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DELAWARE, FEDERALISM, AND THE EXPERTISE-BIAS TRADEOFF

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Scholars have long debated whether competition between the states for corporate charters leads to good or bad corporate law. Recent contributions recognize that Delaware has such strong advantages over other states that inter-state competition is not tremendously strong (Bebchuk & Hamdani; Kahan & Kamar), although significant benefits from the interaction between states remain (McDonnell 2004b). Other recent contributions focus on how the federal government creates much law regulating corporate governance (Roe 2004a; Roe 2004b; Bratton & McCahery; Kahan & Rock; Jones; Thompson & Sale). We thus now need to think more about the interaction between Delaware and the federal government, rather than between Delaware and other states. We still have a long way to go, though, in understanding the Delaware-federal government interaction, and whether it leads to good or bad corporate law.

This paper addresses those questions. On many issues, the states, led by Delaware, will set the initial legal position. Various federal actors, including Congress, the SEC, federal courts, and the national stock exchanges, may then step in and overrule or supplement the rules that the states adopt with rules of their own. The federal rules are important in themselves, and furthermore, as Mark Roe has emphasized, the threat of federal intervention may affect how Delaware behaves (Roe 2004a, Roe 2004b). Does Delaware really matter at all, then, if its laws survive only at the sufferance of the federal government? Yes, Delaware does still matter. Although various federal actors have the power to intervene, powerful forces both internal within the various federal actors and external in the interaction between the actors often make change from the status quo difficult. Only if the status quo falls far from the preferred positions of the

federal actors will they (re)act. Thus, the power to set the status quo is important, and Delaware sets the prevailing status quo in much of corporate law. The federal system leaves Delaware with much, although far from total, discretion in setting its law.

Does this interaction between Delaware and the federal actors result in good law?

Delaware presents us with a tradeoff. Its expert judges and the dynamic of its interaction with other states result in well-tested and thoughtful law. On the other hand, Delaware tends to be particularly biased in favor of managers and against non-shareholder constituencies such as employees, consumers, and the general public. The federal actors are relatively less biased, but also less expert. We would like to benefit from Delaware's expertise while controlling its bias, and our mixed federal system helps do that. In effect, the system allows Delaware to use its expertise in setting the law, while the federal actors stand ready to intervene should Delaware's bias get out of hand. The resulting law might well be better than either Delaware or the federal actors alone could generate. The formal model of this paper suggests that under some circumstances the mixed system with Delaware setting law subject to federal intervention outperforms either acting alone. In other circumstances having Delaware alone set the law generates the best outcome, while in yet other circumstances Congress setting the law alone generates the best outcome. The mixed system never yields the worst outcome, and it has a moderating impact, avoiding the worst outcomes possible under either a purely state or purely national system. The mixed system is thus more robust than the two alternatives.

This paper develops its argument in several steps. Section I explores how various factors at the national level often stop the federal actors from intervening. Some of these factors are internal to the various actors. Within Congress, the bicameral system, committee structure, and

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conflicting interest groups make action difficult. Judicial power is limited, and the SEC also has internal limits. Other factors arise from the interaction of the different federal actors. Each actor may try to change the law only to find that other actors are able to block the change. A large degree of stalemate is built into our federal system. This stalemate gives Delaware a wide range in which it can set law with relatively little fear of being overturned. The section includes a formal model of some of these interactions.

Section II explores the tradeoff between expertise and bias, and how the federal system helps cope with that tradeoff. It includes a formal model in which Delaware and the federal government differ both in the quality of the law they can generate and in how they favor opposing interest groups. As I have argued elsewhere (McDonnell 2004b), Delaware displays an overly pro-managerial and anti-other-constituency bias, but also can generate high-quality law. The model demonstrates that by allowing Delaware to set the law initially, but with possible federal intervention if it finds that law too biased, the federal government can sometimes achieve a law that is better than it could set on its own. The results are ambiguous, though—in some cases, social preferences might be such that society would prefer to have Congress alone setting the law rather than Delaware, and in other circumstances society would prefer having the states alone set law law. However, in a wide variety of circumstances there is a social gain from having Delaware set the law subject to federal intervention despite its interest group bias, and that system is never the worst of the three alternative systems. The mixed system has a moderating impact on outcomes. This section also provides an additional reason why Delaware has room to set corporate law despite the ability of Congress to preempt state law: Delaware's ability to provide higher-quality law than Congress gives Congress a reason to forbear from preemption. Section III combines the models of the first two sections.

this article.

Section IV considers two examples of the state-federal interaction. The first concerns freezeout mergers. The second concerns the Sarbanes-Oxley Act of 2002. Both examples show Delaware acting, the federal government responding, and Delaware responding to that response. They suggest that relatively good law has generally resulted.

Section V notes that much of the logic of the formal models of sections II and III applies to a variety of other areas as well. The tradeoff between expertise and bias is ubiquitous, and in a variety of contexts we allow specialist institutions to take the lead in setting legal rules while generalist institutions stand ready to correct them if they go too far off course. This story can help make sense of the interaction between regulatory agencies and courts, specialist courts and generalist courts, and legislative bodies and their committees.

I. Delaware's bias and room to maneuver

Delaware (and other states) take the lead in setting much corporate law. Various federal actors, however, may intervene and enact their own rules which may supplant the state rules. One must consider both how Delaware and the federal actors are likely to differ in their preferences, and how much discretion Delaware has to set the law without one of the federal actors intervening. The answers to these questions will help tell us how much influence Delaware really has in shaping corporate law.

There are of course fifty states setting corporate law, but for public companies Delaware is by far the most important, and I shall concentrate on it. The interaction between Delaware and other states is important for us here, though, insofar as it helps shape Delaware law. I am particularly concerned with the extent to which the law reflects the interests of three general groups: managers, shareholders, and other constituencies, including employees, customers, and the general public.

Because of the internal affairs doctrine, for the most part corporations can freely choose in which state they will incorporate. However, for large public corporations Delaware offers large advantages other states cannot match simply because it has been the clear leader (McDonnell 2004b; McDonnell 2003; Klausner; Romano). Recently, some scholars have argued that Delaware's advantages are great enough that little real competition for corporate charters exists (Bebchuk & Hamdani; Kahan & Kamar). I believe, however, that the existence of choices among states still creates a variety of benefits (McDonnell 2004b). However, this competition with a dominant player leads to two strong sources of bias in Delaware's interest group politics. First, Delaware courts are more subject to corporate law lobbying groups than federal or other state courts, simply because corporate law cases are such a large part of the docket in Delaware (McDonnell 2004b). Managers and corporate lawyers tend to be the best-organized and most politically influential groups in this area (McDonnell 2004b; Carney; Romano; Macey & Miller). Hence, Delaware courts should tend to exhibit a more pro-manager bias than other courts.

Second, Delaware's dominance strengthens managers and shareholders relative to other interest groups (McDonnell 2004b; Roe 2004b; Carney). Managers and shareholders determine where a business will incorporate, so Delaware politicians must keep them happy. The employees, customers, and other constituencies that Delaware corporations affect mostly live in other states. Few mechanisms exist to induce Delaware politicians to consider their interests. In other states and nationally, by contrast, many of the affected constituencies are located within the jurisdiction, and will have at least some tendency to lobby for or against legal rules that help or hurt them.

Thus, we see that political dynamics will tend to push Delaware to favor managers more and non-shareholder constituencies less than politicians and institutions in other states or at the

federal level. Thus, to the extent that Delaware has room to maneuver in setting the law, Delaware's dominance will tend to push the law in a way that favors managers and hurts other constituencies, with ambiguous effects for shareholders. Mark Roe has recently made this point quite strongly (Roe 2004b). The questions that arise from his work, though, are how much room does Delaware have to maneuver, and why does it have that room, given the ability of various federal actors to intervene.

There are a variety of federal actors. Congress and the President can pass statutes. The SEC can promulgate rules.¹ Federal courts can develop new rules to interpret the securities statutes. The New York Stock Exchange and Nasdaq, under close SEC supervision, can create rules governing those companies listed on their exchange.²

Roe argues that this variety of federal actors increases the likelihood of federal intervention, as even if one actor is not inclined to act another may do so (Roe 2004a). In some circumstances that may be right. In other circumstances, though, the variety of actors may inhibit federal action, as one actor creates a check limiting the ability of another to step in. For instance, in some cases the SEC may want to create a new rule to stop a perceived managerial abuse, but may refrain from doing so in response to pressure from Congress or the President.

A notable recent example may be the expensing of stock options. Many have argued that stock options granted to a company's managers and employees should be treated as an expense, hence reducing the accounting profit (Buffett). In the early nineties the SEC considered forcing public companies to make this reform, but Congressional pressure forced the SEC to back off (Practising Law Institute). Federal courts, too, may sometimes act to stop the SEC from

¹ Within the broad, but not unlimited, scope allowed under existing statutes. *See infra* notes – through – and accompanying text.

² The SEC supervision seems to be quite important. Indeed, to a large extent recent corporate governance reforms appear to be largely indirect forms of SEC regulation. *See* Thompson 2004b.

spreading its authority. A particularly notable case, for our question, is the SEC's attempt to force the stock exchanges to not allow dual class recapitalizations. The Supreme Court held that this is a question of state corporate law which is not within the statutory mandate of the SEC.³

Internal obstacles may also stop the various federal actors from taking actions. It is notoriously difficult to pass legislation through Congress if there is any sort of determined opposition, as there are so many points in the legislative process at which a bill can be killed (Eskridge, Frickey, & Garrett). Moreover, states can frequently do well at protecting their interests within Congress.⁴ Thus, although Roe notes that at three different points Congress has threatened to move to a national system of incorporation (Roe 2004a), it is also notable that Congress has not done so. At this point the system of state-based incorporation seems well enough entrenched that it would take quite a crisis to create the political momentum required to surmount the strong opposition such a move would generate (Bratton & McCahery). Thus, although Delaware decisionmakers may have some reason to fear that particular threat, surely they also know that they would have to do something quite strikingly provocative before Congress would be likely to take such a big step.

Federal courts also have some internal obstacles to an overly-great expansion into traditional state regions of corporate law. For one, many judges have much respect for the role of the states within the American political system—indeed, federalism is a major theme of the current Supreme Court.⁵ Also, federal courts have become rather swamped (Posner), and are

³ See *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990), . In the end, though, the SEC was able to convince the exchanges to adopt a recapitalization rule on their own. See New York Stock Exchange Listing Manual Rule 313.00, Nasdaq rule 4351.

