They are - it is a fault of mine. People raise arguments and I am not a big fan of saying: 'I find this unconvincing, period.' To me, that is not really treating with the argument."

The judge is not finished. "I think you need to tell a story. I want people to be able to follow my train of thought. You are never going to get everyone agreeing with you, but I want them to follow what I was doing and understand it, and be able to say: 'You know, Strine, I was with you until here and then when you made that move, I understand why you did it, but I disagree with it.'"

Strine is no ordinary judge. He works with disarming directness and speed, bouncing back replies to his e-mails within minutes. When in his Wilmington office, decorated with several big posters of the singer/songwriter James Taylor, he often answers his own phone. In the official picture of the five chancery judges, four wear polished black shoes and Strine wears brown steel-tipped boots. The mention of the name "Leo" to anybody connected with Delaware law evokes a smile of rueful admiration.

There have been brilliant young judges on the Court of Chancery before. The outstanding one was Collins Seitz, who in 1952 became the first US judge to order the desegregation of public schools. Seitz's judgment, made at the age of 38 when he was chancellor (the court's senior judge), was affirmed by the US Supreme Court two years later in the landmark *Brown vs Board of Education* ruling. A painting of Seitz hangs in Strine's court, opposite a 19th-century portrait that Strine likes because the judge in it resembles Sting.

But there has never been one quite like Strine. "I think Leo is an extraordinary talent. No one I know of is more dedicated, or can produce the work he can in such a short period of time," says Myron Steele, chief justice of the Delaware Supreme Court. "The only thing I would ever ask Leo to do is, during the course of an evening, let someone else say something. I love listening to him, but please, not all night."

For all his intellectual bravura, Strine would probably still be unknown outside the Delaware bar, but for two events. One was the tide of US corporate scandal, involving malfeasance at companies such as Enron and WorldCom. That thrust the court into the limelight because some 60 per cent of Fortune 500 companies are incorporated in the state. The second was the misbehaviour of Conrad Black, the larger-than-life former proprietor of The Daily Telegraph, The Jerusalem Post and Chicago Tribune.

Lord Black was accustomed to shrugging off questions about the mingling of his personal finances with those of his Delaware- incorporated Hollinger International. But his efforts to do so in the Wilmington witness box during a struggle over control of Hollinger failed. As Strine puts it: "I will say to people when they are avoiding answering the question: 'I am giving you a last chance. Mr Black has asked you this six times. Is it this or is it that?'... I am not big on playing pretend. If I think it is really wrong and intentionally wrong, I will state that."

The result was a 134-page judgment last February that not only stopped Lord Black selling his titles behind the backs of Hollinger's directors, but was also a gripping narrative of corporate wrongdoing studded with vivid condemnations. Black, Strine wrote, had behaved "in a cunning and calculated way... suggested an outrageous strategy... breached his fiduciary and contractual duties persistently and seriously". Strine was dismissive of Black's evidence in court: "On more debatable points, I found Black evasive and unreliable."

As usual at the Court of Chancery, the judgment had to be written quickly - there is a 90-day deadline on written opinions to avoid prolonged uncertainty for businesses involved in court cases. At the Supreme Court, Steele had to review a related ruling by Strine immediately to prepare for a possible appeal. "I can remember reading it as it came through the fax machine, page after page, thinking to myself, 'How did he do this?' Whether I agreed with his tone, which to be fair I had some problems with, on the law he was correct. I was just virtually in awe of the way he could spin it out in the way he did, almost flawlessly. It was an extraordinary piece of work."

In terms of legal precedent, the Hollinger judgment was unremarkable. But it sent a loud signal about the shifting mood in Delaware. The state and its courts have always been regarded as being friendlier to the managers who run companies than to shareholders. But the Hollinger judgment, and others involving Walt Disney and the software company Oracle, upset conventional wisdom. Both in tone and substance, Delaware's judges show signs of losing patience with bosses.

That means a lot to US business because most companies are incorporated in Delaware, even if their headquarters and operations are elsewhere. As a result, civil legal disputes over how they are run, and whether their chief executives are acting in good faith towards shareholders, end up in the chancery court. The five judges - a chancellor and four vice-chancellors including Strine - thus oversee the day-to-day affairs of US capitalism.

Delaware acquired this position of influence in a strange way. It is a small state on the eastern coast, next to Maryland and Washington DC. It is the 45th most populous of the 50 states and ranks 49th in physical size. DuPont, the chemical company, is its best-known corporation. But that is the closest Delaware gets to being identified with a particular industry (apart from corporate law) in the way that California is home to Silicon Valley.

The state's rise was triggered by the election of Woodrow Wilson as governor of New Jersey in 1910. Many trusts - then the dominant form of corporation - were based in New Jersey because of its accommodating state laws. But Wilson, a progressive who as US president went on to pass the 1914 Sherman Antitrust Act, tightened New Jersey's corporate regulations and passed an employer liability law. Many New Jersey corporations reacted by striking out across the border to Delaware.

