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**Author**
Bratton, William W.

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# THE CONTENT OF CORPORATE FEDERALISM

**William W. Bratton**
Professor of Law
Georgetown University Law Center

**Joseph A. McCahery**
Professor of Law
Universiteit van Tilburg

# INTRODUCTION

This is a time of spirited debate about the state-federal allocation of corporate regulation. Arguments about the legitimacy of charter competition and Delaware's national role as a corporate law maker are as intense as ever. The Sarbanes Oxley Act simultaneously has triggered a loud discussion about the legitimacy of federal intervention into corporate internal affairs traditionally regulated by the states. We, however, see no cause for excitement on either front. Despite recent evidence of infirmities in the charter market, we think Delaware legitimately plays a national role. At the same time, we see no support for the view that recent federal expansion into internal affairs territory destabilizes or impairs corporate law's federal structure.

This Article explains why corporate federalism remains robust, offering a positive political economy. Drawing on the history of corporate law and basic concepts of evolutionary game theory, we locate the content of corporate federalism in two stable equilibriums. The first equilibrium prevails in the charter market, following from Delaware's successful pursuit of an evolutionarily stable strategy to maximize rents from the sale of charters. The strategy, first followed by New Jersey, caused a radical change in corporate law in the late nineteenth century. Since then, stability has ruled. Corporate law's basic, enabling outline changed little during the twentieth century. Operative incentives, market structure, and regulatory results have been more constant than dynamic, even as Delaware often has adjusted its strategy as ithas adapted to events.

The second equilibrium is more political than economic and prevails among the makers of national corporate law -- Congress, the Securities and Exchange Commission, the stock exchanges, and the federal courts. These actors react to events in a more volatile manner. But even here equilibrium has prevailed since 1934. In theory, under the prevailing norm, national regulation covers the securities markets and mandates transparency respecting firms with publicly traded securities and internal corporate affairs are left to the states. In practice, federal lawmakers often disregard the norm, entering into internal affairs as the national system grows episodically. But they follow a norm of cooperation even as they make these incursions. Federal regulators never structure interventions so as to disrupt the state equilibrium. They leave Delaware in place, along with its stable strategy and its rents. In our view, this is the core of the federalism, a view that contrasts with a prevailing subject matter-based conception.

The cooperative federal strategy gradually evolved toward stability after 1934. Federal regulatory restraint was politically contested for much of the twentieth century, as progressives objected to rent-driven lawmaking in the states and proposed preemption of the entire field. But the public interest approach steadily lost political salience. On the other side, beginning in the latter part of the century, free market proponents made a case against any national corporate law, in effect proposing an irrebuttable presumption favoring state regulation of internal affairs. That case also has lacked political salience. The actors who make corporate law have resisted the influence of both ideological paradigms, instead regulating by reference to a governance agenda. This is a set of regulatory strategies, mostly process-based, directed to the amelioration of agency costs

in publicly traded, management-dominated firms. Discussions of agenda items tend to devolve on functional questions about performance and welfare effects. Ideological lines tend to be drawn only when questions arise as to the relative costs and benefits of self regulation and process mandates. Since answers tend to be cautious, they by default favor state autonomy. At the same time, the internal affairs presumption yields quickly whenever a national level political imperative presents itself.

In the evolving pattern, the federal system mandates while Delaware consistently favors self regulation. The federal government is the bad cop. Its mission is to make sure that firms tell the truth about themselves. It performs the mission with a massive, mandatory apparatus peopled by prosecutors with political aspirations and greedy plaintiff's lawyers, imposing fines and large money judgments and occasionally sending miscreants to jail. Delaware is the good cop. It arbitrates between shareholder and management interests, making sure never to chill risk taking. It articulates governance standards in a dialogue with the actors it regulates. It only polices when forced. Even then it chooses its techniques with care, sometimes enjoining a transaction but almost never imposing a money judgment. Its corporate case law is mandarin, conversant with financial technicalities, and full of procedural nuance.

The good cop/bad cop routine follows from the federal structure. Delaware's sales of domiciles to firms operating nationwide can implicate externalities. Externalities do occur because Delaware's strategy structurally favors management on allocational questions. It follows that a state with Delaware's incentives would not be tolerated as a de facto national lawmaker absent the possibility of federal preemption to reverse or modify state law results. At the same time, when financial crises and compliance breakdowns coincide, national political demands arise concerning the conduct of corporate business. Delaware is disabled from responding to such demands, self regulation and kid glove treatment being essential components of its evolutionarily stable strategy. Charter competition embeds enabling state corporate law and inhibits policing. By default, then, the job of confronting external shocks goes to actors at the national level. This leaves Delaware structurally vulnerable to shifting preferences and abrupt changes in response at the federal level.

Market declines trigger federal interventions, following the classic cause and effect pattern of market regulation.[1] One hears a lot of talk about this post Enron. The story goes something like this. Market reverses and scandals scare politicians, who hastily package regulations to defuse constituent anger. Therefore, the regulations are bad. Market regulation, to the extent necessary at all, should not reference periods of aberrant market performance. In this Article we confirm the tie between dropping stock market averages and incursions on internal affairs. But we add a point to the story: Regulatory innovations that cut management slack for wheeling and self-dealing correlate with rising stock markets, with the correlation obtaining at both the state and national levels. Taken together, the upside and downside correlations teach us much about the

[1] Indeed, price declines have been triggering governmental regulation of the securities markets for 300 years. See Stuart Banner, Anglo-American Securities Regulation: Cultural and Political Roots 1690-1860 (1998).

political economy of corporate law. But, in our view, neither carries much evaluative weight.

As to political economy, federal responses have been progressively less threatening to the state equilibrium. Federal elected officials tend traverse internal affairs on the upside to satisfy interest group demands, expecting no adverse political consequences. On the downside, officials legislate in response to more broadly-based political demands, acting to avoid finding themselves on the wrong side of median voter preferences rather than acting at the behest of the interest groups. Meanwhile, median voter demands have moved away from early and mid twentieth century populist concerns like corporate bigness and labor relations. Now, in the era of pension fund socialism, national political demands tend to be driven by shareholder value. Today's populist agenda concerns compliance with laws designed to assure accurate market prices.

These legislative packages are designed to correct policy imbalances in the voters' eyes and avoid any fundamental restructuring of corporate law. This makes political sense in light of Delaware's emergence in the good cop role. Just as the good cop's role is untenable without a bad cop in the other room, so does the bad cop make use of the good cop. As the good cop, Delaware figures in the wider politics of shareholder value. It follows that interference with the state equilibrium implies more than just interest group opposition; it also holds out political risks with the median voter.

Where national corporate law is driven by valuations in securities markets, state corporate law is driven by rents. Many take this point as a basis for questioning the system, persuasively showing that the state equilibrium does not measure up as first best when analogized to an efficient product market. While we agree with the second best description of the charter market, we do not see any negative implications for Delaware's legitimacy, in theory or in practice. For us it suffices that the system is consensual, responsive, and monitored at the national level. Indeed, it is not clear to us that a first best market for law could exist in the first place. Law rarely works as product in the real world because lawmakers lack entrepreneurial incentives. It accordingly is unsurprising to find a jackpot of rents in the financial profile of a state that not only turns itself into an entrepreneurial shop but successfully pursues the same business plan for a century.

Summing up, this Article brings five points to corporate federalism discussions. First, federal intervention into internal affairs is inevitable because Delaware follows an evolutionarily stable strategy that constrains its ability to respond to shocks that create national political demands. Secondly, national interventions are structured so as to leave the rent-driven state equilibrium undisturbed. Thirdly, the cooperative federal strategy has evolved in response to political demands focused on shareholder value. Fourthly, the state equilibrium's second-best quality has no bearing on corporate federalism. From all of this follows a fifth point -- the threat of federal intervention has sunk into the deep constitutional structure, leaving Delaware safe in the present context.

Part I starts at the end of the line, setting out an ahistorical description of the present state-federal allocation of corporate regulation. We apply the typology devised by Reiner Kraakman and others in the recent book, *The Anatomy of Corporate Law*.[2]

Part II recounts the evolution of state corporate codes from the appearance of charter competition in New Jersey in 1888 through the takeover wars of the 1980s. This account shows that an enabling approach quickly became embedded in corporate law due to the appearance of a stable strategy for charter market success. The discussion goes on to describe the opposing evaluative models drawn on by the charter system's opponents and proponents – the trust paradigm of Berle and Means and the market paradigm of Henry Manne and Michael Jensen. Finally, Part II takes up the question whether the charter market's second best properties make any difference for federalism and the internal affairs norm, concluding thatthey do not matter.

Part III turns to national law, setting out a political economy of federal incursions on corporate internal affairs since 1934. This begins with two prominent failed initiatives, federal chartering and federal protection of hostile takeovers, showing how both the trust and market paradigms fell short as political motivators. Discussion turns to incursions that succeeded, mostly prominently the Williams Act, the Foreign Corrupt Practices Act, and the Sarbanes Oxley Act. This shows that where the state system is embedded, federal corporate lawmaking is historically contingent and responsive to events. But federal regulators respond to events in an institutional framework shaped by the governance agenda, the shareholder value enhancement objective, and a cooperative pattern of respect for the stable state equilibrium.

Part IV focuses on state responses to developments in the national political economy, looking at Delaware's evolution since the mid 1970s. Delaware, under national pressure, adjusted its strategy to make itself a more credible source of corporate fiduciary law. It learned how to draw on the governance agenda to build self regulation into fiduciary enforcement. It emerged in the role of national good cop, the important point being that it found a way to police and without defecting from the stable strategy. Delaware also held to its strategy on the focal point issue of antitakeover protection, in the teeth of federal pressure. Today, with takeovers off of the federal political agenda and newly empowered shareholders taking up governance slack, Delaware looks in better shape than ever.

Part V concludes.

## I. STATE AND NATIONAL REGULATORY STRATEGIES

This part takes a snapshot of the present division of subject matter between state and national corporate law. Subsequent parts of the Article describe the political and economic factors that operated in history to bring corporate law into this posture.

[2] Reinier R. Kraakman, Paul Davies, Henry Hansmann, Gerard Hertig, Klaus J. Hopt, Hideki Kanda & Edward B. Rock, The Anatomy of Corporate Law: A Comparative and Functional Approach (2004).

**A. The *Anatomy* Typology**

In describing the structural division between state and national corporate regulation, we draw on the typology of corporate law set out by Reinier Kraakman and others in *The Anatomy of Corporate Law*.[3] The *Anatomy* imports coherence and transparency to the exercise. It depicts corporate law as a collection of "strategies" for protecting principals from expropriation by agents. It divides the strategies into two categories, (a) *regulatory strategies*, through which the law mandates the terms of relationships among principals, agents, and the firm; and (b) *governance strategies*, through which the law channels the ongoing articulation of the terms of corporate agencies. Legal manifestations of strategies within each category differ depending on the time of application, ex ante or ex post.

The *Anatomy* identifies two categories of corporate law that pursue regulatory strategies. Law in the first category imposes performance mandates on agents. These *agent constraints* apply on an ex ante basis by rule and on an ex post basis through open-ended standards of conduct. Law in the second category governs the terms of the principal's financial engagement with the firm. These *affiliation terms* apply on an ex ante basis when capital is transferred to the firm and on an ex post basis when capital is withdrawn or shares are sold. The *Anatomy* goes on to identify three categories of corporate law that pursue governance strategies. The first category, *appointment rights*, concerns the ex ante selection of agents and their ex post removal. The second, *decision rights*, concerns control over the terms of the firm's governing contracts and its business plan. Ex ante decision rights control the initiation and amendment of investments, divestitures, contracts, and corporate legislation; ex post rights go to the ratification or veto of investments, divestitures, contracts, and legislation. The third set of governance strategies, *agent initiatives*, concerns the incentives of the firm's agents. Ex ante these go the agents' qualifications and normative acculturation as responsible fiduciaries; ex post these go to the agents' financial rewards.[4] There emerge ten categories as follows:

| | **Regulatory Strategies** | | **Governance Strategies** | | |
|---|---|---|---|---|---|
| | *Agent Constraints* | *Affiliation Terms* | *Appointment Rights* | *Decision Rights* | *Agent Incentives* |
| Ex ante | Rules | Entry | Selection | Initiation | Trusteeship |
| Ex post | Standards | Exit | Removal | Veto | Reward |

**B. State and National Regulatory Strategies**

Using the typology to describe corporate law's federal content implicates a categorical mitosis, with state and national level content being broken out within each of the ten categories. We arrange the results strategy by strategy.