⁴ A point noted by the Supreme Court, see *Garcia v. San Antonio Metropolitan Transit Auth.*, 469 U.S. 528, 547-55 (1985).

⁵ See *United States v. Lopez*, 514 U.S. 549 (1995); *Seminole Tribe v. Florida*, 517 U.S. 44 (1996).

often reluctant to wade into areas likely to generate too many lawsuits. As we shall see shortly,⁶ this may partly explain the Court's partial retreat from aggressive use of Rule 10b-5.

The SEC and the exchanges also have internal obstacles to an interventionist policy. The SEC's relatively small staff size limits its ability to investigate corporations. Its close contact with the very corporate managers and their lawyers can sometimes encourage capture by the interests it is supposed to be regulating. SEC commissioners are political appointees, and hence to a degree constrained by political considerations set by the President. Finally, the SEC can only act within the bounds of authority set by the securities statutes, which does place some broad limits on it.⁷ As for the exchanges, they must compete with each other for market share. Thus, to the extent that corporate managers are not adequately induced to account for shareholder interests, creating a race to the bottom between the states, a similar race may exist between exchanges, thus reducing the extent to which they are likely to act as a strong limit on the states.

We should push our consideration beyond corporate and securities law, and hence include other federal actors as well. A large variety of laws regulate the behavior of corporations, and many of those laws work to protect the interests of corporate constituencies such as employees, consumers, and the general public. Hence, we might want to think of labor law, employment law, consumer protection law, even environmental law, as in a real sense a part of the making of corporate law. If so, then relevant federal actors would also include the National Labor Relations Board, the Equal Employment Opportunities Commission, and the Environmental Protection Agency, among others. Some analysts who oppose consideration of constituencies other than shareholders and managers when setting corporate law argue that other

⁶ See *infra*, notes – through – and accompanying text.

⁷ See e.g. *Business Roundtable*, discussed *supra* note 3.

areas of the law protect other constituencies (Carney). That may be so, but then one must realize that we may want to add those areas of the law into the mix when considering how corporate law is set.

Thus, a variety of factors will in many instances inhibit the various federal actors from becoming involved in a corporate law controversy. That is not to say that they will never become involved. Often they do, as Roe has extensively documented (Roe 2004a). Sometimes even when they do not, and in fact would not given the obstacles just discussed, it may be hard for Delaware decisionmakers to accurately predict their reaction, so that the threat of intervention may still matter. However, often the obstacles to federal action will be relatively strong. Under our federal corporate law system, state corporate law rules provide the basic background law for corporations. If any of the federal actors wants to change those rules, they must actively intervene. However, if a political constituency exists which likes the state law rules, they will often be able to use one of the mechanisms just discussed to block federal intervention, thus maintaining the state law status quo. The power of the status quo should not be underestimated in the American system of politics. That is, after all, an important part of the design of our constitutional system.

Let us consider a simple formal model of these interactions, drawing upon a type of model commonly used in the political science literature.⁸ Assume we can array potential corporate law rules along a line that varies according to how much the rules favor two competing interest groups. I use two different interpretations of the interest groups. The first opposes shareholders and managers; in the figures below, policies further to the right favor managers more. The second interpretation opposes managers and shareholders, on the one hand, to other

⁸ For an example of the use of such models in the legal literature, *see* Eskridge.

constituencies, such as employees, customers, and the general public; in the figures below, policies further to the right favor managers and shareholders more.

We represent the policy preferences of different political institutions by a point on the line. That point represents the favored outcome for that institution. The further a policy lies away from an institution's preferred point, the less that institution likes that policy (and I assume that the strength of preferences are symmetric around the preferred point). Figure 1 starts out simply, including the preferred points of just Delaware's policymakers (D), the House (H), and the Senate (S). If Delaware could simply set the law on its own, it would set the law at D. However, policy is set as follows. Delaware sets the initial law. However, if both the House and Senate agree, they can set a law of their own that overrules Delaware.

What will be the outcome? Assuming that Delaware knows the location of H and S, the resulting law will be at point S. To see this, suppose that Delaware set the law at some point to the right of S, such as x . Then the Senate prefers any point between x and x' (the point the same distance to the left of S) over x , and the House agrees; indeed, the House prefers x' the most of those points. In fact, for any point between x and S, there are some points between S and x' such that both the House and the Senate prefer those points. Even without assuming an exact bargaining outcome between the House and Senate, so long as we assume that they will bargain to a Pareto efficient outcome (as between their own preferences), then they will set a new law somewhere between S and x' . Delaware will realize this, and notice that as x moves closer to S, then the possible House-Senate bargaining space to the left of S also narrows. The best Delaware can then do is set the law at S. If it does, Congress will not change the law, as the Senate can do no better than S. If Delaware sets the law to the right of S, we have just seen that the final outcome will be to the left of S, which is worse for Delaware than S. If Delaware sets

the law to the left of S , then the law will remain at that point (so long as it is to the right of H), but that outcome is worse for Delaware than S . Thus, setting the law at S is Delaware's optimal strategy.

Now let us add in another Congressional actor, a committee. As before, Delaware sets the initial law. A committee can choose to introduce a bill setting a new law. If the committee passes a bill and sends it to the full House and Senate, they can vote on that bill. If the committee does not pass a bill, then the full House and Senate do not act. Whether or not this changes the outcome from the previous case depends on the location of the committee's preferences. Figure 2 gives two possibilities. If the committee's preferences are at C_1 , then the outcome will still be S . If Delaware sets a law to the right of S , the committee would prefer a law further to the left, and will pass a bill that falls within a range that the Senate prefers to Delaware's law. The analysis thus proceeds as above.

Suppose however that the committee's preferences are at C_2 . Now Delaware's best strategy is to set the law at C_2 . If it sets a law to the right of C_2 , the committee can pass a bill with a new law further left. If Delaware sets the law at C_2 , the committee will not introduce a bill, and hence the House and Senate will not act. Note that the outcome is further to the right, and closer to Delaware's preferred point, than before. The introduction of a new federal actor has widened Delaware's discretion, and allowed it to get closer to its preferred outcome. Does Delaware matter at all in this revised model? Yes. If Delaware were to have a preferred point to the left of C_2 , it could set the law at its preferred point, and if the committee tried to introduce a law to its right that bill would fail in the full Congress.

To get a bit more of a sense of how adding federal actors can increase Delaware's range of discretion, see Figure 3, which adds in the President's preferred point. The President can veto

bills.⁹ If the President has a preference to the right of P, Delaware can now set its law at P—the President would veto any Congressional attempt to move the law to the left of that point. Of course, were P to fall between H and C in Figure 3, then the veto threat would not widen Delaware’s effective discretion. However, the moves from Figure 1 to 2 to 3 are enough to give a sense of how adding actors at the federal level can increase Delaware’s room to set corporate law without fear of being overridden.

Adding in more federal actors does not always have the effect of increasing Delaware’s discretion, though. Sometimes, with more actors there will be more institutions able to intervene and change the law, and hence a greater chance that one of them will choose to do so. Much depends on how the federal actors interact. Do they tend to veto each other, as the model so far suggests? Or does each have the ability to act independently with relatively little fear of a veto? To see how the latter possibility can limit Delaware’s role, let us add in the SEC as another federal actor, and for simplicity go back to the case with just the House and the Senate as the other federal players.

Figure 4 adds in the preference of an executive agency, giving four possible preferences for that agency, A_1 through A_4 . I consider two different structures for how Delaware, the agency, and Congress might interact in setting law. In the first, Delaware first sets a law, then the agency has the chance to move the law to a new point, then Congress has the chance to move the law. In this model, Delaware becomes irrelevant. The agency can move wherever it pleases, and its only concern is the reaction of Congress, not Delaware. If the agency’s preferences are at A_1 , it will set the law at H; if A_2 , then at A_2 ; and if at A_3 or A_4 , then at S. If Delaware initially sets the law at any other point, then the agency will simply move the law to the point just given.

⁹ For simplicity I do not consider the possibility of an override. To see how to add that possibility into this sort of a model, *see* ---.

An alternative model could see the law being set as follows. First, Delaware sets a law. The agency follows with a superseding law. If the House and Senate agree, they can overturn the agency's rule, but they can only go back to Delaware's law—they cannot set their own law, perhaps because they lack the expertise and/or interest to devise a law of their own. This leads to different results from the previous model for some locations of agency preferences. If the agency's favorite point is at a point like A_1 , the outcome is still H as before. If the agency sets law at H, the House will not agree to any movement, whereas if the agency set a law to the left of H, then if Delaware's rule were at or a bit to the right of H, then Congress would move to Delaware's rule. If the agency's preference is at A_2 , then the result will again be A_2 —the House and Senate cannot agree on any move from there.

Now, however, if the agency has a preference at A_3 , the result will be A_3 , not S. Delaware sets its rule at A_3 or to the right, the agency sets its rule at A_3 , and Congress will not change. If the agency has a preference at A_4 , to the right of Delaware, then the final result will be D, Delaware's favorite point. Delaware sets the law at D, the agency sets its rule at either D or to the right of D, and Congress either lets the law stand (if the agency sets the rule at D) or chooses Delaware's rule at D (if the agency sets the rule to the right of D). Thus, Delaware has some effect on the final outcome in some circumstances, depending on the exact location of preferences. A variety of more complicated models are of course possible—for instance, Delaware could have a chance to respond to the agency's rule before Congress has a chance to intervene. Moreover, I have not even added in either federal courts or the stock exchanges.¹⁰

The end result of these simple models must be a fairly nuanced claim. In some circumstances, the existence of many federal actors may give Delaware more room to maneuver; in other circumstances, they may give Delaware less room. Much depends on the exact nature of

the interaction. Section IV will present some cases where I believe that Delaware has shown a significant degree of power to set the law, despite possible federal intervention.

One final point for this section is to note that I have not yet said anything about the socially optimal point. That requires an analysis of whose interests corporate law *should* reflect. If one believes that the law should only reflect the interests of managers and shareholders, as many in the U.S. do, then Delaware's effect on the law's direction might look good. If one instead believes, as I do, that at least some other groups' interests, especially those of employees, should matter too, then Delaware's effect looks more unsettling. This latter position becomes more persuasive if one interprets this analysis as including not just corporate and securities law, but more widely the setting of a host of laws that regulate corporate behavior, an interpretation suggested above. Once those laws are included, it becomes very hard to maintain that we should only include the interests of managers and shareholders in setting all of these laws.