Once there, they found themselves under the charge of Delaware's unique chancery court. The court traces its origins to the King's Chapel in feudal England, which judged matters outside common law. The English High Court of Chancery, which succeeded the King's Chapel, was dismantled in 1875, but Delaware's version, founded in 1792, survives. It was established to deal with disputes involving rulings on fairness and equity, rather than the strict application of law. The court's judges still pride themselves on applying common law - offering judgments tailored to the facts of each case rather than establishing broad precedents.

Corporations and their lawyers soon warmed to the court. Unlike in two-thirds of states, Delaware judges are appointed rather than elected. There has to be a balance of judges who are registered as Democrat or Republican voters, but the nomination process tends not to be partisan. The judges also sit without juries, which eliminates the chance of a corporation's fate being decided by a populist jury. Above all, the court took the view that it should not try to second-guess managers, provided that they had acted in good faith - its "business judgment rule".

Its focus on efficient and speedy settlement of corporate disputes, combined with an inclination towards letting managers manage, drew other companies towards Delaware. The flow quickened after 1985, when the US was struck by the leveraged buy-out craze and many corporations faced hostile bids. The Court of Chancery made a series of judgments upholding the right of corporate executives to resist hostile takeovers, at least temporarily, with "poison pill" defences - a threat to flood the market with extra shares.

This reinforced Delaware's reputation for being deliberately soft on managers in order to attract business. All the 600,000 companies incorporated there pay a franchise tax, and a third of state revenue comes from corporate law-related businesses. Delaware makes great play of ensuring its laws remain up-to-date and attractive for companies considering incorporation. Indeed, officials make no bones about the importance of attracting companies. "We are a small state, so the prestige means a lot to us," says Ruth Ann Minner, Delaware's governor.

The state's reputation goes back a long way. When it passed its first corporation law in 1899, it was accused of being a "little community of truck-farmers and clam-diggers... determined to get her little, tiny, sweet, round, baby hand into the grab-bag of sweet things before it is too late". In 1974, William Cary, a former chairman of the Securities and Exchange Commission - the main federal financial regulator - made a scathing attack on the way in which "a pygmy among the 50 states prescribes, interprets, and indeed denigrates, national corporate policy".

Delawareans do not see things that way. They prefer to be seen as benefiting from the court's expertise and general philosophy, rather than indulging in a "race to the bottom", as it is sometimes termed. "Here, corporate law is an industry that is important unto itself, and we know that if we are perceived as unfair, it matters," says Strine. "The two key constituencies are stockholders and management, and we more or less go up the fairway because if we go up either side, it would hurt us. It may be fair to say we are somewhat biased in favour of management, but we cannot go off in either direction." He says that Delaware law protects shareholders' rights more than any other US jurisdiction. Whatever the rights and wrongs of Delaware law, its strategy has been highly successful. Figures compiled by Lucian Bebchuk, a Harvard University law professor, show that 68 per cent of non-financial corporations that went public between 1996 and 2000 incorporated in Delaware. Virtually every company that incorporates outside its home state now chooses Delaware.

But these are difficult times for the First State - its nickname because it was the first of the 13 colonies to ratify the US constitution in 1787. Not only did the public mood towards corporate executives harden following scandals at Enron and other companies, but also the federal government responded by making a big incursion into Delaware's sphere of influence. The Sarbanes-Oxley Act of 2002 established new regulations governing how corporations should be run and who should sit on boards of directors.

Shareholders and corporate governance activists have also become more aggressive in pressuring managements that they believe are not acting in their best interests. A notable case is that of Walt Disney, which faced shareholder suits after Michael Eisner, its chief executive, allowed his number two, Michael Ovitz, to receive Dollars 140m following his dismissal in 1996. The court has been under pressure to take such complaints seriously, rather than dismissing them as matters of business judgment.

After stopping off at Starbucks to buy a large iced coffee with a green straw, Strine strides into the law school to find Michael Wachter, the professor with whom he

will teach the class. The long-awaited Disney trial is due to start the next day under William Chandler, the court's chancellor. When Wachter asks about the trial, Strine responds: "You know the real Disney story? Ovitz was sleeping with Minnie Mouse and Mickey got jealous, so they had to get rid of him. The chancellor told me that. That's the inside dope."

It is characteristic of Strine to start a conversation with a joke that challenges the credulity of the listener. He often accompanies his jokes with a piercing look, just short of a stare. Strine is naturally sociable and likes to engage with people, from law clerks to lawyers, students and professors. He also likes to test them out. He tends to stand close: far enough away to avoid them feeling uncomfortable, but near enough to ensure that he has their undivided attention.