[3] Id. at 23-28.
[4] Id. at 23.

**Regulatory Strategies**

**(1) Agent Constraints**

| | **State Level** | **National Level** |
|---|---|---|
| **Rules (ex ante)** | Free contract<br>(outside of insolvency) | (1) Compliance systems<br>(2) Generally Accepted Accounting Principles<br>(3) Proscriptions of loans to directors and officers<br>(4) Trust Indenture mandated terms<br>(5) Labor law<br>(6) Consumer protection |
| **Standards (ex post)** | (1) Fiduciary duties<br>(2) Veil piercing<br>(3) Creditor protection (within the zone of insolvency) | (1) Insider trading and fraud proscriptions<br>(2) Bankruptcy duties<br>(3) Auditing standards |

**(2) Affiliation Terms**

| | **State Level** | **National Level** |
|---|---|---|
| **Entry (ex ante)** | Free contract | (1) Disclosure mandates for publicly traded companies<br>(2) Stock exchange listing requirements |
| **Exit (ex post)** | (1) Managers and other constituents: free contract<br>(2) Shareholders:(a) free transferability default; (b) liquidation process default; (c) appraisal in some mergers; and (d) poison pill and other tender offer barriers | (1) Third party tender offer rules<br>(2) Issuer tender offer rules<br>(3) Bankruptcy plan confirmation requirements and distribution preferences |

Let us first take up the state level regulatory strategies, comparing the states' ex ante agent constraints and ex ante affiliation terms. State law's enabling structure is apparent immediately. State corporate law neither mandates contractual terms respecting the engagement of directors and officers, nor imposes significant constraints on corporate dispositions of capital for the benefit of creditors. Nor does it constrain insiders' discretion respecting the terms and distribution of new equity issues. If ex ante constraints are desired, the burden is on the principal, whether an equityholder or

creditor, to constrain the agent with explicit contract terms.[5] This enabling approach leaves these central matters unconstrained by legal rules and open to dynamic evolution over time. Meanwhile, management traditionally has controlled the contracting agenda.

State law does address agent behavior ex post, imposing fiduciary constraints against agent self dealing transactions and oppression of minority shareholders. Review of the substance of business decisions is avoided: Although the fiduciary regime imposes a duty of care, the standard of scrutiny is minimal. Fiduciary protection does not extend to the firm's other constituents—creditors, employees, suppliers, and customers. They are excluded from the state system of corporate rights and duties (subject to the late-breaking imposition of creditor protection rules at point of insolvency) and must bargain for any substantive protection from exploitation by corporate agents.

Now consider the state law of exit. The states regulate the shareholders' terms of exit more heavily than they regulate the terms of entry. Under the default rule on liquidation, the board of directors has agenda control. This as a practical matter prevents dissolution at the initiation of the equityholders and locks their capital into the firm, importing stability for the going concern. But the exit terms display a management protective aspect even as they reduce volatility. Although the default rule makes shares freely transferable, the availability of a poison pill can disable the shareholders from using their transfer privilege to shift control to a hostile tender offeror. The pill gives the board of directors veto power over the transaction, subject to minimal ex post fiduciary scrutiny.

We now shift attention to the national level. Note first that federal law holds out significant protections for the interests of corporate constituents other than shareholders. The law of bonds provides an illustration. The bondholder-issuer agency begins as a contractual, state level relationship, with the bond contract setting out elaborate agent constraints ex ante.[6] Affiliation terms -- matters of market issuance, issuer disclosure, and trading -- are dealt with by federal securities laws and stock exchange rules. But there also is substantial federal intervention in respect of the bond contract's provision of agent constraints and decision rights. The Trust Indenture Act of 1939[7] imposes minimum standards on the states' bond contracts, in effect imposing terms on the contracting parties. Upon insolvency, federal bankruptcy law heavily supplements and sometimes displaces state law with ex post agent constraints and affiliation terms.[8]

Returning to national level protection of the shareholder interest, the core provisions of the federal securities laws show up in the third column above, providing for (a) ex ante and ex post agent constraints respecting financial reporting and legal compliance; (b) ex post agent constraints concerning misstatements and insider trading;

[5] We do not claim that state corporate law is completely denuded of mandates. The typology reveals quite a few. For the definitive discussion, see Melvin Aron Eisenberg, The Structure of Corporation Law, 89 Colum. L. Rev. 1461, 1480 (1989).
[6] The law of the bond contract, by contracting custom, is the law of New York. Delaware law is never chosen even when Delaware is the borrower's state of incorporation.
[7] 15 U.S.C. § 77aaa et seq.
[8] See David A. Skeel, Jr., Corporate Anatomy Lessons, 113 Yale L. J. 1519, 1552-62 (2004).

and (c) ex ante affiliation terms bound up in the mandatory disclosure system governing new issues of securities sold to the public. These regulations nominally address the conduct of the national securities markets rather than the agents' conduct of the firm's business. They apply only to firms issuing securities in those markets toward the end of assuring those firms' transparency. (Firms that raise all capital privately, remaining closely held and borrowing solely from banks or in the private placement market, remain entirely within the state law system.) Mandates are the dominant mode of regulation, in contrast to state law's enabling approach. The mandates apply on national and market wide bases, importing regulatory harmony. The fifty state law systems, in contrast, apply firm by firm.

The disclosure mandates significantly impact day to day conduct of business, despite their formal denomination as market regulation. They are highly detailed, extending to all aspects of a firm's business on an ongoing basis. Failure to comply can trigger significant legal proceedings, whether at the instance of the enforcing agency, the Securities and Exchange Commission (SEC), or lawsuits by private plaintiffs. Commentators point out that such proceedings implicate complex fact questions about the business and management decisions, subjecting ordinary operations to regulatory review.[9] They in effect substitute for the minimalist state law duty of care.[10]

### C. State and National Governance Strategies

**Governance Strategies**

**(1) Appointment Rights**

| | **State Level** | **National Level** |
|---|---|---|
| **Selection (ex ante)** | (1) Shareholder franchise default<br>(2) Contracted for non voting and weighted voting stock | (1) Proxy rules<br>(2) Stock exchange committee membership requirements<br>(3) Stock exchange prohibition of nonvoting stock |
| **Removal (ex post)** | Shareholder removal | Proxy rules |

**(2) Decision Rights**

| | **State Level** | **National Level** |
|---|---|---|
| **Initiation (ex ante)** | Board control default | Shareholder proposals |
| **Ratification (ex post)** | Shareholder approval | Stock exchange mandated |

[9] Robert B. Thompson & Hillary Sale, Securities Fraud as Corporate Governance, 56 Vand. L. Rev. 859, 895-901 (2003).
[10] Id. at 903-09; Joel Seligman, The New Corporate Law, 59 Brook. L. Rev. 1 (1993).

| | required for charter amendments and some fundamental changes | shareholder votes on (a) equity compensation plans, (b) auditor, and (c) some mergers |
|---|---|---|

**(3) Agent Initiatives**

| | **State Level** | **National Level** |
|---|---|---|
| **Trusteeship (ex ante)** | Processes for disinterested director approval of self dealing transactions | (1) Disclosure mandates<br>(2) Mandated independent directors on board and committees<br>(3) Auditor independence rules |
| **Reward (ex post)** | (1) Pro rata dividends<br>(2) Repurchases within board discretion<br>(3) Compensation—free contract subject to loose fiduciary scrutiny | (1) Disclosure mandates<br>(2) Accounting mandates<br>(3) Shareholder ratification mandates<br>(4) Committee process and composition mandates<br>(5) Insider trading proscription |

We turn now to the state-federal disposition of appointment rights. Here Delaware imposes a bottom line mandate: the holder of at least one class of equity security must have the residual right to elect and remove the directors.[11] If that minimum standard is met, the corporate charter may freely divide the vote among different classes of stock, there being no further barriers to the issuance of nonvoting and weighted vote issues.[12] To see how the voting system works, reference also needs to be made to the states' ex ante rule on decision rights, which are granted to the board of directors under a default rule. The allocation of day to day decisionmaking authority to the board in turn shapes the real world exercise of power respecting appointments. Even though the shareholders have the vote, the board and its agents control the nomination of candidates, send out the proxies, and conduct the shareholders meeting. Of course, nothing bars a challenger from presenting the shareholders a competing slate of candidates, provided it has extensive resources. The federal securities laws here intervene with the proxy rules. Once again disclosure is the focus -- the proxy rules dictate the matters to be covered in the proxy statement point by point (and sometimes sentence by sentence), subject to an overarching federal antifraud rule. This disclosure mandate is accompanied by governance process rules that tightly control the conduct and timing of proxy solicitation.

State law on decision rights is less permissive than first appears. Although the regime of board control follows from a default rule rather than a mandate,[13] the default

[11] Del. Gen. Corp. L. Del. Code Ann. tit. 8, § 151(b)(2001).
[12] Id. § 151(a).
[13] Id. § 141(a)

rule operates as a mandate in effect. This is because the default can be contracted around only by remitting management power to the shareholders,[14] a modification that makes functional sense only for a closely held firm. As a practical matter, then, state law vests decision rights respecting the management of the business of publicly traded firms in the board of directors. The state governance strategy goes on to hardwire the board's control of the firm's agenda. Shareholders are accorded ratification rights respecting charter amendments and many mergers and asset sales, but, as a practical matter, enjoy no right of initiative. At this point the federal proxy rules enter in again, adjusting the corporate decision agenda significantly, according shareholders a right to access the proxy statement at the firm's expense. They may make such proposals as state law permits and in addition may make nonbinding proposals respecting subject matter defined by the proxy rules themselves. The stock exchange rules also intervene to expand the list of matters for shareholder ratification.

We turn finally to agent initiative strategies. Traditionally, state law leaves these up to contractual treatment at the board of directors' discretion, excepting only a weak pro rata distribution mandate[15] respecting dividends. Independent directors are not required; compensation levels are subject only to the most cursory fiduciary review. Recent state cases have been developing a definition of an "independent" or "disinterested" director, but this actor serves a limited function: Boards draw on their independent directors to review self dealing contracts so as to insulate the contracts from judicial review under the fiduciary rubric. The federal regime enters in to impose highly specific disclosure requirements concerning compensation and conflict of interest situations. The stock exchanges add a lengthening list of process mandates that deploy independent directors at key moments in decisionmaking sequences.

### D. The Federal-State Regulatory Pattern

All of the foregoing national level regulations originated as interventions that followed the state system in time and adjusted state results. They presuppose that the state system creates and defines corporate rights and duties and then supplement the state system, adding agent duties and according the principals additional rights. Only rarely do federal corporate regulations displace the state system altogether.[16] The constitutional

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[14] Id.

[15] The distribution mandate is weak because nothing prevents the firm form creating a class of preferred stock and placing it in the hands of insiders.