II. The expertise/bias tradeoff

The discussion and models in section I only consider how Delaware and federal actors differ in their responsiveness to different interest groups. Making law is not simply a matter of choosing who to favor and disfavor, though. Laws can be well-written and conceived, or poorly-written and conceived. A fair amount of what goes on in corporate law and its reform has no strong distributive consequences, and instead involves technical questions that nonetheless affect how well the law functions. Delaware and the federal actors may differ systematically in the quality of the law they offer. In this section I argue that Delaware tends to create higher-quality corporate law, albeit law that is overly-biased in favor of managers and against other constituencies. The section goes on to argue that by allowing Delaware to set the law, but subject to possible correction at the national level, we can achieve the benefits of high quality

¹⁰ For a model along the same lines that considers the role of the exchanges, *see* Thompson 2004a.

Delaware law while limiting its bias. However, the resulting limits on Delaware's bias will not always be enough to make the resulting system better than a world without state law, or than a world with only state law. Still, the mixed system performs best over a variety of possible locations of state, federal, and societal preferences, and it never performs worse than both of the alternatives. The section also shows how Delaware's ability to set higher-quality law gives a further reason, beyond those developed in the previous section, why Delaware has room to set its preferred version of corporate law despite the threat of federal intervention.

Several factors help Delaware create high-quality corporate law. The existence of other states also making corporate law both induces Delaware policymakers to continually update their law, and also allows them to learn from good innovations in other states. (McDonnell 2004b) As the dominant state in corporate law, Delaware has developed a very experienced and competent judiciary and corporate bar. This leads to both expert caselaw and to well-crafted statutory reforms. The caselaw is of particular importance.

Federal actors are mostly less expert. Congress spends little time on corporate and securities law, and the same holds for federal courts. Their lack of expertise compared to their Delaware counterparts is hard to question. We face a harder comparison if we add in the SEC. The SEC specializes in securities law, and hence has considerably more expertise than Congress and the federal courts. The expertise of many SEC commissioners may compare decently well with that of Delaware judges, although much of the day-to-day work at the SEC is done by junior staffers with much less experience and knowledge. However, the SEC does not benefit, as Delaware does, from the experience of fifty other states. Yes, states do have their own securities laws, but ever since the creation of the federal laws, those state securities laws have become increasingly moribund. My overall judgment is that Delaware likely creates higher-quality law

than the SEC, but I grant that this is a more complicated and controversial judgment than a comparison of Delaware with Congress and federal courts. In this section I focus only on the relationship between Delaware and Congress, adding in the SEC in section III.

Inclusion of the exchanges also makes the Delaware/federal comparison harder. The exchanges, like the SEC, are specialized with a great deal of expertise. Moreover, with the exchanges one even gets some of the benefits from competition between several exchanges. Indeed, to the extent that exchanges really acted independently and competitively in setting corporate governance rules, with oversight from the SEC and other federal governmental actors, then much of the story I tell here about the Delaware/federal relationship could also apply to the exchange/federal government relationship. However, increasingly the SEC has come to dominate rulemaking by the exchanges. When the SEC thinks that some reform in exchange rules is desirable, it lets them know, and they generally follow the SEC's lead. This limits both the independence of and the competition between the exchanges (Thompson 2003b). Thus, in this paper I do not further consider the separate role of the exchanges, although that remains a topic of some interest.

Let us consider a model of the relationship between Delaware and Congress to see how we might gain from having Delaware set the law initially with Congress standing ready to intervene. In section I, Congress and Delaware differed along only one dimension, their preferences between competing interest groups. Here we will keep that dimension, but add a new one, the quality of corporate law. Think of higher-quality law as creating more overall wealth. Delaware and Congress thus differ both in the size of the pie they can create and in how they prefer to divide up the pie among opposing interest groups.

Figure 5 illustrates what Congress and Delaware would do if either acted on its own. The horizontal axis represents the division among interest groups, as in section I's models. P_C represents the preferred distribution of Congress, and P_D represents the preferred distribution of Delaware. The vertical axis represents total wealth created under a particular law. W_{\max} is the best a law could do, W_D is what Delaware can achieve, and W_C is what Congress can achieve, with $W_D > W_C$. Thus, acting on its own, Congress would go the point (P_C, W_C) , while Delaware on its own would go to the point (P_D, W_D) .

But they do not act on their own. Suppose instead that Delaware sets the law initially, but Congress can replace Delaware's law with one of its own if it so chooses. Assuming perfect information about preferences and abilities, in setting its law Delaware thus knows that Congress will not overturn Delaware's law so long as Congress believes that law is better than, or at least no worse than,¹¹ (P_C, W_C) , the best Congress can do acting on its own.

To see how Delaware will act, we must specify Congress's preferences more exactly. Suppose that Congress prefers point A to point B iff the distance¹² from A to (P_C, W_{\max}) is less than the distance from B to (P_C, W_{\max}) . Note that the distance here is the distance from (P_C, W_{\max}) , not from (P_C, W_C) . (P_C, W_{\max}) is the ideal point for Congress, while (P_C, W_C) is the best that Congress can accomplish acting on its own. Figure 6 gives three illustrative Congressional indifference curves, with the higher curves representing a higher level of utility.¹³ Of particular interest for our analysis is the indifference curve going through (P_C, W_C) . So long as Delaware sets its law on that curve or above and to its left, Congress will let that law stand.

¹¹ I assume that if Congress is indifferent to Delaware's law and what Congress can do on its own, Congress will not bother changing Delaware's law.

¹² In most of this section I use the absolute value measure of distance rather than the more usual sum-of-squares measure, purely for graphic and algebraic simplicity. The choice of metric only matters at one point in the analysis, which I shall discuss when we get there.

There are two basic possibilities, illustrated in Figure 7. As long as (P_D, W_D) is located above and to the left of the indifference curve through (P_C, W_C) , then Delaware will set the law at (P_D, W_D) , and Congress will not move it. (P_{D1}, W_D) illustrates this case. If (P_D, W_D) is located to the right of the indifference curve through (P_C, W_C) , then Delaware will set the law at (P^\wedge, W_D) , the point where the line $W = W_D$ crosses the indifference curve.¹⁴ To see this, remember that Delaware cannot set W higher than W_D . If P_D is to the right of P^\wedge , then if Delaware tries to set its law to the right of (P^\wedge, W_D) , Congress will intervene and set the law at (P_C, W_C) , which is worse for Delaware than (P^\wedge, W_D) . (P_{D2}, W_{D2}) illustrates this case.

Congress thus is at least as well off by letting Delaware set the law as it would be by setting the law itself, and in the first of the two cases considered in the previous paragraph Congress is better off. The end result is a corporate law that is further to the right (pro-manager, anti-other constituencies) than Congress would set, but also a higher-quality corporate law.

The model has not yet added in social preferences. Clearly society is better off, *ceteris paribus*, with a higher-quality law that generates greater wealth, but what of the distribution between groups? Figure 8 illustrates the three basic possibilities. If the preferences of Congress and society coincide, as with P_{S1} , then as we have just seen, society, like Congress is at least as well off by letting Delaware set the law as it would be were Congress to set the law, and strictly better off so long as $P_D < P^\wedge$. Society is also at least as well off as if Delaware set the law without the threat of federal intervention, and strictly better off if $P_D > P^\wedge$.

If society's preferences are to the right of those of Congress, as with P_{S3} , then society is better off than were Congress to set the law on its own even when the law is set at (P^\wedge, W_D) , as society appreciates Delaware's rightward pull on the law. If societal preferences are far enough

¹³ The curves are straight rather than curved because of the choice of distance measure, as described in the previous note.

to the right, it might be better still were Delaware to set the law without the threat of Congressional intervention. That is so, for instances, if $P_S = P_D$. Even then, though, the mixed system is better than a purely Congressional system.

The most complicated case is where society's preferences are to the left of those of Congress, as in P_{Σ} . This may well be the case, if one believes that public choice problems lead all political institutions to overly favor managers and to under-favor other constituencies. Given the simple distance measure I have used for preferences here, society is still at least as well off by letting Delaware set the law, and still better off when $P_D < P^{\wedge}$. To see this, Figure 8 includes the social indifference curve that runs through the point (P_C, W_C) . This curve overlaps exactly with the Congressional indifference curve above and to the right of that point.

This is an artifact of using a simple linear measure of social utility, though. If one instead assumes that Congressional and societal preferences vary based on the square of the distance from their ideal points, then society prefers (P_C, W_C) , the outcome if Congress simply set the law, to (P^{\wedge}, W_D) , the outcome when Delaware's preferences are sufficiently far-removed from those of Congress that Delaware sets the law along the Congressional indifference curve through (P_C, W_C) . Figure 9 illustrates this case. The problem is that Congress is willing to allow Delaware more room in moving the interest group division to the right than society would prefer as a trade off for the higher quality of Delaware's law. That is so because society is further away from its preferred point than Congress, so that moves rightward are more damaging to society than to Congress.¹⁵ Even in this case, though, allowing Delaware to set the law initially improves social welfare as long as Delaware's preferred point is not too far to the right of the

¹⁴ $P^{\wedge} = P_C + W_D - W_C$.

¹⁵ Technically, this shows up in figure 9 in the social indifference curve having a steeper slope through (P_C, W_C) than the Congressional indifference curve. Algebraically, the slope of the Congressional curve through that point is $(x - P_C)/(W_{\max} - y)$, while the slope of the social curve is $(x - P_S)/(W_{\max} - y)$.

preferred point of Congress—in Figure 9, as long as Delaware's preferred point is to the left of P_D' , where Delaware's preferred feasible outcome is as good, for social preferences, as Congress's preferred feasible outcome acting on its own. Moreover, the mixed system yields a result better than if Delaware set the law on its own without threatened Congressional action if Delaware's preferred point lies to the right of P^{\wedge} --the mixed system prevents Delaware from setting the law even further to the right.

Thus, the results are somewhat ambiguous when we compare the three systems: states setting the law on their own, Congress setting the law on its own, and the mixed system where states set the law subject to Congressional intervention. For some combinations of state, federal, and social preferences and relative quality of state versus federal law, the mixed system yields the best outcome. For other combinations, a purely state system is best, and a purely national system is best for yet other combinations. Still, the mixed system always yields an outcome at least as good as at least one of the other systems. It thus yields more acceptable results across the full range of possibilities. It does so by moderating the most anti-social outcomes possible under the other two systems.