After a brisk run-through of the issues that Wachter intends to cover, the two men amble into the lecture room where the students are gathered. The class proceeds casually, with pauses as Wachter picks on students to answer questions. One student at the back scans internet celebrity gossip on his laptop while the professor runs through some arcane points of law. Strine largely keeps silent, sipping from his coffee, occasionally interjecting with a question or insight.

This is familiar territory for Strine, who graduated magna cum laude from this law school in 1988. Strine was brought up in Delaware after his father got a job as a department store buyer in Philadelphia and his Catholic family moved from Baltimore. He went to the local high school, where he became a keen soccer player and played centre-forward for the state. He now coaches his six-year-old son's soccer team, and watches UK Premiership games on cable television.

After law school, Strine worked as a clerk for two judges before joining the best-known US corporate law firm: Skadden, Arps, Slate, Meagher & Flom. But instead of pursuing a lucrative career in corporate law, he diverted in 1993 to become legal counsel to Tom Carper, Delaware's governor, who implemented policy reforms in schools and welfare of the kind advocated by Bill Clinton and the reformist wing of the Democrats. "Leo was really the intellectual force behind policy development in the governor's office," says Richard Geisenberger, an assistant secretary of state who worked with him in the Carper administration.

The role played to Strine's fascination with politics and policy, but he upset some traditional Democrats with his dogged pursuit of the governor's reform agenda. As a result, when Carper nominated him to the chancery court in 1998 - at the age of 34 - he faced some opposition. From a financial perspective, Strine would have done better to have been rejected. A lawyer of his talents could earn millions working for companies, whereas a Delaware vice-chancellor is paid Dollars 145,000 a year. He teaches law at the universities of Pennsylvania, Harvard and Vanderbilt partly to be able to afford to send his sons to private schools.

Even by Delaware's standards, the Walt Disney case has attracted plenty of attention. This time Strine is not at the centre of it. The morning after his law class in Philadelphia, the trial starts in Georgetown, a town of 4,700 people near the southern tip of the state. It takes two hours to drive from Wilmington to Georgetown, which sits on a hook of land poking out into the Atlantic. Here are Delaware's beaches, its farms, and the Sussex County chancery court.

Autumn has lingered in Georgetown, and there are pumpkins on doorsteps around the town. The courtroom, in a Dollars 4.1m building constructed in 2003, is crowded with lawyers and journalists from a broad selection of titles, including Vanity Fair. If it seems odd that the fates of some of the world's biggest companies are decided here, there is an explanation. Bill Chandler, Delaware's chancellor, comes from Sussex County and lives near Georgetown. A lean, courteous man, he is often to be seen jogging around the town during the court's lunch break.

In the weeks to come, a cast of Hollywood names, from Eisner to Sidney Poitier, the actor who formerly sat on Disney's board of directors, will come to Georgetown to give evidence. It is more convenient than it looks: there is an airfield nearby where private jets can land. But that does not make the experience comfortable for the Disney directors. They have to defend themselves against accusations from shareholders that they breached their duty of loyalty to the company, their first calling under Delaware law.

Along with the Hollinger judgment, the Disney case symbolises a change of mood in Delaware. It turns on whether Eisner and the other directors acted properly in allowing Ovitz, the former Hollywood agent who briefly became president at Disney in 1995, to take the Dollars 140m compensation. In 1998, Chandler dismissed the initial complaint against Disney from its shareholders, citing the business judgment rule. The size of Ovitz's severance package did not justify a court interfering in a board's decision, he ruled.

The situation changed when the Delaware Supreme Court allowed the complaint to be refiled in 2003. This time, Chandler considered it against a backdrop of corporate scandal in the US and regulatory action against directors. This time, he allowed it to go to trial because Disney's directors were accused of not paying attention when the Ovitz pay-off was raised at a board meeting. That could mean, he wrote, that they "failed to exercise any business judgment, and failed to make any good-faith attempt to fulfil their fiduciary duties to Disney and its stockholders."

Delaware's critics argue that the Court of Chancery took too long to realise that the kind of boardroom behaviour seen at Disney was unacceptable, and only woke up once the federal government had passed the Sarbanes-Oxley Act. Only then did the court scramble to change its ways. "There is a limit to how much states can favour corporate insiders because of the possibility of federal intervention. The climate, and the sense that we did not have sufficient limits on management, put pressure on Delaware to move," says Lucian Bebchuk of Harvard.

In his chambers during a break in proceedings, Chandler takes a different view. He admits that some of Delaware's recent rulings appear tougher on managers than in the past, but says that merely reflects the cases that have come before it. He cites the remark of Norman Veasey, Delaware's former Supreme Court chief justice, that its judges are "like clams in the water" - they wait for what comes along. "If there are cases that surprise people, I would submit that is because they have bad facts. It is not the law that has changed, or the judges," he says.