[16] For discussion of the points of preemption, see Robert H. Thompson, Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue, 62 L. & Contemp. Prob. 215 (1999). The one share one vote rule presents a famous case of direct conflict. The NYSE instituted this rule in 1926, trumping the state law allowance of nonvoting and weighted voting stock. See Robert B. Thompson, Collaborative Corporate Governance: Listing Standards, State Law and Federal Regulation, __ Wake Forest L. Rev. __, __ (2003). When the NYSE relaxed its rule in the mid 1980s, due to issuer pressure, the SEC inserted Rule 19c-4 under the 1934 Act, to limit future adoption of dual class voting schemes, only to have its intervention ruled outside of its statutory authority in Business Roundtable v. Securities and Exchange Commission, 905 F.2d 404 (D.C.Cir. 1990). Where in that case, the management interest went to court to avoid preemption, in a more recent case, management went to Congress to get preemption. Section 18 of the Securities Act of 1933, 15. U.S.C. § 77r (1994), contained a savings clause leaving in place state securities law and actions based thereon. The National Securities Markets

term "preempt" does figure into the description, however. Federal law is supreme under the constitution and preempts all state law in conflict with it.[17] When federal law imposes a duty that state law does not impose, the state law regime is preempted in the sense that the state accorded the firm or agent a right to proceed unburdened by the duty. But there results no further impairment of the state system. State law's enabling character makes this possible. Delaware, for example, allows the board of directors to subdivide itself into committees and empower the committees to act as the board.[18] It stops there, leaving a blank slate to be filled in by the firms. When the federal government follows up, mandating an audit committee and specifying committee powers and practices, it fills in the blank slate with mandates but displaces no state law. Stock exchange rules work similarly, the difference being that the supplementation is instanced as a matter of the firm's contractual consent rather than as a matter of sovereign mandate. But this is a distinction without much difference, for firms fall under the federal government's mandates only after voluntarily tapping the trading markets for capital.

The pattern of federal restraint – supplementation rather than displacement -- does not follow from a constitutional mandate. Congress could draw on the same Commerce Clause[19] that it draws on in supplementing the state system to occupy the entire field of corporate law. The restraint instead follows from informal norms of federalism. Traditionally, the Congress permits state regulation to stand absent a contrary national regulatory objective, and federal legislative drafters exercise reserve at points of systemic intersection. In corporate law, the norm of restraint is combined with the state-federal regulatory pattern to result in a limiting federalism norm, termed "internal affairs." Under this, federal law appropriately addresses trading markets, adding disclosure, antifraud, and insider trading mandates. All other corporate subject matters concern "internal affairs" and presumptively are left to the states.

The internal affairs norm carries considerable descriptive weight. But it is fragile, both descriptively and normatively. Even as it influences the national regulatory agenda at some level[20] and federal regulators habitually restrain their entries into state territory, the norm does not contain the federal agenda in a formal sense. With the proxy rules, for example, the federal securities laws shift from regulation of market transactions to regulation of shareholders meetings, going deep into internal governance territory. Many other significant national level entries into internal affairs show up in the outline above. When, for example, the national market regulators seek to assure the quality of financial

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Improvement Act of 1996, Pub.L.No. 104-290, 110 Stat. 3416, and The Securities Litigation Uniform Standards Act of 1998, Pub.L.No. 105-353, 112 Stat. 3227, revised the section, so as to preempt securities fraud class action suits under the common law and statutes of individual states. See Richard W. Painter, Responding To a False Alarm: Federal Preemption of State Securities Fraud Causes Of Action, 84 Cornell L. Rev. 1, 2 (1998).

[16] The SLUSA was meant to cover a "loophole" in the Private Securities Litigation Reform Act of 1995. It was believed that the loophole allowed plaintiffs to "forum shop" by bringing class action securities fraud suits in state rather than federal court. Id. at 4.

[17] U.S. Const. art. VI, cl. 2.

[18] Del. Gen. Corp. L. Del. Code Ann. tit. 8, § 141(c)(2001).

[19] U.S. Const. art. I, § 8, cl. 3.

[20] See infra text accompanying notes __-__.

reports, their governance strategies – compliance systems, audit committee requirements, and auditor independence rules -- traverse the states' enabling internal affairs regime, cutting slack. As the list of such interventions lengthens, the subject matter-based internal affairs norm loses some of its salience in the description of the content of corporate federalism.

Now turn to the federal side of the internal affairs dividing line. In addition to implying state autonomy, the internal affairs norm implies national regulatory primacy over the trading markets and issuer transparency. Here the practice closely follows the norm. This is a nationally dominated regulatory landscape. Federal directives are so extensive that concomitant state law regulation of the subject matter sometimes is minimal or nonexistent. For example, the state law fiduciary principles do extend to insider trading, but only tentatively and ineffectively. As to regulation pursuing high quality financial reporting -- compliance systems, accounting principles, and auditing standards -- there never has been any significant state law.[21] A functional implication arises: These matters are regulated nationally as a means to the end of providing the national securities markets with a regulatory regime that is vigorously enforced on a national basis, unhampered by jurisdictional barriers.[22] A system not only vigorous but harmonized, harmonization being something the fifty states are intrinsically unable to achieve. The implication should be taken with a degree of caution, however. There are counterfactual possibilities: State regulation of these matters might have developed had the national regime not come to occupy the field. State securities regulation preceded the federal regime in time and continues to factor into the enforcement picture;[23] the stock exchanges, left to their own devices, might have filled any gaps.[24]

A lesser structural imperative does emerge. By virtue of its very existence, the national apparatus of market regulation causes the regulatory agenda on transparency and other trading market topics to be set at the national level. When a problem with national market implications arises, all parties expect the national system to address it. From a functional point of view, there is no reason to turn the matter over to the fifty states for variegated treatment on a longer timetable. The states in turn pass over the subject matter.

## E. Summary and Restatement

[21] The Delaware courts have created a parallel set of disclosure standards. See, e.g., Malone v. Brincat, 722 A.2d 5 (Del. 1998). These expand the palette of litigation theories for Delaware plaintiffs without figuring significantly in the national transparency regime.

[22] Marcel Kahan & Edward Rock, Our Corporate Federalism and the Shape of Corporate Law (SSRN working paper 2004), at 36, points out instances where the states could not constitutionally replicate the federal enforcement regime because personal jurisdiction would be unobtainable. These include broker dealer regulation, disclosure requirements for large shareholders, and the prohibition of insider trading under the misappropriation theory.

[23] The emergence of Eliot Spitzer on the securities enforcement scene wielding the law of New York exemplifies this. See, e .g, Brooke A. Masters, Eliot Spitzer Spoils for a Fight; Opponents Blast Unusual Tactics of N.Y. Attorney General, Wash. Post, May 31, 2004, at A1.; In Spitzer's Sights, Economist, Sept. 13, 2003; Mara Der Hovanesian & Paula Dwyer, Where Will Eliot Spitzer Strike Next?, Bus.. Wk., Mar. 8, 2004, at 66.

[24] See infra note __.

Shareholder capitalism has been said to rest on five conditions: (1) market value is the principal measure of the shareholder interest; (2) other constituents should be protected by contract and outside regulation; (3) ultimate control should rest with the shareholders; (4) managers should be obligated to manage in the interests of the shareholders; and (5) noncontrolling shareholders should be strongly protected.[25]

The most extensive national supplementation addresses the first condition, market value, and does so with regulatory strategies pursuing the goal of transparency. This has become national regulatory territory for all intents and purposes. The second condition, the exclusion of constituents other than shareholders and remission of their interests to outside regulation, describes the system at both state and federal levels.[26] The states address the third condition, ultimate shareholder control, with governance strategies – the voting and veto rules. But the capacious and indeterminate property of the states' enabling approach makes it unclear just how meaningful that "ultimate" control tends to be in practice. Under an enabling system, management can exploit the collective action problem of dispersed shareholders so as to make the mechanisms of ultimate shareholder mere formalities, empowering themselves. To ameliorate this tendency, the federal securities laws pursue governance strategies in the proxy rules, making the shareholder franchise a subject matter of joint state-national regulation. The state system's ex post affiliation rule of free transferability also implicates ultimate shareholder control, working in the shareholders' favor by opening a door to hostile tender offers and containing management power. But here, in the regulation of exit, both state and national level regulators have intervened to modify the regime of free contract to protect managers by making tender offers more costly to effectuate. Once again, then, the subject matter is shared. The states address the fourth condition, management in the interest of the shareholders, with both fiduciary regulation and an array of governance processes. This is a zone where national regulators have historically respected the states control of internal affairs, limiting their governance interventions to disclosure mandates concerning

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[25] Henry Hansmann & Reinier Kraakman, The End of History of Corporate Law, 89 Geo. L.J. 439, 440-41 (2001).

[26] Although both of these national-state allocations seem well-settled, both remain subject to spirited theoretical challenge. Those confident of transactional solutions and suspicious of sovereign mandate contend that issuers should be permitted to choose their securities regulator, whether a national regime or self regulatory securities exchange Steven J. Choi & Andrew Guzman, Portable Reciprocity: Rethinking the International Reach of Securities Regulation, 71 S.Cal. L. Rev. 903 (1998)(advocating reciprocity across national securities regimes and issuer choice in their selection); Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 Yale L. J. 2359 (1998)(arguing that issuers should be permitted to choose a securities regime among US jurisdictions and foreign states); Paul G. Mahoney, The Exchange As Regulator, 83 Va. L. Rev. 1453 (1997)(arguing that the exchanges should be the principal drafters and enforcers of disclosure rules); A.C. Pritchard, Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers, 85 Va. L. Rev. 925 (1999)(arguing that exchanges could serve as fraud enforcers). But see Merritt B. Fox, Retaining Mandatory Securities Disclosure; Why Issuer Choice Is Not Investor Empowerment, 85 Va.L. Rev. 1335 (1999)(contending that issuer choice would lead to suboptimal levels of disclosure).

Those suspicious of exercises of power in the absence of democratic accountability would like to see the constituents brought inside the firm as members. See , e.g., David Millon, Redefining Corporate Law, 24 Ind. L. Rev. 223 (1991); Lawrence Mitchell, A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes, 70 Tex. L. Rev. 579 (1992).

sensitive subject matter rather than taking the additional step of mandating processes where the states only enable. But this is changing, with the stock exchange taking the lead with new committee mandates and independence requirements. Only the fifth condition, minority shareholder protection, lies largely in the hands of the states, under their regime of ex post fiduciary regulation. But it is not an internal affairs redoubt. A federal regulatory addition comes in the form of disclosure rules covering issuer tender offers, a transactional extension of the regime of market regulation.

Viewed in the abstract, this federal regulatory allocation lacks complete coherence. The broad organizing factors – markets and mandates at the national level; internal affairs, free contract, enabling governance strategies, and ex post fiduciary review at the state level – do not suffice to explain the entire picture. But the picture results from more than a century of political and economic interaction among actors in large firms, in the securities markets, and in state and federal governments. As a descriptive matter, it follows that the federalism's content can be accessed fully only if the static picture is recast in the historical, political, and economic framework that created it. Two concomitant questions arise respecting the internal affairs norm. The first is descriptive: Whether the internal affairs norm in fact operates as a presumption that constrains national level lawmakers. The second is normative: Whether, the extent the internal affairs norm does constrain at the national level, it follows from a reflexive subsidiarity and lacks policy content or, in the alternative, possesses welfare enhancing properties.

## II. POLITICAL ECONOMY AT THE STATE LEVEL

Charter competition determines choices of regulatory strategy at the state level. The question concerning the appropriate strength of the federal internal affairs presumption accordingly tends to overlap the question concerning charter competition's welfare effects. In this part we enter onto this contested territory with a descriptive agenda. The description leads us to depict the states as noncooperative players of a rent-driven game and Delaware as the follower of a successful, evolutionarily stable strategy. Corporate law emerges in a stable equilibrium state.

Section A traces the evolution of the state system, identifying its principal political and economic determinants. This is a history of regulatory responsiveness induced by rents paid by management. The funding removes state corporate law from the ordinary influences that shape democratic government and embeds state level governance strategies, which show a notable constancy over time. It also structurally removes corporate law from the ordinary political conditions that shape regulation, whether at the state or national level. Externalities emerge as a distinct possibility. It follows that, absent the active possibility of federal intervention at the behest of actors disadvantaged by the state system but not represented in the chartering state, state-level charter competition would be intolerable in a federal system.