A final question to ask within this section's model is how the results change as Delaware's ability to set high-quality law changes or as its interest group preferences shift. As Delaware's relative advantage over Congress in setting high-quality law increases,¹⁶ a higher-quality corporate law obviously results from having Delaware rather than Congress set the law. However, in some circumstances this change may move the final result further to the right—this happens where before the shift Delaware has set its law to the left of its preferred point, along the Congressional indifference curve. In such a situation, Delaware's choice of law will move up and to the right along the Congressional curve, until the point where Delaware can set the law at

P_D , beyond which Delaware will simply move up vertically as W_D increases. If social preferences equal Congressional preferences, this represents no change in utility so long as Delaware's choice moves along the Congressional indifference curve, and a gain in utility once Delaware's choice moves up vertically from its preferred point. If social preferences are to the right of Congressional preferences, the move up and to the right is a gain. If social preferences are to the left of Congressional preferences with the absolute value measure of utility, the results are the same as when social preferences are the same as Congressional preferences. However, if social preferences are to the left of Congressional preferences with a sum-of-squares measure of distance, then in some circumstances the increase in Delaware's quality may actually lead to a worse outcome—a somewhat surprising result. This happens if before the change Delaware is setting the law on the Congressional indifference curve, to the left of its preferred point. As figure 10 illustrates, given the way that the Congressional and social indifference curves intersect at that point,¹⁷ as Delaware's choice of law moves up along the Congressional curve, social utility worsens—the move rightward in favoring interest groups outweighs the improvement in legal quality. This is so because, as explained above, society is further than Congress from its preferred point, so society is more bothered than Congress by the move rightward in interest group division. This result holds only for a small enough improvement in the quality of Delaware law, such as a move from W_{D1} to W_{D2} in Figure 10. If the improvement is large enough that Delaware is able to set the law at its preferred point, and move straight up from there, at some point the improvement in quality outweighs the move to the right. In Figure 10 the move from W_{D1} to W_{D3} illustrates that case.

¹⁶ That is, as $W_D - W_C$ increases.

¹⁷ For the algebra on the two slopes at the intersection, *see supra* note 15.

As for a change in the strength of Delaware's interest group bias, as Delaware shifts to the right relative to Congress, the resulting outcome will either also shift to the right or remain unchanged—it remains unchanged if Delaware was already constrained by the threat of Congressional preemption and chose a law along the Congressional indifference curve. The quality of the law will not change—in this model, Delaware always sets its law at the highest quality it can attain. Where social preferences are equal to or to the left of Congressional preferences, a move rightward in the law is a loss, although it may be a gain if social preferences are enough to the right of Congressional preferences.

The model illustrates how Congress and society can benefit from having Delaware set corporate law rules initially, with Congress intervening to change the law only if Delaware goes too far off-base in its interest group preferences. It also shows how society can be hurt in some circumstances relative to either Congress or Delaware acting on their own. It also shows an additional reason why Delaware has room to maneuver within the federal system: its ability to set high-quality law provides a reason for federal actors to refrain from preempting that law.

III. The models combined

Section I presents models explaining how a proliferation of federal actors could sometimes increase the range in which Delaware can set corporate law without being overruled. It did not consider possible differences in quality between Delaware and federal actors. Section II presents a model in which Delaware sets higher-quality laws than Congress, and hence Congress can benefit from allowing Delaware to set the law initially despite greater interest group bias in Delaware. It does not consider the interaction between different federal actors. This section starts to bring together the ideas of those two sections.

Consider the bias/quality model of section II, but add in a new federal actor, an executive agency such as the SEC. The agency's preferred interest group allocation is P_A , and the quality of its laws is represented by W_A , with $W_C < W_A < W_D$, i.e., the agency creates more efficient laws than Congress but less efficient laws than Delaware. Let us first suppose that the agency's preferences are to the left of those of Congress, as in Figure 11. This could be because the SEC tends to favor more active, intrusive rules as a way of extending its own power, and such rules tend to favor shareholders more than managers.

Rulemaking proceeds as follows: Delaware sets the initial law. The agency may then overrule Delaware. Finally, Congress may overrule the agency, either by setting its own law or by reverting to Delaware's law. This follows the final model considered in section I, except that there Congress did not have the option of setting its own law. What will happen? The exact results vary somewhat depending on the exact placement of preferences and relative efficiency, but the basic analysis is as follows.

Points 1, 2, and 3 represent what Delaware, the agency, and Congress, respectively, would do on their own. As drawn, the analysis from section II shows that point 1 is also the outcome that would occur if only Delaware and the Congress were present, with Delaware setting the law and Congress overruling if it so chooses. Point 4 would be the outcome for a parallel game between just the agency and Congress.

Once we have the game between all three actors, the results change. If the agency sets the law at 4, then if Delaware set the law at 1 Congress would overrule the agency and set the law back to 1. To avoid being overruled if possible, or to at least force Delaware to move as far to the left as the agency can force it, the agency will set a law that pleases Congress as much as it

can. Point 5 is that law—it follows Congressional preferences for the division between groups P_C , while making law as efficient as the agency can manage, W_A .

Knowing that the agency will set the law at point 5, Delaware will set its law as far to the right as it can while still inducing Congress to choose its law over the agency's. That occurs at point 6.¹⁸ Given a choice between points 5 and 6 or the best Congress can do on its own, Congress will choose point 6, Delaware's law.

Note several interesting things about this result. First, it intuitively would appear that Delaware has more effect here than in the final model of section I. That is, Delaware has more effect on the final outcome, and indeed, here Delaware's own law will be the final outcome. That greater power comes from Delaware's ability to set more efficient law than the agency, a point left out of the models in section I. Second, the result here is better for Congress than if the agency were not an option. Without the agency option, point 1 is the result, whereas with the agency, point 6 is the result. Even though Delaware's law wins in the end, the threat of the agency induces Delaware to move its law to the left to ensure that Congress chooses its law over the agency's. Third, if social preferences are at or to the left of those of Congress, this leftward move in the prevailing law also benefits society. Even if social preferences are to the right of those of Congress, the leftward shift will be a social gain as long as social benefits are not too far to the right from those of Congress.

A similar analysis applies if the agency's preferences are to the right of those of Congress, though still to the left of those of Delaware, as in Figure 12. Here again the agency will sometimes set a law at the best efficiency it can achieve and at the preferred distribution of Congress, (P_C, W_A) , which again induces Delaware to set its law to the left of the point it would

¹⁸ Assuming that Congress breaks a tie in favor of Delaware. If a tie goes to the agency, then Delaware will set its law infinitesimally to the left of point 4.

choose without the agency presence; agency preferences P_{A1} in the figure are an example, with an ultimate outcome at point 1. In some cases the agency will not have an effect on the outcome, where it is inefficient enough relative to Delaware. In other cases, the agency may not choose to set its law as far left as P_C , if setting the law at some point to the right of that will induce Delaware to set a law exactly at the agency's preferred point; agency preferences P_{A2} with outcome at point 2 are an example. Even then, though, the result will be at least no worse, from the point of view of Congress, than if the agency were not present, as Delaware must always beware of the constraint that Congress may choose to set its own law if it is unhappy with both the Delaware and the agency alternatives.

The models in these three sections obviously only begin to hint at the variety of possibilities and considerations present in the world. Still, they at least hint at some of the possible interactions. Collectively, they provide some support for the two main points of this paper. First, although the presence of various federal actors that may set corporate law may constrain Delaware in setting its law, Delaware still has considerable room to maneuver, and in some instances a greater number of federal actors can actually increase Delaware's discretion, though in other instances it could decrease that discretion. Second, if indeed Delaware can set higher-quality corporate law than the federal actors, then we can benefit from having Delaware set corporate law rules initially, with federal actors intervening only if they are unhappy with Delaware's rules. The result will be higher-quality legal rules than if Delaware were not allowed to set the law, although Delaware will be able to bias the laws somewhat in favor of its preferred interest groups. That tradeoff will often be worth making, and the system avoids the most extreme bad outcomes possible under a purely state-based system or a purely national system.

IV. Some historical examples

Let us look a bit more closely at several areas where some federal intervention has occurred,¹⁹ to see that even with some intervention considerable room for state maneuvering exists. I consider three examples: general state fiduciary duty rules, the law affecting freezeout mergers, and the Sarbanes-Oxley Act.

Fiduciary duty law is probably the most crucial way that modern state corporate law helps control managerial misbehavior. Yet, various limits on this body of law, such as the business judgment rule (Block, Barton & Radin) and the board demand requirement²⁰ often limit the chances of success for shareholder suits under state law. Instead, shareholders may try to use federal securities law and suits in federal court to in effect enforce fiduciary duties. In the sixties and seventies a variety of federal court decisions, especially ones interpreting Rule 10b-5, opened up federal courts to such suits.²¹

However, as the number of such suits grew, the Supreme Court started to apply the brakes. For instance, it limited the number of shareholders who have standing to sue under Rule 10b-5.²² It also eliminated liability for aiding and abetting Rule 10b-5 violations.²³ Most interestingly for us, the Court in *Santa Fe* decided that fiduciary duty is a core state law function and that federal securities law should not be used to horn into the state's turf.²⁴ This did not stop shareholders from using securities law disclosure requirements to attack possible fiduciary duty

¹⁹ The fact that federal intervention does occur is not actually consistent with the simple models of this paper—in those models, Delaware always reacts to the threat of intervention in a way that forestalls intervention. A more realistic model could account for actual intervention in a few ways. Delaware may be uncertain about federal preferences and ability to set legal quality, so that sometimes it may guess wrongly and set a law that provokes intervention. Alternatively, federal preferences or ability may change over time, so that a state rule that when set did not provoke intervention may do so after the change.

²⁰ See *Levine v. Smith*, 591 A.2d 194 (Del. 1991).

²¹ See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2nd Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971).

²² See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

²³ See *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

²⁴ See *Santa Fe Industries v. Green*, 430 U.S. 462 (1977)

violations.²⁵ A recent article persuasively argues that Rule 10b-5 litigation has become more important than state fiduciary law litigation as a way of monitoring managers except in the specific contexts of acquisitions and self-dealing transactions (Thompson & Sale). Indeed, the main response to the Enron scandal in civil suits has been under federal securities law, not state corporate law.²⁶ However, *Santa Fe* at least slowed down the move for federal disclosure law to effectively supplant state fiduciary duty law. The Supreme Court thus gave some room to Delaware to maneuver.