Despite having to wait for individual cases to come up before making rulings, the Delaware bench has one thing on its side in shifting ground: its unusual degree of collegiality. The judges often read each other's rulings before they are published and there are no obvious political divisions among them. Tom Carper not only nominated Leo Strine to the Court of Chancery, but also Stephen Lamb, who is a registered Republican.

When three vice-chancellors - Strine, Lamb and Donald Parsons, the newest member of the bench - gather over lunch at a restaurant near the Wilmington courthouse, they talk seamlessly, with one often finishing a thought about Delaware law for another. "In the end, the purpose of the corporation is to make money, to create wealth and jobs," says Lamb. Managers should be encouraged to take risks and not be punished if they "made the wrong decision in good faith, or they made the right one and it did not work out."

From the other end of the table, Strine interjects. "It is like Steve says. It is not in the interests of stockholders for every willy-nilly claim to be indulged. It costs a lot of money, and if disinterested stockholders can fairly have a vote, or something like that, our law gives deference to that." Lamb glances amiably over at Strine and then says: "I don't think I did say that, but I agree with it."

The court has little choice but to fall in line with federal law, as defined by the Sarbanes-Oxley Act, but the judges regard its dirigiste nature with disquiet. It imposes governance obligations that Delaware judges have recommended in particular cases, but mandates them for all corporations. "We allow these things to be made as business judgments. They have taken a lot of terrain about how corporations fulfil their duties and said: 'You now have to do the following things.' That could mean everything else gets pushed to the side," says Strine.

Delaware's judges would prefer simply to rein in abuses by insisting on strict compliance with the traditional duties of directors: loyalty to the corporation and due care in pursuing its interests. Strine insists that Delaware's strictures against "self-dealing" - cases in which an executive diverts wealth from the corporation to himself - cover many modern-day abuses. This accounted for the harsh tone of his judgment against Conrad Black. He also suggests that the rise in executive pay and the celebrity status of chief executives in the 1990s encouraged conflicts of interest.

Strine has been the most vociferous of the Delaware judges in criticising the rising level of executive pay and in questioning its effect on executives and employees. "I

think it really got to the point with some CEOs where they believed they were some form of royalty," Strine says. "Some of them want to come into the court by separate entrances and all that. I often say at directors' colleges: 'You realise if you overpay a CEO a million dollars a year, that is a Dollars 1,000 cheque you could give to 1,000 employees. What is going to create more motivation?'

"One of my favourite things when I talk to directors is to hear them say: 'You know, we would like to be good at this compensation stuff and we don't know how to do it.' I let them go on and then I say: 'You are telling me capital does not know how to hire labour. You are all executives at other companies. If you have a unit represented by a union, you do not hire a compensation expert and say: 'Survey the other companies and make sure our employees are being paid in at least the 75th percentile.' You hire some Philadelphia lawyer to go bust their chops."

For all of Strine's outspokenness, nobody questions his loyalty to the traditions of Delaware. "If someone were to say to me: 'Of the five members of the chancery court, who would be most likely to aggressively change the law?' I would say Leo, but it is not done like that," says Myron Steele. "I don't think Leo would do it without talking to other members of the court. If it were done, it would be in a way that was consistent with a doctrinal change on which everyone agreed. He is not a loose cannon."

To Delaware's critics, that embodies the problem. It is idle to expect a radical change in the way the court operates because of its respect for tradition, precedent and consensus. Delaware's supporters say US capitalism is bound to go through ups and downs, and the court can adjust in a nuanced way without overthrowing all that has gone before, or doing more harm than good. "The tightrope Delaware walks is between being seen to take seriously these harmful things but not over-reacting in a way that is going to make things worse," says Edward Rock, professor of business law at the University of Pennsylvania. "Where Washington has encroached on traditional Delaware areas, it seems to me largely a mistake."

For the judges, it is vital to preserve the flexibility to treat each case as it comes - as they have done since their state sprung to prominence in the last century. "We do not believe in one-size- fits-all decisions. There are all sorts of different sizes. A presumptive set of rules that forces everyone into a lockstep approach would be troublesome to a lawyer," says Chandler. He wants Sarbanes-Oxley to be tested before Washington considers further interventions. "I hope there will be a period to see how it works, and fix it if it has not worked."

So America's corporations will have to keep coming to Delaware to learn how far they can go. They can be reassured that even Leo Strine, its most outspoken judge, regards his job as keeping them not only honest, but also productive. "I am tremendously insecure about my abilities, whether I am going to do a good job," he says. "But you have to put aside your fears to give people good product in a timely manner. I am not Philip Roth or John Updike. They get to write a novel. I get paid to give people a reasoned answer that applies the law to the facts."

John Gapper is the FT's chief business commentator.