Section B looks at theories that evaluate charter competition. First comes the trust paradigm of Berle and Means and Cary, and its race to the bottom description. Next

comes the market paradigm of the late twentieth century and its race to the top description. We show that each of these was more normatively directed against the other than directed to accurate description of the state system and its political economy. Contemporary descriptions correct the shortcoming, showing that the charter market is uncompetitive and riddled with economic distortions. We do not dispute the accuracy of these descriptions. But we do question whether they have any significant implications for the internal affairs norm. In our analysis the presumption leaving internal affairs with the states emerges unscathed even as economic analysis places the charter market deeper and deeper in second best territory.

## A. The Competitive Era

### 1. *New Jersey and Delaware.*

In 1888 the government of New Jersey needed new sources of revenue. James Brooks Dill, a New York lawyer, suggested to the state's politicians that significant sums could be raised if the state provided an attractive domicile for the nation's growing corporate population.[27] The politicians countered that West Virginia already had tried this, liberalizing its corporate code, but without significant fiscal results. Indeed, in 1888 West Virginia's Secretary of State was stationed at the Fifth Avenue Hotel in New York, the seal of the state in hand, ready to sell charters but not finding many takers.[28] Dill assured the politicians that it would be different with New Jersey. The state would not only draft a more liberal code, it would market the code more successfully. Toward the latter end, Dill organized The Corporation Trust Company, which would both serve as the state's marketing arm and as a local agent for incorporating firms, providing them a physical office within the state. Dill, who made sure to put New Jersey's Governor and Secretary of State on the Corporation Trust board of directors, got his corporate code.[29]

The regulatory strategy was enabling. By 1896, all significant ex ante agent constraints had been stripped from New Jersey's code. Governance processes took the place of agent constraints. Corporations were left free to change their business, alter their equity capital structures, and amend their charters.[30] More importantly, the code left them free to merge and combine in holding company structures[31] toward the end of

[27] Christopher Grandy, New Jersey Corporate Chartermongering, 1875-1929, 49 J. Econ. Hist. 677, 681 (1989).
[28] Lawrence Mitchell, The Speculation Economy (book manuscript on file with author).
[29] Harold W. Stoke, Economic Influences Upon Corporation Laws of New Jersey, 38 J. Pol. Econ.551, 570-71, 573 (1930).

The strategy relies on federal constitutional law, under which corporations are treated as "persons" entitled to the constitutions protection. Under a nineteenth century judicial doctrine termed "unconstitutional conditions" it was held to that a state could not exclude corporations incorporated elsewhere. See Herbert Hovenkamp, Enterprise and American Law, 1836-1937, 47-48 (1991). Under a common law conflict of law rule that evolved during the twentieth century, the states respect the chartering states governance of corporate internal affairs. See Restatement (Second) of Conflict of Laws § 302 (1971).
[30] Stoke, supra note __, at 572-573.
[31] The removal of agent constraints facilitated mergers. The removal of legal capital constraints made stock watering legal, which made it possible for a large corporation to buy up competitors by offering stock

facilitating anticompetitive arrangements. New Jersey thus opened the door for mergers[32] even as other states were following the federal government and enacting antitrust laws modeled on the Sherman Act.[33]

New Jersey's code also held out a critical innovaiton respecting g overnance process: For the first time in any state code, initiation rights were vested in the board of directors subject to shareholder ratification.[34] This gave managers agenda control over fundamental changes, including, critically, reincorporation to another state. (Previously, an agency theory of board authority had prevailed and shareholder initiative had been the rule.[35]) There was also an innovative governance mandate: All shareholders meetings had to be held in New Jersey, providing not only rents for the state but assuring that voting would be by proxy, making challenges less likely.[36]

New Jersey's 1896 code became the template[37] for the evolution of the state level corporate regime.[38] Subsequent departures from it have opened new stretches of enabling territory but have not changed the system fundamentally. The New Jersey code became the template because it succeeded competitively. Half of the nation's largest corporations were domiciled in New Jersey by 1899.[39] The state's deficit was wiped out. By 1905, its governor even boasted that none of the state's income was contributed by direct payments from individuals.[40]

Other states entered the new charter market. In 1899, Delaware's Joseph A. Marvel marked up his state's corporate code to mimic New Jersey's. (He also formed the

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consideration at bargain prices. In addition, the code permitted different classes of stock to have different economic and voting rights, facilitating deal-making by making it possible to pay with nonvoting or low-voting shares. Ralph Nader, et al., Constitutionalizing the Corporation: The Case for Federal Chartering of Giant Corporations 45 (1976).

[32] Mergers consummated between 1898 and 1905 implicated 40 percent of all manufacturing capital. Shaw Livermore,

[33] By 1914 all but New Jersey and six other states had done so. Stoke, supra note __, at 575. See also Herbert Hovenkamp, Enterprise and American Law, 1836-1937, 266-67 (1991).

[34] James B. Dill, The Statutory and Case Law Applicable to Private Companies under the General Corporation Act of New Jersey and Corporation Precedents 42-43 (1899)(New Jersey General Corporation Act § 27).

[35] *See* Joseph K. Angell & Samuel Ames, A Treatise on the Law of Private Corporations, Aggregate §§ 297-99 (9th ed. 1871); 1 Victor Morawetz, Treatise on the Law of Private Corporations §§ 243-44 (2d ed. 1888)). Delaware followed in its corporations code of 1899, See Section 135 of the Act of 1899, 21 Del. Laws, 1899, ch. 273; Russell Carpenter Larcom, The Delaware Corporation 11-13 (1937). These agenda control provisions diffused into the codes of other states during the subsequent decades. By 1960, 25 state codes conditioned charter amendment on board approval; see 2 Model Bus. Corp. Act. Ann. 230-31 (1960). by 1970, 28 state codes did so. See 2 Model Bus. Corp. Act. ANN.2D 260-61 (1971).

[36] Nader et al., supra note __, at 46.

[37] See Richard M. Buxbaum, Facilitative and Mandatory Rules in the Corporaiton Law(s) of the United States, 50 Am.J.Comp.L. 249, 249 (2002)(noting that state codes have been facilitative since the New Jersey innovation).

[38] According to Stoke, supra note __, at 579, New Jersey's code in 1929 resembled "very much the laws of 1896."

[39] Id. at 574.

[40] Nader et al., supra note __, at 48.

Corporations Services Company and mailed advertisements.[41]) Marvel's code offered fewer restrictions on the issuance of stock and lower franchise fees. It also carried the contractarian model to its logical conclusion by providing that the charter could contain any provisions not contrary to law.[42] Delaware attracted a handful of large firms but did not threaten New Jersey's dominance.[43] Even so, corporate revenues quickly constituted an important source of Delaware's revenues, rising from 7 percent of total revenues in 1899 to 20.5 percent in 1900 and 30.6 percent in 1906.[44] West Virginia, Maryland, Maine, and Kentucky quickly followed with revisions of their own codes.[45] Other states soon fell into line. By 1912 the laws of most of the states had been revised in varying degrees to follow the enabling strategy.[46] Even New York proved capable of innovation in the removal of agent constraints, in 1912 becoming the first state to permit no par stock.[47]

New Jersey backtracked on February 17, 1913, enacting a series of antitrust amendments called the "Seven Sisters." These variously prohibited monopolization, price fixing, and other anticompetitive behavior, following an agenda set by Governor Woodrow Wilson, who was about to be inaugurated President.[48] The number of charters issued in New Jersey declined in succeeding years.[49] The state's lawmakers then had second thoughts, removing the salient prohibitions from the corporate code in 1915 and 1917.[50]

Chartering firms neither forgave nor forgot New Jersey's defection to the antitrust side. Delaware saw a significant increase in large firm incorporations and reincorporations, numbers that would peak during the boom years of the 1920s.[51] By 1917, 36.4 percent of Delaware's revenues came from chartering. (The percentage peaked at 42.5 in 1929.[52]) By 1922, Delaware had a clear lead, emerging as the state of incorporation of 55 percent of the firms listed on the New York Stock Exchange.[53]

State level corporate law emerged fully formed by the boom years of the 1920s. Then, as now, ex ante agent constraints and affiliation terms were left to be arranged through contract. Then, as now, the law imposed no significant protections for creditors

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[41] See Note, Little Delaware Makes a Bid for the Organization of Trusts, 39 Am. L. Rev. 418 (1899).
[42] See E. Merrick Dodd, Statutory Developments in Business Corporation Law, 1886-1936, 50 Harv. L. Rev. 27, 27 (1936).
[43] Nader, et al., supra note __, at 503-05.
[44] Id.at 535. The percentage figure was volatile, however. In 1908 the percentage of revenues from chartering fell to 15.7. Id.
[45] Stoke, supra note __, at 575-76.
[46] See Nader et al., supra note __, at 50 (noting that 42 states permitted organization for any lawful purpose; 43 had lifted limited on capitalization; 24 permitted perpetual existence; 18 permitted mergers; 40 permitted stock to be issued for noncash consideration, nine of which ,made the judgment of the board respecting the value of the consideration conclusive absent fraud).
[47] Dodd, supra note __, at 44, n. 50.
[48] Stoke, supra note __, at 578.
[49] Id.at 574 n.16, 579.
[50] Id. at 579.
[51] Nader, et al., supra note __, at 503-05.
[52] Id. at 535.
[53] Adolf A. Berle, Jr., Studies in the Law of Corporate Finance 122-25 (1928).

or other constituents. Then, as now, ex post fiduciary law provided the principal constraint. Then, as now, ultimate shareholder control had to be achieved through the exercise of governance mechanisms, the board of directors held agenda control, and the proxy voting system operated as a barrier to soundings of shareholder voice.[54] State law emerged in this mature form in a hotly competitive environment, with two states enjoying the lead in succession and others affirmatively vying for business. Competing state actors were highly incentivized, between the twin payoffs of a significant positive impact on state revenues and private rents for key state actors from stakes in service companies.

Two additional points should be noted about the early period. Charter competition was invented by a New York corporate lawyer, and from the very beginning was fully compatible with the interests of New York's corporate bar. Transactions involving New Jersey and Delaware corporations closed in New York, stage managed by New York lawyers, without any fee sharing with New Jersey or Delaware lawyers. From the beginning, lawyers in financial centers opined on due organization under New Jersey and Delaware law, ignoring the usual formal requisite of membership in the bar of the state law applied in the opinion.[55] Delaware's famously well-compensated bar[56] conducts a litigation practice.

Secondly, the states competed for charters and created enabling codes against a constant threat of federal intervention. Bills proposing federal incorporation of large firms, modeled on nineteenth corporate codes that restricted size, lines of business, and mergers, were a staple of congressional life from 1900 until 1914. All were motivated by a perceived public interest in competitive production and against industry concentration.[57] But the clamour for corporate reform abated after 1914.[58] At both the state and federal level a consensus formed that the Sherman Act's approach to antitrust, broadly directed to restraints of trade, worked better than corporate law's rules-based

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[54] See Dodd, supra note __, at 51 for a summary of the operation of the state codes.

[55] See Association of the Bar of the City of New York, Committee on Real Property Law, Subcommittee on Mortgage Loan Opinions & the New York State Bar Association, Real Property Law Section, Attorney Opinion Letters Committee, Mortgage Loan Opinion Report, 54 Bus. L. 119 (1998) ("With respect to Delaware corporations, partnerships or limited liability companies, many New York lawyers are willing to give limited opinions under Delaware law regarding issues relating to the Borrower's valid existence and its power to enter into the transaction."); see also Scott FitzGibbon & Donald W. Glazer, Legal Opinions on Incorporation, Good Standing, and Qualification to Do Business, 41 Bus. L. 461, 471 (1986) ("Corporate lawyers commonly opine on the corporate status of companies under the laws of their own state and, unless special problems are presented, under the laws of Delaware."); Committee on Corporations, 1989 Report of the Committee on Corporations Regarding Legal Opinions in Business Transactions, 45 Bus. L. 2169 (1990) ("There are certain uncomplicated questions of foreign law on which California lawyers will customarily render opinions. Since many lawyers generally experienced in corporate matters are familiar with Delaware corporation law, their opinions will cover matters relating to the incorporation and good standing of a Delaware corporate client and certain other routine corporate matters.").