Response to the expansion of Rule 10b-5 shareholder suits also came from Congress. The Private Securities Litigation Reform Act of 1995²⁷ tried through a variety of methods to make shareholder derivative suits harder to maintain. It is not clear how successful the Act has been in achieving that goal,²⁸ but this is an example of how one federal actor can try to curb interventions by another federal actor.

Thus, although federal securities law has to a limited extent preempted state fiduciary duty law, the effect has been limited because of the obstacles to federal intervention just described. State law fiduciary duty cases continue to play an important part in the governance of U.S. corporations.²⁹

A closely-related story of federal-state interaction concerns freezeout mergers.³⁰ Initially, Delaware courts ruled that such mergers did not violate any fiduciary duty and that the sole

²⁵ See *Goldberg v. Meridor*, 567 F.2d 209 (2nd Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

²⁶ See <http://www.enronfraud.com/>.

²⁷ Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.)

²⁸ For an argument that subsequent to the Act the number of class actions filed has not decreased, but a higher percentage is now dismissed, see Pritchard; see also Choi.

²⁹ See, e.g., *Quickturn Design Systems, Inc. v. Mentor Graphics*, 721 A.2d 1281 (Del. 1999); *In re Caremark International, Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996); *In re The Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003); *In re Oracle Corp. Derivative Litigation*, 824 A.2d 917 (Del. Ch. 2003).

remedy of minority shareholders was appraisal.³¹ In response, unhappy minority shareholders sought redress in federal courts and from Congress and the SEC. The Second Circuit held that a freezeout merger without any justifiable business purpose violated Rule 10b-5.³² The SEC proposed Rule 13e-3, which would have given it the ability to block freezeouts it determined were unfair.³³ William Cary's famous article beginning the modern race to the bottom debate pointed to the freezeout cases as evidence of Delaware's pro-manager bias (Cary).

In what many observers perceive as a response to the federal and political pressure (Gilson & Black; Roe 2004a), the Delaware Supreme Court changed course and held that a freezeout merger which lacks a legitimate business purpose violates the board's fiduciary duty.³⁴ Roe paints this as an example of Delaware acting in response to federal pressure, and that seems right. However, the story does not end there. At the federal level, some of the limits to federalization kicked in. The Supreme Court reversed the Second Circuit and out of respect for federalism limited the use of Rule 10b-5 as a response to fiduciary duty violations in the crucial *Santa Fe* decision discussed above.³⁵ The SEC backed off somewhat, and in its final version of Rule 13e-3 focused on disclosure, not substantive regulation of freezeouts.³⁶ The Delaware Supreme Court reversed the business purpose rule and instead moved to an examination of the entire fairness of freezeouts.³⁷ It can be argued that entireness fairness scrutiny as it has developed puts a relatively weak break on misbehavior (Mitchell). Moreover, under recent

³⁰ In a freezeout merger, a controlling shareholder directs a cash-out merger which gives it sole ownership of the corporation. See Gilson & Black.

³¹ See *Coyne v. Park & Tilford Distillers Corp.*, 154 A.2d 893 (Del. Ch. 1959) and *Stauffers v. Standard Brands, Inc.*, 187 A.2d 78 (Del. Ch. 1962); Gilson & Black, *supra* note 30, at 1254-55.

³² See *Green v. Santa Fe Industries*, 533 F.2d 1283 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977).

³³ See Sec. Exch. Act. Rel. No. 11231 (Feb. 6, 1975); Gilson & Black, *supra* note 30, at 1307.

³⁴ See *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977).

³⁵ See *supra* note 24 and accompanying text.

³⁶ See Sec. Exch. Act. Rel. No. 16075 (Aug. 2, 1979); Gilson & Black, *supra* note 30, at 1307.

³⁷ See *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

decisions the entire fairness standard can be avoided entirely if the controlling shareholder purchases 90% of shares in a tender offer and then engages in a short-form merger (Aronstam, Balotti & Rehbock).

Roe sees the *Singer* story as an example of Delaware acting under federal pressure. That is right. But it is also an example of some of the counter-pressures which limit federal intervention, and of the ability of Delaware to act within a fairly wide range of discretion.

The other instance of federal intervention I want to briefly consider is the Sarbanes-Oxley Act of 2002.³⁸ A response to a series of corporate scandals at Enron, WorldCom, and other prominent companies, Roe says of the Act that

Sarbanes-Oxley does not even pretend to stay on the disclosure/trading side of the division of power, not even offering up rhetorical respect for state rules governing the corporation's internal affairs. It digs deep into corporate governance, regulating the nitty-gritty. (Roe 2004a p. [39])

Sarbanes-Oxley certainly does trespass on some traditional state-law areas. The prohibition on loans to officers and directors is the most obvious.³⁹ However, that prohibition is not of terribly great consequence. Moreover, there is considerable uncertainty as to what qualifies as a loan under the Act, and a memorandum circulated by leading law firms suggests that practitioners are going to try to interpret this section of the Act in an extremely limited way.⁴⁰ The fact that the Act violates a long-established state law practice will probably help this attempted revolt against the loan prohibition. We shall see how the SEC and Congress respond, but it would not surprise me if this apparent flouting of state law tradition does not have much lasting impact. Roe notes this possibility, but says that the “point is that Congress was, and is, ready to act, even on details of corporate internal governance.” (Roe 2004a p. 40 n. 51) That is

³⁸ Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

³⁹ Sarbanes-Oxley § 402(a).

indeed one important point. However, the possible resilience of the traditional state law rule after the federal intervention is another important point. Proper understanding requires that we keep in mind both the possibility and actuality of federal intervention and also the possibility and actuality of defense of the state law rule and prerogatives.

Other provisions of Sarbanes-Oxley tread into traditional state-law areas. Public companies must disclose what they have done to set up internal control and audit systems to assure that officers and directors are receiving adequate information.⁴¹ Certain officers must forfeit bonuses if profits are restated within a limited period of time.⁴² The list goes on. One can make the list seem rather long and impressive. However, some analysts, with whom I sympathize, suggest that upon closer examination most of the corporate governance provisions of Sarbanes-Oxley are likely to have rather little real impact. Public companies and their lawyers will have to spend a fair amount of time and money making sure they comply with a formalistic list of rules. However, it is hard to see that many of the provisions mean much individually, or even collectively (Cunningham, McDonnell 2004a). The part of Sarbanes-Oxley which could possibly make a real difference is the Public Company Accounting Oversight Board established to revamp the regulation of the accounting business.⁴³ However, that has never been an area covered by state law, and there is much doubt that the new Board will really do much that differs terribly from its predecessor. Certainly the initial setting up of the Board, which was so botched that it led to the resignation of SEC chair Harvey Pitt, does little to reassure one that the new Board will be significantly free from accounting industry influence, the main alleged purpose of the new structure.

⁴⁰ See Attachment A to Baker.

⁴¹ Sarbanes-Oxley § 302.

⁴² Sarbanes-Oxley § 304.

⁴³ Sarbanes-Oxley Title I.

Indeed, it seems quite possible that Sarbanes-Oxley will ultimately go down as representing a very typical legislative response to crisis and scandal. Corporate governance and accounting are an area where limited special interests have much interest and knowledge in what the law does, while there is no well-organized interest group opposing them. When scandal and crisis draw too much public attention to such an area, Congress may feel obliged to respond in some way to reassure the public that it is looking out for the public interest. So Congress passes a law which on the surface seems quite formidable. When one looks more closely at the law, though, it actually does little. The public is appeased because it just sees the surface. The interest group is not upset, because it understands the underlying reality of the law. Members of Congress can thus sleep soundly, knowing that the issue no longer threatens to cost them campaign money or votes (McDonnell 2004a).

If this story proves right, then Sarbanes-Oxley still leaves much room for states to operate in their core area of corporate law. States can respond to the current situation as an important independent voice in the U.S. corporate governance system. That is indeed the message in a recent paper by two Delaware Chancery Court judges entitled “The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State.” (Chandler & Strine) Note the irony of that title: these are not two mere “residents,” and Delaware is not just any random “small state.” Anyone interested in corporate law enough to check out this paper will be immediately aware of that, which illustrates the continuing importance of Delaware. Chandler and Strine see the process of corporate governance regulation as a dialogue among the federal government, state governments, and the stock exchanges.⁴⁴ This of course recognizes much of the force of Roe’s position. It also recognizes, though, that the federal system still leaves much room for states to have an important

voice in that dialogue.

Moreover, the give-and-take between Congress, Delaware, and the SEC in Sarbanes-Oxley may well have resulted in better law than any would have produced on its own. Congress was more willing to act in the face of public unhappiness with corporate managers than Delaware, yet Congress showed in much of Sarbanes-Oxley that it really is not very familiar with this area of law. However, its action has provoked the more expert and experienced Delaware courts to attempt to find more nuanced and effective ways to reign in some of the excesses of corporate management (McDonnell 2004a).

V. Other instances of the expertise/bias tradeoff

The tradeoff between expertise and political bias identified in section II for the Delaware court and legislature as opposed to Congress and federal courts would appear typical of a general tradeoff between expertise and capture or bias in political institutions. It is precisely those specialized political institutions which are most able to develop expertise in a particular policy area which are also most subject to capture or bias. Both individual psychological factors and political factors are at work here. At the individual level level, persons with a strong interest in a particular topic are most likely to want to work for an institution specializing in that topic, but those persons are also particularly likely to develop strongly held views on that topic. Even if they do not start their careers like that, they are likely to develop stronger views over time working for the institution. Indeed, that would seem to be an implication of Bayes' Theorem: those with strong priors on a point will quite rationally give less weight to new information presented on point by a particular case or instance for rulemaking.

At the political level, institutions which deal repeatedly with a particular area are naturally more likely to be subject to political lobbying by interest groups especially interested in

⁴⁴ *See id.* at 8.

that area. They are thus especially prone to capture. This occurs both with lobbying of the institution itself (Delaware judges are repeatedly exposed to arguments from the corporate bar, and even outside of the courtroom will attend conferences and meetings dealing with questions of corporate law) and lobbying of those who appoint the leaders of the institution (corporate lobbyists will care much, much more about a new appointment to the Delaware Supreme Court than to the Montana Supreme Court).

We see these same general factors at play outside the context of Delaware and corporate law. Consider the relationship between specialist executive agencies and generalist courts. It is well-recognized that the agencies will generally have more expertise in their subject matter than the courts. However, the problem of capture of agencies by regulated groups is also well-understood, and this capture problem is greater for agencies than for courts. What is perhaps less-frequently noted is that these differences in expertise and bias are systematically connected. A similar comparison holds when considering generalist courts and specialist courts, such as the Federal Circuit or bankruptcy courts. A similar analysis holds for the relationship between legislative bodies and committees that specialize in a particular subject matter.