[56] Marcel Kahan & Ehud Kamar, The Myth of State Competition in Corporate Law, 55 Stan. L. Rev. 679, 695 (2002)(showing that Delaware lawyers are the most highly paid in any state).

[57] Mitchell, supra note __. See also John W. Brabner-Smith, Federal Incorporation of Business, 24 Va. L. Rev. 159 (1937).

[58] Stoke, supra note __, at 579.

restrictions on lines of business and combinations, which had not provided a viable basis for distinguishing between good and bad mergers.[59]

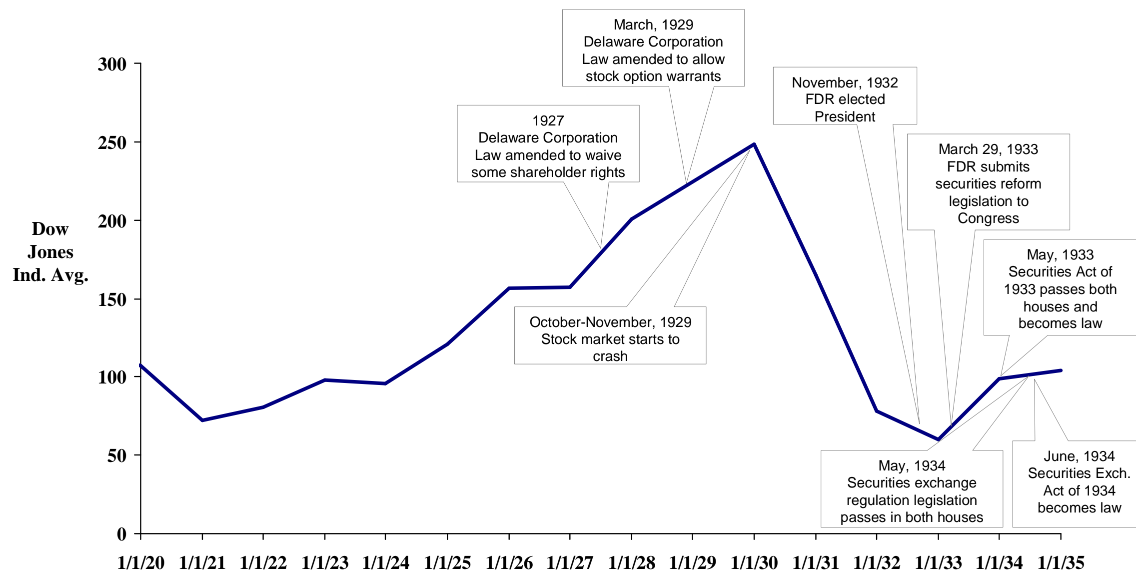
2. *State Corporate Codes after 1913*.

Legislative innovation at the state level never again reached the intensity experienced in the wake of New Jersey's competitive initiative. But three smaller waves of change did occur in subsequent decades. Here we describe the first two, which occurred in the 1920s and 1960s. The third wave, the state antitakeover statutes of the 1980s, will be taken up below.[60]

The first round of innovation came in wake of the boom stock market of the 1920s. Corporations and their promoters, utilizing the corporate codes' allowance of nonvoting preferred and common, took advantage of the market boom to float new equity issues that carried no sacrifice of control. But, in 1926, the New York Stock Exchange intervened with a one share one vote rule.[61] Delaware followed up with give backs, removing from its code some remaining constraints on stock issuance. First, in 1927, it removed one last mandate respecting affiliation terms -- preemptive rights, which thereafter became optional.[62] Secondly, in March 1929, it amended its code to permit blank stock charter provisions,[63] permitting corporations to waive shareholder ratification respecting the terms of new stock issues, enhancing managements' freedom of action respecting equity capital structure.[64] Thirdly, and also in March 1929, Delaware sanctioned the issue of stock option warrants, facilitating the distribution of bargain purchase rights to insiders even in a world of one share one vote.[65]

[59] See Hovenkamp, supra note __, at 247-48, 266-67.
[60] See text accompanying notes __-__ infra.
[61] See supra note __.
[62] Joel Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance 43 (1982).
[63] Id. at 43.
[64] Nader, etal., supra note __, at 56-57. Delaware also added a loophole in its legal capital provisions in the late 1920s — the "nimble dividend." Id.
[65] Id.

**Figure I--Market Context 1920-41**[66]



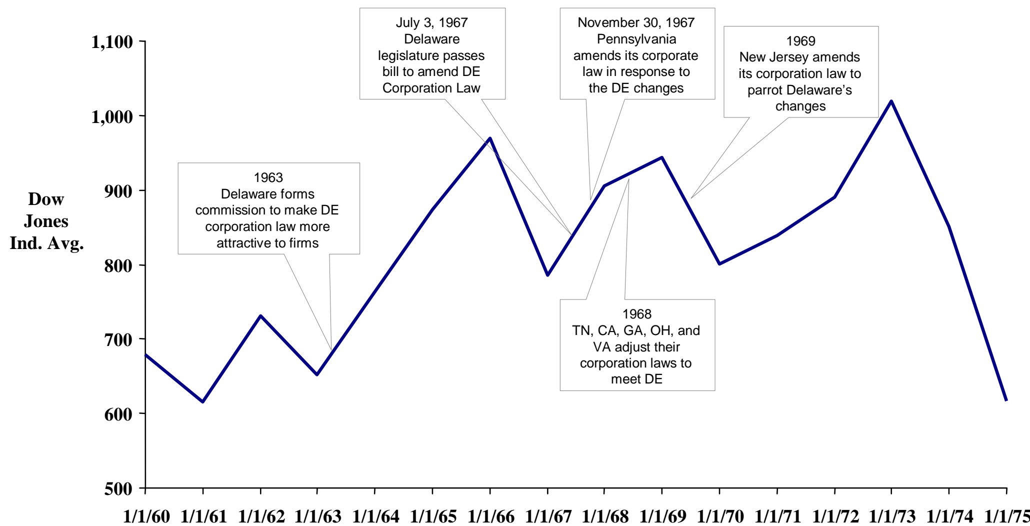

The stock market crash six months later caused the venue of corporate law innovation to move to the national level and stay there for three decades. At the same time, new incorporation activity in Delaware slowed substantially. Delaware would not equal the dollar amount of its 1929 chartering revenues until 1952.[67] Even then, 1952 in no sense equalled 1929 so far as concerned Delaware's public fisc. The portion of its revenues contributed by chartering would remain under 10 percent of the total until after 1967. Worse, during the 1950s and early 1960s, reincorporation to Delaware continued only at the diminished pace set during the Depression.[68]

By 1963, revenues from chartering had declined to 7 percent of Delaware's total, and its lawmakers began to fear competition from New Jersey and Maryland. The legislature organized a law revision commission to review the code.[69] Another round of innovation followed, with the amendments becoming effective in 1967. These added an enabling section liberalizing indemnity of officers and directors found liable for breaches of fiduciary duties.[70] The amendments also significantly narrowed the class of shareholders accorded merger appraisal rights,[71] facilitating acquisitions by large firms.[72] Figure II shows that the equity market environment at the time resembled that prevailing during the first round of code innovations of the late 1920s: Delaware returned to an aggressive, competitive mode during the "go go" stock market of the 1960s, during

[66] Source: Yahoo Financial (graph developed using the opening level of the Dow Jones Industrial Average on the first trading day of each month over the course of the cycle).
[67] Nader et al., supra note __, at 535.
[68] Id.
[69] Id. at 60-61.
[70] Del. Gen. Corp. L., Del. Code Ann. tit. 8, § 145(2001).
[71] Id. § 262(b).
[72] Comment, Law for Sale: A Study of the Delaware Incorporation law of 1967, 117 U. Pa. L. Rev. 861, 863-72 (1969). See Ernest L. Folk III, Some Reflections of a Corporation Law Draftsman, 42 Conn. Bar J. 409, 411-419 (1968), for a realistic description of the influences that came to bear on the revision.

which the Dow Jones Industrial Average reached the 900 level for the first time since 1929.

**Figure II--Market Context 1960-75** [73i]




Delaware's initiative yielded palpable rewards. Incorporations and reincorporations of large firms increased markedly in 1966 and continued through 1971 at levels not seen since the 1920s.[74] Even though other states quickly copied the new provisions, Delaware's market share recovered to one-third of NYSE companies.[75] Since then, Delaware has steadily increased that market share: By 1977, 40% of publicly traded companies were organized in Delaware;[76] in 1981 the figure was 44 percent;[77]the 50 percent figure was reached again by 1991;[78]and by 1999 the figure was 57.8 percent.[79]

3. *Stability and Political Insulation.*

We emerge from this discussion with a confirmation, a prediction, and a structural conclusion.

[73] Yahoo! Finance (graph developed using the opening level of the Dow Jones Industrial Average on the first trading day of each month over the course of the cycle).
[74] Nader, etal., supra note __, at 505.
[75] Comment, supra note __, at 891-92.
[76] See Peter Dodd & Richard Leftwich, The Market for Corporate Charters: "Unhealthy Competition" Versus Federal regulation, 53 J. Bus. 259 (1980).
[77] Stephanie S. Rojo, Comment: Delaware Versus Texas Corporate Law: How Does Texas Compare?, 3 Hous. Bus. & Tax L.J. 290, 291 (2003).
[78] Martin Lipton & Steven A. Rosenblum, A New System for Corporate Charters: The Quinquennial Election of Directors, 58 U.Chi. L. Rev. 187, 190 n. 6 (1991).
[79] Lucian Bebchuk & Alma Cohen, Firms' Decisions Where to Incorporate, 46 J. L & Econ. 383 tbl. 2 (2003).

The confirmation is that state legislative innovation tends to enhance management's freedom of action by expanding the enabling envelope.[80]

The prediction is that management friendly innovation tends to occur against the background of a strong stock market. Concerns about legitimacy and federal intervention could have something to do with this. But marketing does also. Corporations tend bring reincorporation proposals to their shareholders in the wake of abnormal run ups in their stock prices.[81] The competitive state strikes while the iron is hot, drawing attention to its product line so as to focus management's attention of the benefits or reincorporation.

The structural point concerns the overall trajectory of state legislative innovation. The post-1913 rounds of innovation amount to minor adjustments to a stable legal regime. New Jersey set the states' enabling agenda in 1888 and the agenda remained stable for eight decades thereafter.[82] The economic shock of crash and depression at most brought quietude. The only political shock came when Woodrow Wilson took the presidency and New Jersey legislature opened its code to the influence of the broader public's political concerns. The management customers in the charter market reacted emphatically. The message has never changed: Public politics and corporate law do not mix; any significant departure from the norm means reincorporation to another state.

Political theorists evaluate political systems in terms of their accountability and representativeness. Accountability is high when voters can identify the actors responsible for making policy and oust those who perform badly. Representativeness is high when policies reflect the preferences of a large spectrum of voters.[83] The larger the political subdivision, the more likely it is that policies are broadly representative, as politicians are forced to seek the support of broad coalitions, representing multiple socio-economic groups. In smaller districts, competing politicians may cater to narrower, geographical constituencies.[84]

Charter competition rearranges the conventional patterns. The possibility of reincorporation out of the state assures a high degree of accountability. But now accountability goes not to the voters of state (whether a broad or narrow coalition), but to the firms' managers and shareholders, who react not as voting citizens but as economic interest holders. Paradoxically, we simultaneously see a high degree of representativeness, at least in the one state with a stake in chartering revenues. So far as the concerns the people of Delaware, any corporate law policy that suits the chartering

[80] We do not claim that all states match Delaware in providing menus of enabling terms. For a survey of some residual mandates and a empiricaql showing of their contribution to outward migration, see Marcel Kahan, The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection? (SSRN working paper 2004).
[81] See Michael Bradley & Cindy Schipani, The Relevance of the Duty of Care Stadanrd in Corporate Governance 75 Iowa L. Rev. 1, 67 (1989); Peter Dodd & Richard Leftwich, The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation, 53 J. Bus. 259, 272-78 (1980).
[82] Bayless Manning pronounced corporate law intellectually dead in 1962. See Bayless Manning, The Shareholders Appraisal Remedy: An Essay for Frank Coker, 72 Yale L.J. 223, 245 (1962).
[83] Torsten Persson & Guido Tabellini, The Economic Effects of Constitutions 12, 17 (2003).
[84] Id. at 17-18.

customers also suits them. This complete concord between the voters of the chartering state and the chartered firms condons off corporate law from conventional political influences and concomitant regulatory volatility. Such a stable political settlement could never be reached at the federal level, where broad political coalitions could contest it.

The stable settlement holds out a possibility of externalities, of course. Even as the dominant chartering state makes corporate law without regard to conventional politics within its borders, its firms carry its law across the wider national political and economic geography. As a national lawmaker, it potentially impacts the economic interests of actors nationwide, actors who may be badly represented or entirely unrepresented in its lawmaking process and as to whom it is unaccountable. To the extent that corporate law has political implications at the more broadly representative national arena, such an arrangement is politically tolerable only given the possibility of preemption by the national government. Any disadvantaged group or broad public interest coalition gets a right to contest the state level result by making a political appeal to the Congress. In view of the fact that chartering state may impose its law outside its borders only due to a federal constitutional mandate,[85] federal political contestability makes structural sense.

**B. Chartering Races**

Because national level political appeals are a constant structural possibility, national level respect for state control over internal corporate affairs remains in a contingent posture. The magnitude of respect accorded could vary in response to prevailing views on the state system's welfare effects, with normative frameworks used in evaluating the state system bearing on national responses. This section sets out the two leading evaluative paradigms – trust and market. Under the trust paradigm, charter competition is described as a race to the bottom. The market paradigm reverses the story, describing a race to the top.

1. *The Trust Paradigm and the Race to the Bottom.*

The race to the bottom charge dates back to charter competition's first appearance, when critics denounced it for facilitating anticompetitive activity.[86] Subsequent decades saw no abatement of criticism, even as the critics shifted their focus. The leading basis for denunciation became the trust paradigm articulated in 1932 by Adolf Berle and Gardiner Means in *The Modern Corporation and Private Property*.[87]

The enabling state system, said Berle and Means, had facilitated the appearance and success of the large, mass-producing, management-controlled corporation. This had been a reactive rather than a purposive development – a change that followed from underlying economic facts.[88] But the law thereby had become implicated in the creation and perpetuation of an unsatisfactory separation of ownership and control. The big

[85] See supra note __.
[86] See Liggett v. Lee, 288 U.S. 517 (1933)(Brandeis, J,. dissenting).
[87] Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (rev. ed. 1991).
[88] Berle & Means, supra note __, at 131.

corporations of the twentieth century had split the classical entrepreneurial function between salaried executives, who sat atop hierarchical organizations, and anonymous equity participants, who held small stakes and prized market liquidity over participation. This presented problems of competence and responsibility absent in an ideal, classical capitalist world inhabited by self-employed individual producers.[89] In the classical model, market competition effectively controlled the producers, constraining both the incompetent and the greedy and legitimating private economic power. But corporate mass production on a large capital base broke those parameters, with firms taking on significant attributes and powers, social as well as economic.[90] Industrial oligarchs exercised unified control over the wealth under their charge, and the law played a role in investing the power.[91] Therefore, said Berle and Means, corporate property should no longer be deemed private property.[92] That assertion in turn supported a presumption favoring new regulation of corporate internal affairs.

Berle and Means recommended no pervasive system of government oversight, however. Instead they focused on the problem of management self dealing in the context of the enabling system. Corporate insiders were writing their own contracts, with immunity clauses and waivers of shareholder rights allowingmuch diversion of corporate profit to managers' pockets.[93] The law, they said, would do a better job if it were rewritten to follow basic principles of trust law. More particularly, there should be a pervasive equitable limitation on powers granted to corporate management (or any other group within the corporation) by the enabling system: Power should be exercisable only for the ratable benefit of all the shareholders.[94] Berle and Means had in mind an overarching standard that would constrain the enabling system ex post: No language in a corporate charter could deny or defeat the fundamental equitable control of the court.[95] Meanwhile, enforcement of the equitable limitation safely could be remitted to the state judiciary. In Berle and Means' view, charter competition impacted only statutes, leaving the common law of fiduciary duties as the one area of corporate law remaining robust:[96] "Flexible and realistic" judges, "if untrammeled by statute," could be expected to find solutions to problems that demanded a remedy.[97]

Events did not unfold in accordance with the book's description, however. Delaware's judges did indeed prove "flexible and realistic," but their flexibility followed their realism and so benefited management interests. By the 1960s, observers attempting

[89]Id. at 3-10.
[90]Id. at 3.
[91]Id. at 4, 131.
[92] Id. at 219.
[93] Id. at 128, 220, 312.
[94]Id. at 220.
[95] Id. at 242.
[96] One of us has argued that Berle's plan was frustrated in 1938 by the United States' Supreme Court's decision in *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938). Prior to *Erie* a corporate law plaintiff who could establish diversity got to choose between not only state and federal venues but state and federal common law. This allowed plaintiffs to circumvent Delaware's courts and case law by going into federal court under federal common law. William W. Bratton, Berle and Means Reconsidered at the Century's Turn, 26 J. Corp. L. 737, 768 (2001).
[97]Berle & Means, supra note __, at 197, 295.

to explain why no other state had wrested a significant market share away from Delaware were mentioning Delaware's courts as well as its code. The accumulated stock of precedent was mentioned, along with competence and fairness. But Sam Arsht, a dean of the Delaware bar, added a telling point -- corporations considered Delaware the most favorable forum available.[98]

The results frustrated proponents of the trust paradigm, whose views were embodied in William L. Cary's famous indictment of Delaware, published in 1974.[99] Cary reviewed leading Delaware opinions, along with the statutory developments reviewed above, and concluded that Delaware had "no public policy left . . . other than the objective of raising revenue."[100] To Cary, the "public policy" at stake was the integrity of corporate managers. Rents had led a single state to "grant management unilateral control untrammeled by other interests,"[101] thereby sacrificing the national public interest. Charter competition was a "race to the bottom." The stable settlement between Delaware and the chartering firms meant that corporate law addressed only the interests of a narrow class of management consumers, causing it to be more and more removed from the public interest.

Cary recommended a preemptive federal regime of fiduciary standards, a traversal of internal affairs that might have enervated the charter market. Unlike the federal mandates we see in practice,[102] fiduciary standards would have removed fiduciary lawmaking to the federal courts, destroying Delaware's body of case precedents and removing its judiciary from the front line of corporate lawmaking. A whole product line would have disappeared overnight. Given the gradual convergence of corporate codes, Delaware's customers thereupon might have reappraised the costs and benefits of domicile in the state.

Berle and Means limited the trust paradigm's class of beneficiaries to the corporation's shareholders. But many of the paradigm's subsequent proponents expanded the zone of beneficiary to include other corporate constituents and the public interest. The "public" characterization in *The Modern Corporation and Private Property* invited the extension. So did the book's emphasis on managerial power: To mid-twentieth century antimanagerialists, power implied responsibility and, given the separation of ownership and control, responsibility needed to be imposed in law, federal law.[103]

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[98] Comment, supra note __,at 893-94.
[99] William L. Cary, Federalism and Corporate Law: Reflections on Delaware, 83 Yale L. J. 663 (1974).
[100] Id. at 684. See also Marvin A. Chirelstein, Towards a Federal Fiduciary Standards Act, 30 Cleve. St. L. Rev. 203 (1981).
[101] Cary, supra note __,. at 697, 698.
[102] If the federal mandates described above at any time adversely affected Delaware, they did so in the period between 1929 and 1967, when Delaware lost market share and suffered reduced revenue support from chartering. Since the mandates stayed in place after Delaware's 1967 recovery, it seems sounder to refrain from inferring a negative impact during any period.
[103] See Ralph Nader, Joel Seligman & Mark Green, Taming the Giant Corporation 1, 7 (1976); See also Dahl, Governing the Giant Corporation in Corporate Power in America at 2 (Ralph Nader & Mark Green, eds. 1972).

2. *The Market Paradigm and the Race to the Top.*

The market paradigm rebuts both the trust paradigm's description of separated ownership and control and its call for regulation. This perspective, which originated in economics during the 1960s and 1970s, recasts the firm as an incident of contracting among rational economic actors. The firm becomes a series of contracts joining inputs to outputs, with equity capital as one of the inputs and corporate law as a part of the input's governing contract.[104] The imperfections identified under the trust paradigm reemerge under the denomination "agency costs," costs that firms must minimize due the free market's competitive force. Managers are no longer seen as empowered actors and responsibility is no longer seen as a problem. When managers fail, they get removed – either a hostile offeror takes over the company and throws them out,[105] the firm with a high agency cost base fails to survive in the product market, or poor managers fail to survive in the management labor market. Their incentives accordingly are focused on long run productive success for the firm.[106] Given these market deterrents, corporate property again becomes private, the regulatory agenda goes blank, and a powerful presumption lies against national intervention.[107]

The market paradigm also counters Cary's denunciation of Delaware. It draws on public choice theory to debunk the public interest ideal of regulatory motivation and assert that regulators should be expected to behave no differently than actors in private economic relations.[108] There is, accordingly, nothing suspicious about the sale of charters. This point, coupled with the market deterrent story of well-aligned agent incentives, reverses the race to the bottom into a race to the top.[109] In the race to the top description, state corporate codes and judicial venues are viewed as products consumed by corporations. Competition for the legal business of firms forces the states to adapt the law to the dynamic conditions in which the firms operate. State lawmaking emerges as a trial and error process suited to the accurate identification of optimal corporate arrangements.[110]

3. *State Antitakeover Statutes, the Structural Defect, and the Failure of the Market Paradigm.*

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[104] See Michael Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J.Fin.Econ. 310 (1976). For a review of the literature, see William W. Bratton, The "Nexus of Contracts" Corporation: A Critical Appraisal", 74 Cornell L. Rev.404, 420 (1989).

[105] This point originated in Henry G. Manne, Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110 (1965). For a discussion of Manne's contribution, see William J. Carney, The Legacy of "The market for Corporate Control" and the Origins of the Theory of the Firm, 50 Case W. Res. L. Rev. 215 (1999).

[106] Bratton, supra note _, at 417-18.

[107] William W. Bratton, The Economic Structure of the Post-Contractual Corporation,87 Nw. U. L.Rev. 180, 186-90 (1992).

[108] Michael E. Levine & Jennifer L. Forrence, Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis, 6 J. L. Econ. & Orgs. 167, 168-69 (1990).