How do these other sorts of specialist/generalist pairs handle the tradeoff between expertise and bias? At an abstract level, their responses can often be understood as following the general lines that section II suggests. That is, we often allow the specialist institution to go first in setting a rule, giving it a fair amount of room to maneuver, with the generalist institution standing by to intervene if it believes the specialist institution has strayed too far from the mark. Courts defer to rules and statutory interpretations by agencies, but only up to a point. Generalist courts will frequently defer to the expertise of specialist courts, but there are limits to that deference. Legislatures frequently follow the leads of their committees, but not always. In each

case, the knowledge that their rules can be overridden can and does affect how the specialist institutions choose to set those rules in the first place.

Conclusion

Competition between states for corporate charters has resulted in a clear leader, Delaware. That competition has made Delaware into a mixed blessing: it tends to create high-quality corporate law, but that law often may be overly biased in favor of managers and against non-shareholder constituencies. The fact that various federal actors may set corporate and related law, thereby preempting Delaware, must seriously qualify any conclusions one draws from looking at the states alone. As several commentators have recently stressed, Delaware may shape its law to reduce the chances of federal preemption. However, this does not mean that Delaware does not really matter. It does, for several reasons. First, a variety of factors may prevent federal actors from acting, so that Delaware has a lot of room to maneuver in setting the law. Second, if Delaware can provide higher quality law than the federal actors, they may often defer to Delaware even where they think that Delaware is somewhat biased because the higher legal quality is worth it.

The social consequences of this mixed federal system do have some ambiguity. Under some circumstances it is possible that Congress will allow Delaware to set a law whose bias outweighs its quality from the public's point of view. However, in a wide variety of circumstances the public stands to gain from the system. The higher quality we gain from Delaware's expertise and from state-level experimentation outweighs the bias that Delaware is able to introduce into the system. The system moderates the worst outcomes possible under either a purely state-based system or a purely national system. Moreover, this interaction may be

typical for many areas where specialized institutions make rules subject to possible overruling by more generalist institutions.

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Figure 1

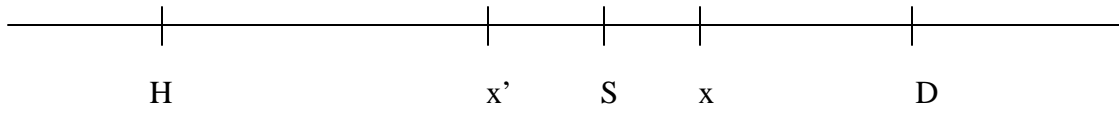


Figure 2

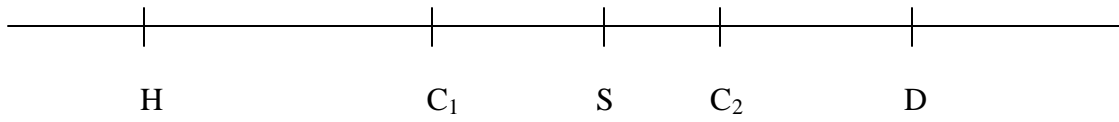


Figure 3

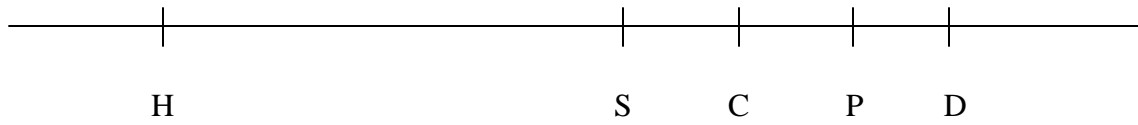


Figure 4

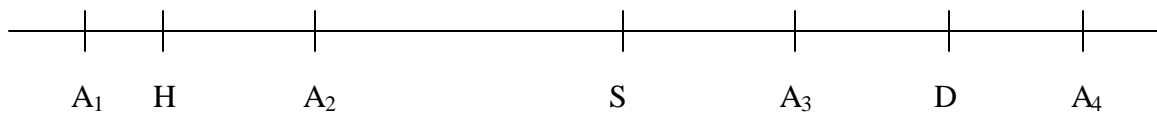


Figure 5

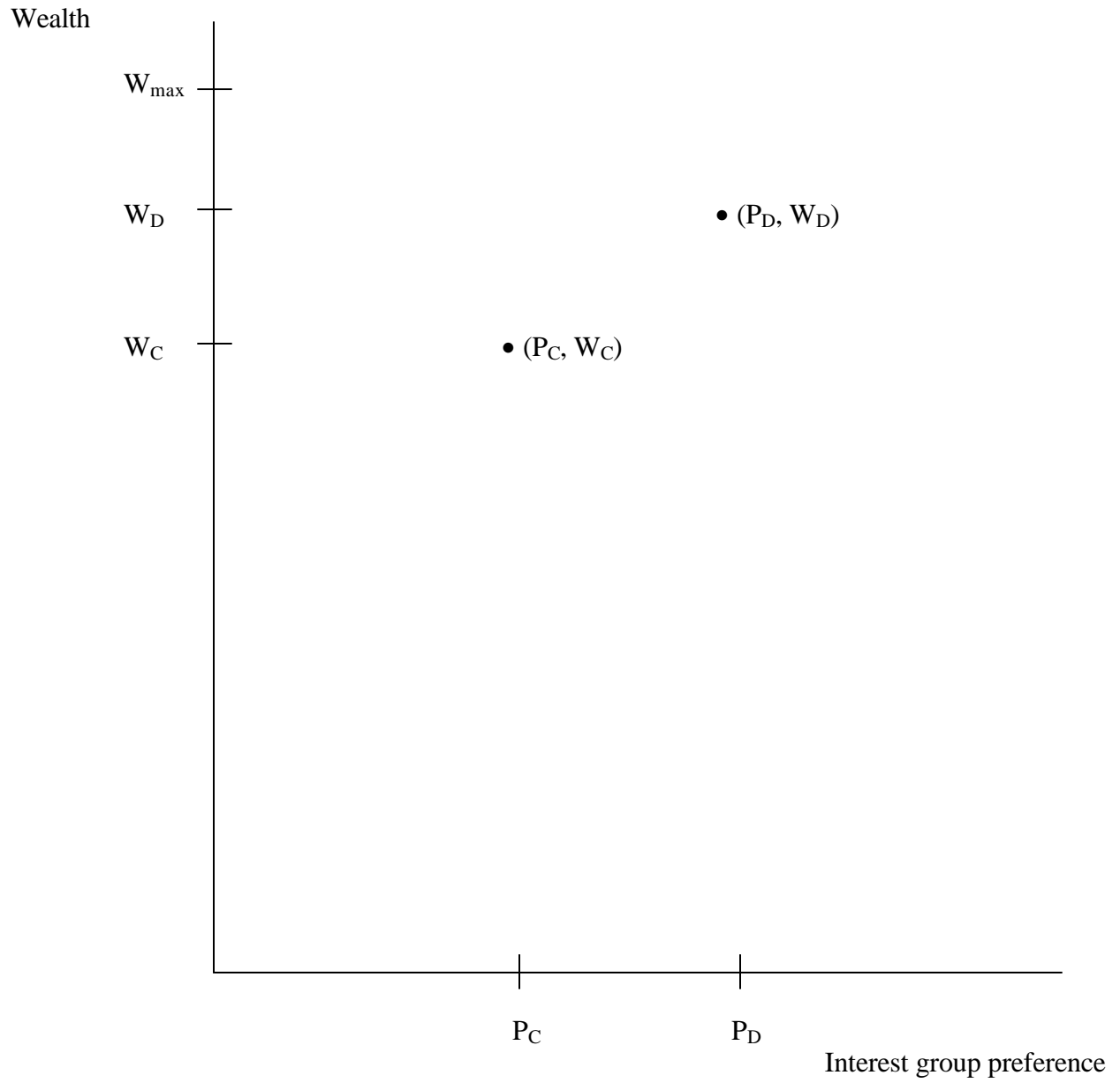


Figure 6

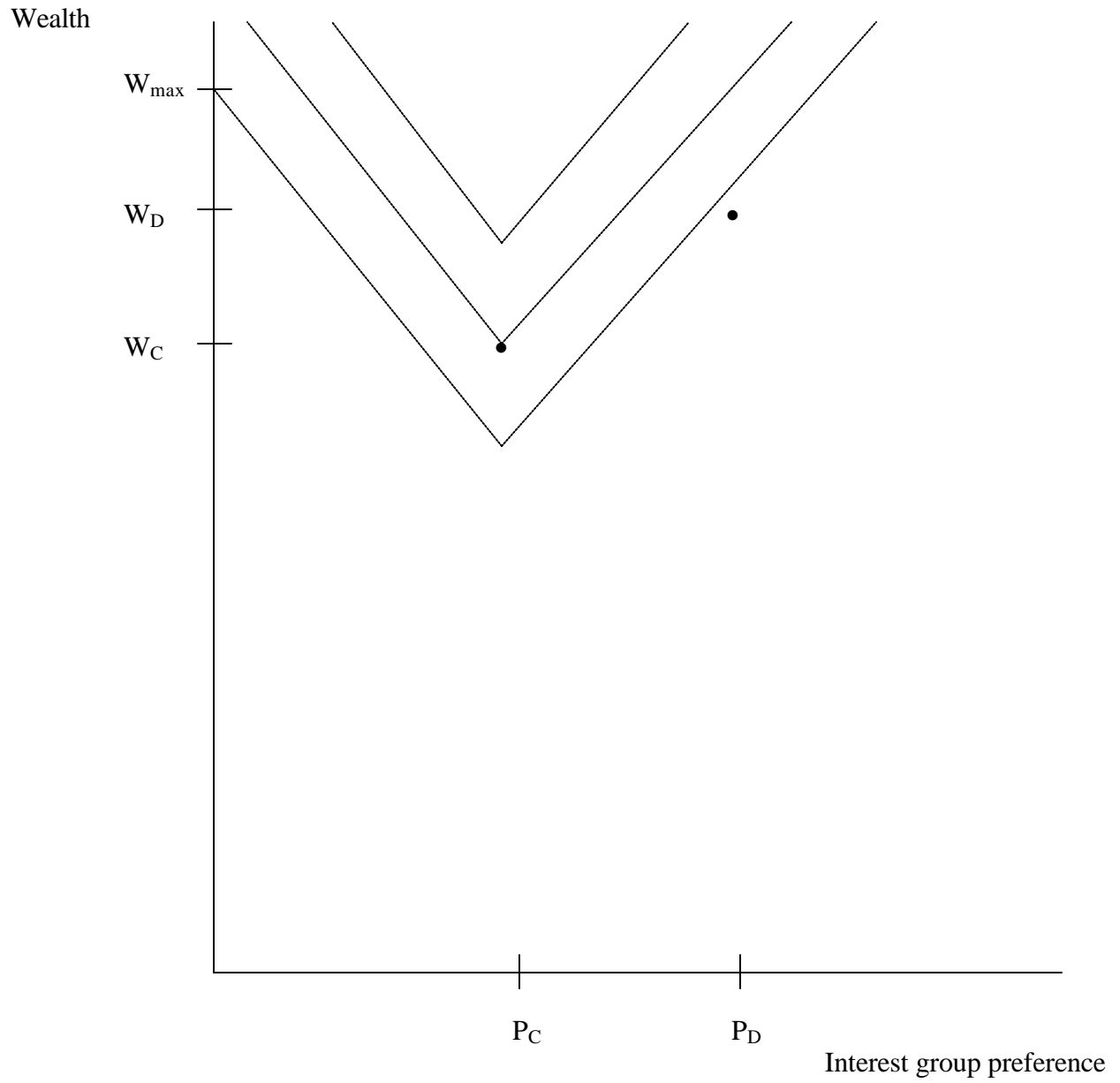


Figure 7

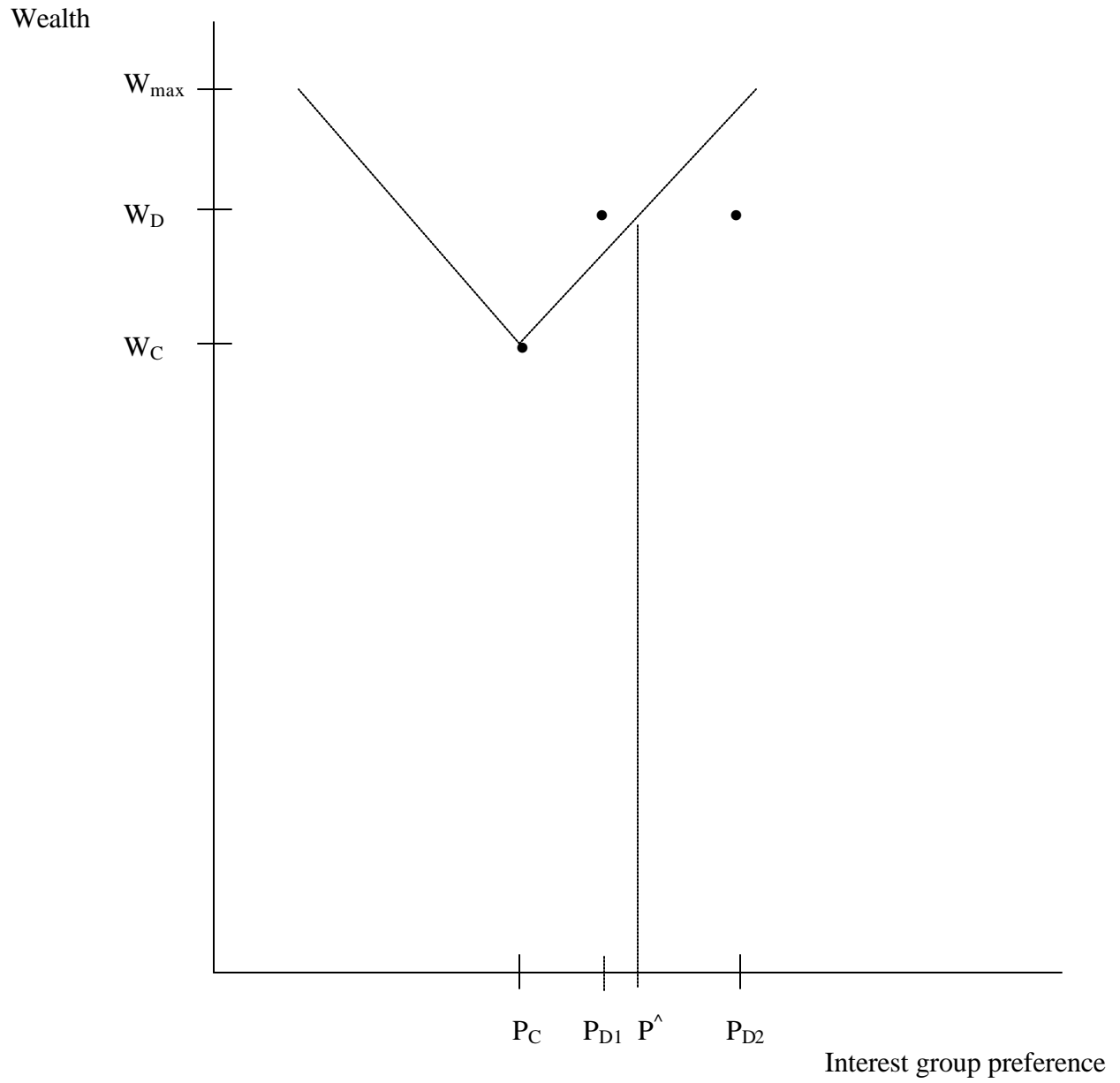


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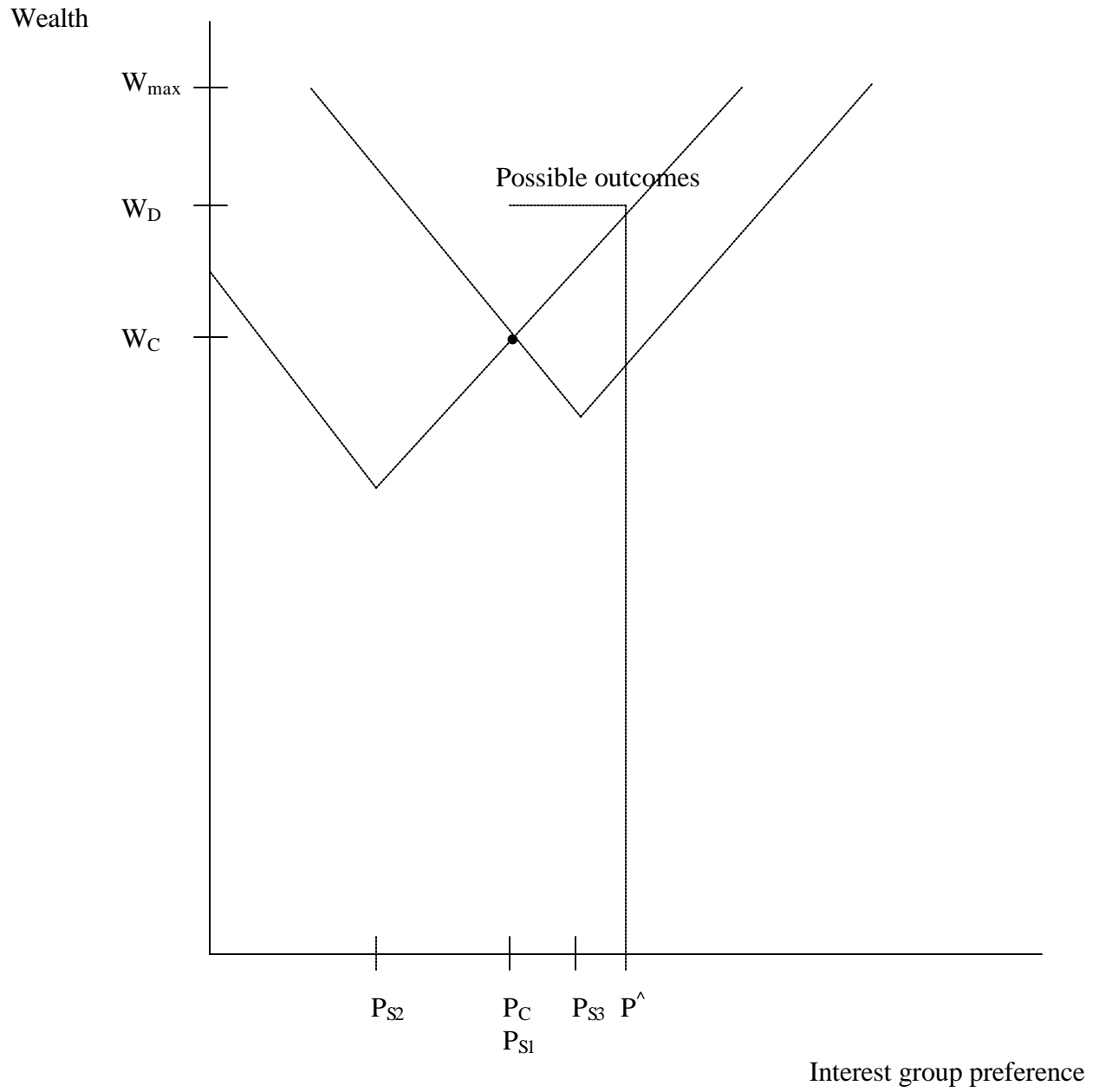