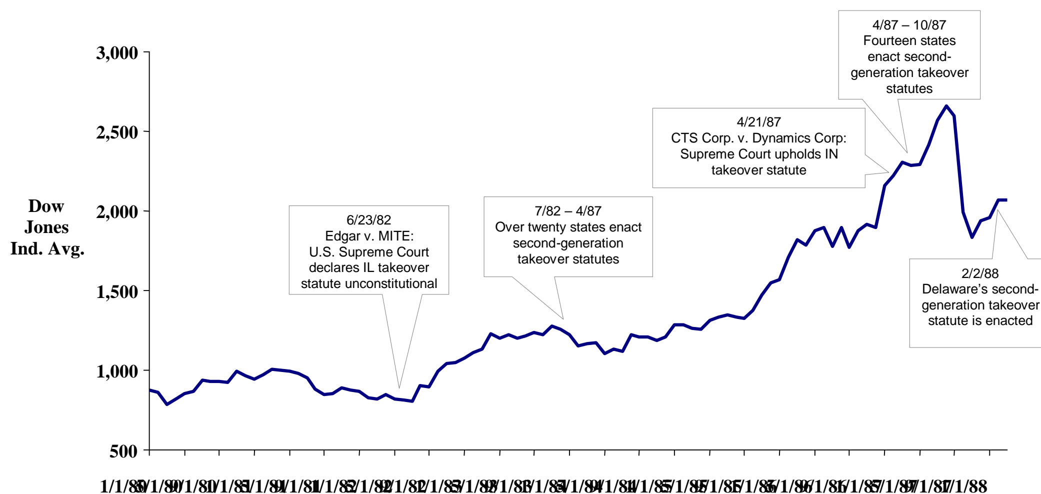
[109] See Ralph W. Winter, State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251, 254-62 (1977).

[110] Romano, supra note, __ at 6.

Each paradigm, trust and market, has a strong ideological affinity. The trust perspective suits progressives disposed to impose regulations that disempower managers and protect actors in vulnerable economic positions. As such it lost its leading role in public policy discussion after 1980, along with the general collapse of confidence in regulatory solutions to economic problems. The trust paradigm still echoes in a significant body of academic commentary.[111] But it neither informs corporate law agendas in the wider polity nor figures importantly in contemporary criticisms of the charter competition system.

The market paradigm presents an ideological mirror image. It suits deregulatory policy agendas and devolutionary federalists. The deregulatory 1980s should have carried it to unquestioned ascendancy in corporate law discussions. But it instead ran into an unanticipated public choice problem when the mature, state-level enabling system underwent a third and final round of statutory innovation.

**Figure III--Market Context 1982-88[112]**




During the 1980s, a majority of the states added antitakeover provisions to their codes. The statutes entered territory where free contract formerly had prevailed, making takeovers more expensive and variously inserting ex post affiliation terms and ex ante shareholder decision rights.[113] The statutes began to appear in 1982, when the Supreme

[111] See Lynn A. Stout & Margaret M. Blair, A Team Production Theory of Corporation Law, 85 Va. L. Rev. 247 (1999); Millon, surpa note __.

[112] Yahoo! Finance (generated using the closing price of the Dow Jones Industrial Average on each day of the historical period); see also Romano, supra note __, at 461-463.

[113]More specifically, the statutes tended either to condition the voting right of bidders on the approval of the shareholders as a whole, to impose freeze periods on combinations between bidders and targets, or to

Court, in *Edgar v. MITE*,[114] invoked the commerce clause to invalidate state statutes that subjected hostile tender offers to substantive review by state securities administrators. The new statutes, which operated in traditional internal affairs territory, passed constitutional inspection in 1987, when the Supreme Court decided *CTS Corp. v. Dynamics Corp. of America*.[115] Twenty states enacted such statutes in the years between the two rulings, with fourteen more acting in the six months after *CTS*.[116] Delaware, lagging, followed in 1988.

The antitakeover round followed the earlier pattern of state law innovation in two significant respects. The statutes once again were enacted against the backdrop of a booming stock market, as shown in Figure III. They also catered to management's interest in freedom of action.

But the antitakeover statutes also broke the pattern in significant respects. Innovations in the bull markets of the 1920s and 1960s facilitated dealmaking; here the states chilled transactions. Formerly, state law innovation almost always moved in an enabling direction. Here, even as the governance device of shareholder ratification figured prominently, so did mandates. Formerly, the first mover had been Delaware, the charter market leader. Here states that did not pursue charters made the first move. Where Delaware innovated with an eye to business preferences nationwide, the states enacting antitakeover statutes moved at the behest of nervous managers with local influence. The politics were unrepresentative. Threatened managers and local lawyers , acting independently of local business, labor, and community leaders, used their influence to procure legislation.[117] The legislators then externalized the costs of takeover defense on out of state shareholders. Even so, rising stock prices figured into picture: Takeover activity, friendly as well as hostile, rises and falls with the stock market.[118]

The Delaware process differed, reflecting the more diverse constituency swept in by to its law's national reach. Managers seeking protection (and their lawyers) lobbied in favor, some even threatening to pull out of the state. They were countered by institutional investors, shareholders organizations and SEC commissioners. [119] A weak statute emerged.

The pattern broke because, for the first time in corporate law history, the enabling framework held out a means of management removal unimpeded by the shareholder collective action problem. When the states adjusted by erecting new barriers, the shareholders, again for the first time in corporate law history, went into irreconcilable opposition. Previously, the states' successive moves to extend managers more slack

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require that an equal price be paid in the second stage of a two tier acquisition. For a summary see Roberta Romano, The Genius of American Corporate Law 53-57, 74-75(1993).

[114] 457 U.S. 624, 640-46 (1982).

[115] 481 U.S. 69 (1987).

[116] Roberta Romano, The Future of Hostile Takeovers: Legislation and Public Opinion, 57 U.Cin.L.Rev. 457 461-62 (1988).

[117] Romano, supra note __, 462.

[118] Cite

[119] Id.at 464.

failed to rouse shareholder opposition. There were a number of reasons. First, as the trust proponents noted, the shareholders suffered collective action problems. Secondly, under the "Wall Street Rule," shareholders were content to resort to exit by market sale when excessive slack led to poor results. Thirdly, since 1934, the SEC had stood in to protect the shareholder interest at the national level.[120] Sleazy market practices facilitated by enabling innovations in the 1920s had been dealt with by federal disclosure and market regulation mandates. In the 1980s, however, federal regulators did not come to the shareholders' rescue. Institutional shareholding, meanwhile, ameliorated the collective action problem. Now organized, the shareholders found their voice, a dissenting voice.

Just as the market paradigm had enervated the trust paradigm, so did the market paradigm now suffer enervation. The market-based race to the top validation of state law had bypassed the problem of the shareholders' lack of influence over state lawmaking with a reference to the control market deterrent. The assertion, in effect, was that the managers' option of exit adequately disciplined the states, while the possibility of shareholder exit by tender to a hostile offeror adequately disciplined the managers. The collaboration of managers and state politicians to hamper the market deterrent presented a manifest case of charter market failure. The responsive states had acted to contain the very mechanism on which the market paradigm relied to incentivize corporate agents. Charter competition, far from acting as a check on rent seeking activity, had promoted it. State law results were anything but first best efficient.

The failure of the market analogy was inevitable, given the crystallization of opposing views between shareholders and managers on the appropriate shape of ex post affiliation terms. The law as product analogy works as a policy justification only to the extent that providing jurisdiction purveys an unbundled regulatory product to a consumer with a unitary set of preferences, without externalizing costs on anyone else. The charter market does meet the former qualification – Delaware's customers take only its corporate law free of all other regulations. The latter qualification has always been problematic, for it depends on the heroic assumption shareholder and manager interests always are perfectly aligned, rendering irrelevant the mandated agenda control managers enjoy under the state system. Where, as with takeovers, interests do not stand aligned, the state system displays a structural defect. Because the market forces a state that actually competes to focus on the variables that influence incorporation decisions,[121] there follows a concern for management preferences rather than shareholder value itself. Accordingly, nothing at the state level prevents suboptimal accommodation of management preferences respectingex post affiliation terms and fiduciary standards.[122]

Since the defect is intrinsic to the system, any correction must occur at the national level. Should the issue be joined there, and should the diagnosis of suboptimal

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[120] The promulgation of the proxy rules in the 1950s provides an example of this. See Seligman, supra note __, at __.
[121] Lucian Arye Bebchuk, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 Harv. L. Rev. 1435, 1452, 1454 (1992).
[122] Id. at 1462-63, 1468, 1488.

results prevail there, the internal affairs presumption, standing alone, would present no barrier to intervention. Indeed, the economics of federalism posit intervention to police interstate externalities as a principal justification for the very existence of the national government.[123] Moreover, such intervention could be designed so as to cause minimal disruption at the state level. It could even prove beneficial. We have suggested elsewhere that the federal government could partially preempt the states' provision of management agenda control and mandate a right of shareholder initiative to effect reincorporation. We projected that such an adjustment could jumpstart the charter market and import a state level incentive to create a regime more single-mindedly directed to shareholder value maximization.[124] Lucian Bebchuk and Allen Farrell apply this strategy in a different direction, suggesting that the federal government create a parallel takeover regime and accord the shareholders a privilege to opt into it.[125] There is, then, no shortage of regulatory strategies fitted to the task of correcting the charter market's defects. Yet the federal government has not intervened, even as the era of shareholder capitalism dawned in the wake of the takeover wars of the 1980s.

4. *How Robust is the Charter Market?*

A growing body of commentary criticizes Delaware and the charter market from a different perspective, that of microeconomic theory. The market, it is charged, little resembles an efficient product market – a market that maximizes welfare by producing in the competitive equilibrium quantity.[126] It is instead a bundle of suboptimal distortions.[127] Delaware charges much more for its product than its marginal cost of

[123] See Frank H. Easterbrook, Federalism and European Business Law, 14 Int'l Rev. L. & Econ. 125, 127 (1994).
[124] William W. Bratton & Joseph A. McCahery, Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation, 73 N.C.L.Rev.1861, 1936-47 (1995). The idea of federal level intervention to impose governance processes did not originate with us. See, e.g., Cary, supra note , at 702; Bernard S. Black, Is Corporate Law Trivial?: A Political and Economic Analysis, 84 Nw. U. L. Rev. 542, 582 (1990)(proposing a federal requirement that a majority of shareholders of public companies be required to elect to be governed by changes in state law that affect the division of power between management and shareholders); John C. Coffee, Jr., The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards, 8 Cardozo L. Rev. 759, 744-76 (1987)(proposing shareholder initiative by use of proxy statement to opt out of state rules, amend the charter and change state of incorporation); see also SEC Concept Release on Takeovers and Contests for Corporate Control, Exchange Act Release No. 43-23486, 51 Fed. Reg. 28,096 (Aug. 5, 1989)(suggesting self-governance exemptions to specific tender offer rules); SEC Advisory Committee Report on Tender Offers, Report of Recommendations, CCH Fed. Sec. L.Rep., Special Report No. 1028, at 37-40 (July 15, 1983)(recommending annual shareholder advisory votes on golden parachutes, standstill agreements, and supermajority and disenfranchising charter provisions). Cf. Romano, supra note __, at 83-84 (proposing change of statutory defaults from opt out to opt in at the state level); Jonathan R. Macey, Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty, 15 Cardozo L. Rev. 909, 944 (1994)(proposing that Congress preempt state antitakeover statutes, leaving shareholders to make decisions respecting takeover defenses).
[125] Lucian Arye Bebchuk & Allen Ferrell, A New Approach to Takeover Law and Regulatory Competition [sic], 87 Va.L.Rev. 111 (2001). Stephen J. Choi & Andrew T. Guzman, Choice and Federal Intervention in Corporate Law, 87 Va. L. Rev. (2001), suggests that the proposal might have minor perverse effects.
[126] Howell E. Jackson, et al., Analytical Methods for Lawyers 325 (2003)
[127] Oren Bar-Gil & Lucian Bebchuk, The Market for Corporate Law, (SSRN working paper, 2001), develops a formal product market model that incorporates many of the main points of this line of thinking.

production and its franchise tax rates implicate price discrimination.[128] Other states have no incentives to compete with Delaware, leaving their regimes open suboptimal influence activities by managers and lawyers.[129] Even if actors in another state had incentives to attempt to enter the market to take market share from Delaware, structural barriers would make competitive success highly unlikely.[130] Delaware, for example, takes the benefit of network and learning externalities incident to the sale of an integrated legal system.[131] Its system also is surprisingly friendly to litigating plaintiffs, toward the manifest end of generating rents for its bar.[132]

This thickening description teaches us much about the charter market. But we not perceive any significant implications for the internal affairs presumption and the content of the federalism. We have four reasons. First, the regulatory competition description of

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Their model is based on a process of states choosing a strategy in anticipation of other state's adopting strategies. Revenue payoffs are determined by the content of the state's rules, its institutional environment and network externalities, and the price it charges. The model assumes that that Delaware has an infrastructure that improves revenues, and that the population of firms is domiciled in various states, has dispersed owners, and that not all companies benefit from a legal infrastructure or network externalities.