Figure 9

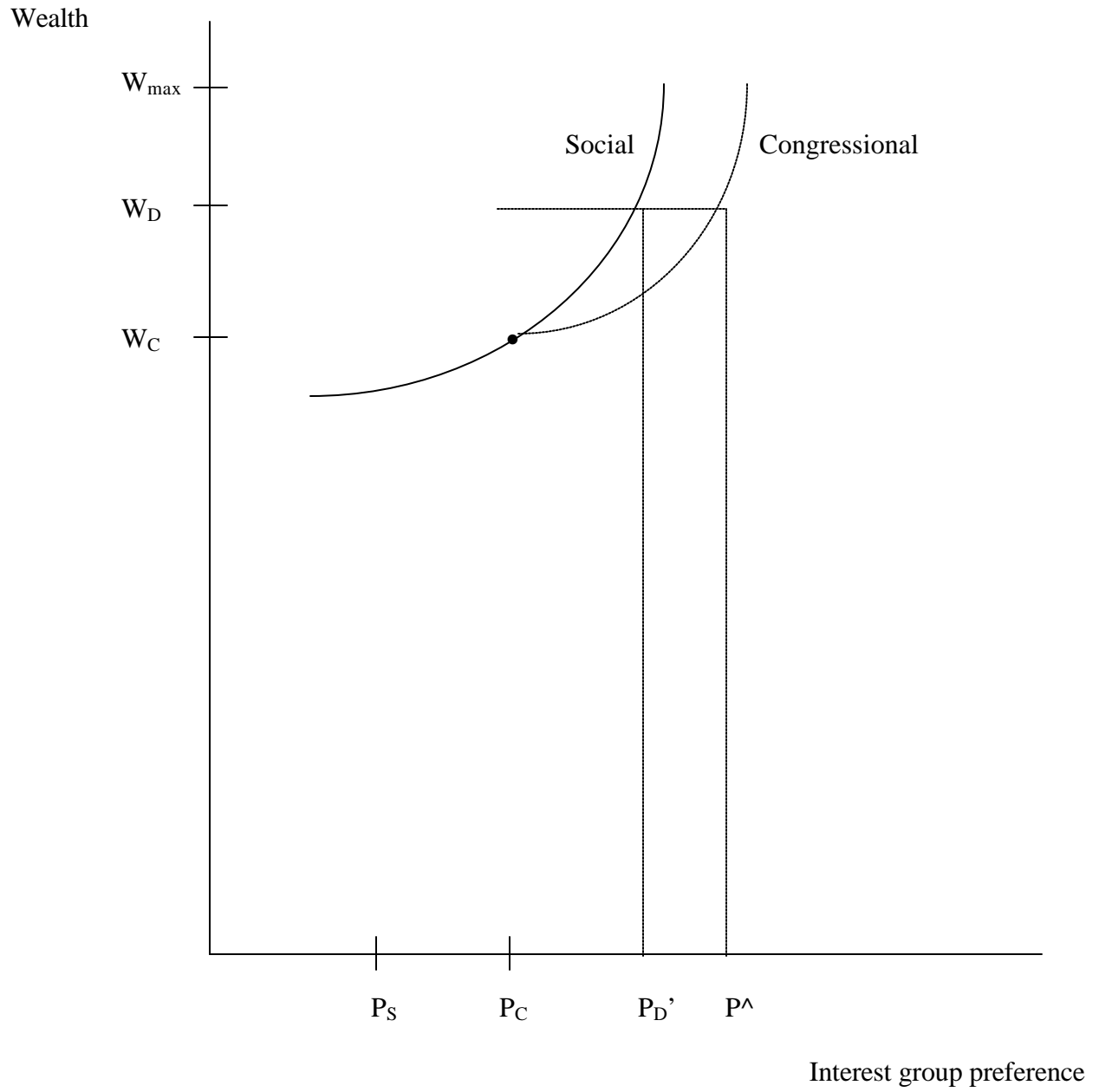


Figure 10

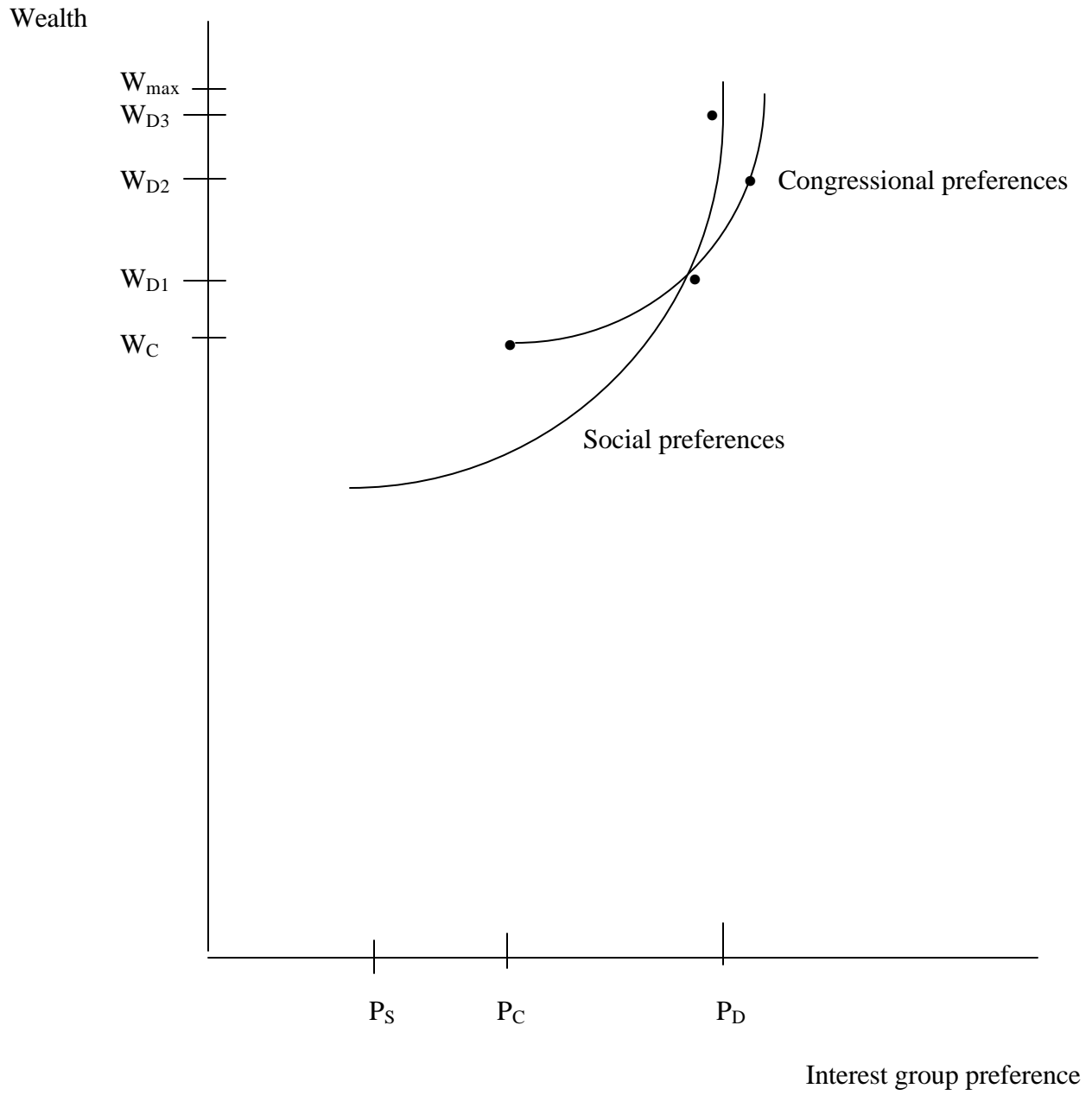


Figure 11

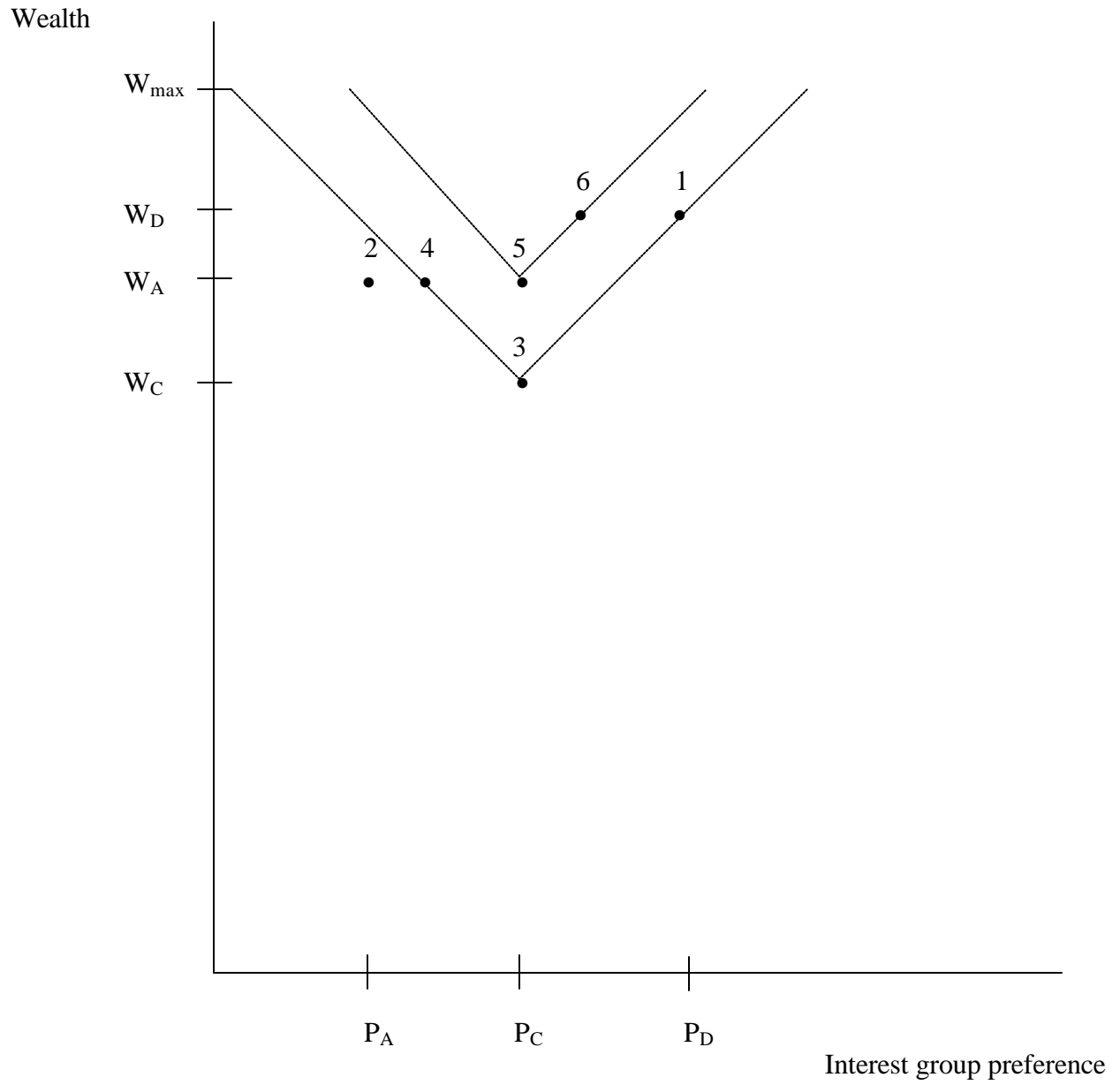


Figure 12