In the first period, each state makes a decision about investing in infrastructure, it corporate law rules, and the price to be charged. These strategies are made and announced sequentially, with Delaware moving first and the other moves are distributed randomly. In the next period, each company makes a decision about its state of incorporation (either stay put or reincorporate). The reincorporation decision follows from the following assumptions: a company will reincorporate if both managers and shareholders wish to do so; managers make take-it-or-leave-it offers; the state of reincorporation is superior to the present state; the shareholders will approve if the reincorporation is not adverse to their interests. In the third period, the payoffs appear. The realized payoffs the states receive are the revenues from reincorporation. A number of factors increase a state's payoffs, namely investment in a legal infrastructure and network externalities.

The model yields a unique equilibrium, possessing the following features: 1) all states choose the rule favored with respect to an issue that is insignificantly redistributive; 2) all states do not chose the same rule concerning issues that significantly redistribute wealth from shareholders to managers, 3) Delaware sets the highest price (preempting other rivals from entering and establish a competitive infrastructure, and making reincorporations attractive enough to companies that benefit from good infrastructure and positive network externalities), 4) Delaware makes a profit; 5) all other states set the price at zero, 6) states without an infrastructure do not invest in creating one, 7) all companies that benefit from an infrastructure and network externalities are incorporated in Delaware the dominant state, and 8) companies reincorporating to Delaware enjoy an abnormal share price movement as a consequence of their actions.

[128] Marcel Kahan & Ehud Kamar, Price discrimination in the Market for Corporate Control, 86 Cornell L. Rev. 1211, 1205, 1215-19 (2001).

[129] Marcel Kahan & Ehud Kamar, The Myth of State Competition in Corporate Law, 55 Stan. L. Rev. 679, 735-40 (2002).

[130] See Lucian Bebchuk & Assaf Hamdani, Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters, 112 Yale L.J. 1775 (2002); Lucian Bebchuk, Alma Cohen & Allen Ferrell, Does the Evidence Favor State Competition in Corporate Law? 90 Cal. L Rev. 1775 (2002).

[131] See Michael Klausner, Corporations, Corporate Law, and Networks of Contracts, 81 Va.L.Rev. 757 (1995); Marcel Kahan & Michael Klausner, Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior, and Cognitive Biases, 74 Wash. U. L.Q. 347 (1996); Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 Colum. L. Rev. 1908 (1998).

[132] See Jonathan Macey & Jeffrey Miller, Toward an Interest-Group Theory of Delaware Corporate Law, 65 Tex. L.Rev. 469, 471-72 (1987). See also Kahan & Kamar, supra note __ at 695 (showing that Delaware lawyers have average incomes higher than those of any other state); Robert Daines, The Incorporation Choices of IPO Firms, 77 N,Y,U. L. Rev. ___ (2002)(noting that the personal interests of chartering lawyers in addition to the substance of the legal regime determines the choice of domicile).

state law only provides a self-standing justification given a parallel market for corporate control that imports incentive compatibility. Once the antitakeover structural defect comes into the description to chill the takeover threat, federal intervention can be justified whether or not Delaware faces active competition. Secondly, the structure of state law showed remarkable stability between 1896 and the takeover wars of the1980s, and that structure was determined in a manifestly competitive environment. Potential entrants prompted Delaware to legislative action as late as 1967. Thirdly, Delaware always remains subject to potential competition from other states. If, like New Jersey in 1913, it defected from the political settlement and took a public interest view of regulation, the firms would find somewhere else to go. The same thing would happen if the quality of its lawmaking took a costly adverse turn. If Delaware raises its rents to point where firms find it too costly, its business will drop off, causing it to reconsider both its franchise tax scheme and litigation rules. Meanwhile, no one forces firms to go to Delaware and pay the rents. And if there is a group of consumers in the world well suited to contractual self protection, it is Delaware's customers. Indeed, more than forty percent of publicly traded firms choose to stay out. So, even though a pinpointed federal intervention could in theory jumpstart the charter market, such intervention is a remote possibility as a political proposition. Excess rents to Delaware and other imperfections highlighted by analogy to the economics of industrial organization seem an improbable basis for invoking national entry into internal affairs.

Fourthly, and most importantly, the economics federalism look beyond competition to support a presumption favoring state and local level regulation. So long as production costs are equal, decentralized regulation is favored because it is more responsive – it narrows the variance in the distribution of preferences, reduces the likelihood of bundled preferences, and ameliorates problems of asymmetric information.[133] On the majority of matters as to which management and shareholder interests stand in alignment, the century-old political settlement between firms and the competitive chartering state, with its extraordinarily high degree of accountability, fits this description. At the same time, the market paradigm succeeds in an important respect, despite its shortcomings. Cary's public interest objection to the sale of corporate law no longer carries weight. Charter competition is no longer seen as inherently corrupt. It is viewed functionally in the wider legal and economic framework of shareholder capitalism.

The picture of an uncompetitive charter market holds out devastating implications not for the internal affairs presumption but for the economic theory of regulatory competition. This economics dates back a half century. It got off to a bright start. For a while it was thought that devolution within federations could be relied on to trigger races to the top respecting diverse subject matters. Competition for domiciliaries and factors of production was posited as the cure for public choice problems: Under the theory, citizens signal their preferences respecting legal goods and services when they migrate from regime to regime. Their ability to exit disempowers government actors, whose welfare

[133] William W. Bratton & Joseph A. McCahery, The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second Best World, 86 Geo.L.J. 201, 215 (1997)

diminishes as citizens depart, taking along votes and revenues.[134] Competition for domiciliaries and factors of production, having disabled the interest groups, then causes government policies to be matched with diverse citizen preferences.[135] A preference for state over national lawmaking also is implied, since the revenue enhancement constraint on the national government is less intense.[136] Because national level competitive constraints also are less intense, the national lawmaking process will be slower, less responsive to productive concerns, and more susceptible to the influence of organized interest groups.[137]

The theory ran into two problems. First, multiple frictions at the state level impair competition. These include product bundling, mobility costs, spillovers, information asymmetries, and the absence of entrepreneurial incentives on the part of government actors.[138] Secondly, even assuming competitive incentives at the state level, the economics proved incapable of predicting stable, long-term equilibriums in competitive lawmaking situations.[139] Charter competition, along with other cases where a conflict of laws regime allows actors to chose a nominal jurisdictional situs for a legal relationship, are the exceptional cases where the theory has descriptive power. This is because nominally sited legal relationships can be sold separately as unbundled legal products.[140] Given something to sell, entrepreneurial lawmakers can appear. Of course, as we have seen with New Jersey and Delaware, a concomitant private sector sideline in the form of service company profits may be necessary to jump start the operation. But the service companies, along with other rent-seeking intermediaries, also serve a market function because they correct information asymmetries. With corporate law, a stable lawmaking equilibrium resulted. But, as we also have seen, externalities have remained a problem.

The scholarship highlighting the charter market's uncompetitive character shows that the problems do not stop with externalities: Even in these close to ideal conditions we have yet to see a competitive lawmaking equilibrium that stands up when inspected under the criteria applied to product markets. We suspect that entrepreneurial incentives lie at the core of the problem. New Jersey and Delaware are exceptional in their entrepreneurship. We do not tend to see similar behavior in other state and local situations where proponents suggest competitive regulatory solutions. Given this, we find it odd to hear that the charter competition system is infirm because rents provide its incentives. Absent the rents it is difficult to imagine the charter competition system ever coming into existence in the first place.

It does follow that competition does not provide a stand alone justification for state level regulation. But we do not think this makes for a federalism problem for Delaware. To our knowledge no first best lawmaking equilibrium has ever been

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[134] See Ronald Daniels, Should Provinces Compete? The Case for a Competitive Corporate Law Market, 36 McGill L.J. 130, 142-43 (1991).
[135] Id. at 4-5.
[136] Romano, Genius of Corporate Law, supra note __ , at 4-5, 48.
[137] Id. at 5.
[138] Bratton & McCahery, supra note __, at 260.
[139] Id. at 261.
[140] Id. at 267.

identified, so it not clear to us why the charter market needs to be judged by that measure in the first place.

### C. Summary: The Stable Equilibrium

The state system can be described as a stable equilibrium. Drawing on concepts from evolutionary game theory, we see that, prior to 1920, New Jersey adopted a noncooperative strategy, turning corporate law-making into a strategic game directed to the acquisition of rents from managers looking for responsive, enabling legal frameworks, despite negative consequences for other states. There followed a period of learning (or adaptive behavior) during which other states adjusted their strategies, following New Jersey.[141] New Jersey then abandoned its strategy for exogenous political reasons. Delaware, playing New Jersey's original strategy, captured its rents. Delaware has been playing noncooperatively vis a vis the other states ever since. Within the game, an enabling corporate code that also vests agenda control over governance matters in management amounts to an evolutionary stable strategy – any state without one will lose its significant charters;[142] any state innovation that fails to follow the strategy will not succeed. Meanwhile, Delaware's agents act as rational maximizers, seeking to protect the state's rents. They update and learn on an ongoing basis, adjusting their strategies respecting the terms of corporate law as they face new situations.[143] The history shows that so long as the states are left alone to play the game, corporate law nearly approaches a stationary state.[144]

The state system and its stable equilibrium pose two questions for federal lawmakers. The first is whether to respect the equilibrium's exclusion of regulation referenced to the wider public interest. Here a federal decision to intervene could so displace the states as to destroy the equilibrium and the strategies and rents that keep it stable. The second question is whether the state equilibrium succeeds as shareholder capitalism, according the shareholders meaningful ultimate control and succeeding in

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[141] See Larry Samuelson, Evolutionary Games and Equilibrium Selection, 22-24 (1997).

[142] Id. at 17.

[143] Id. at 23. Conventional game theory with its stringent rationality requirements, teaches us little about how norms can be self-enforcing.[143] See Paul Mahoney & Christopher Sanchirico, Norms, Repeat Games, and the Role of Law, 91 Cal. L. Rev. 1281 (2002) (showing counterfactuals are de-stabling for equilibrium strategies such as the def-for-dev and always defect). Dissatisfied with the stringent rationality requirements of standard equilibrium approach to strategic environments, the new evolutionary game theory literature has made less stringent assumptions regarding the knowledge and understanding of the players than the conventional theory of Nash equilibrium. They make key assumptions about learning processes of players — that is, a player's behavior will adapt to the new circumstances posed by the game. Samuelson, supra note __, at 91. The evolutionary scholars assume that the learning process will depend on how strong the norm is that arose in the context of the game, and whether other norms have been adopted by other players, etc. Learning will be conditioned on how important the game is to the players and how complex the task is in question.

The learning process is crucial for the charter market game because Delaware's agents have needed to accumulate, through many rounds of play, sufficient experience to learn the optional behavior required to keep the system in equilibrium. The learning dynamics, for example, allows players to distinguish between noise (cheap talk) and out-of-equilibrium strategies (real threats), which could cause the system to move toward another equilibrium.

[144] Id. at 26.

directing management in the shareholders' interest. Here views differ on the probable state level effects of federal intervention. Some argue that the states' failure to contain externalities and regulate toward the end of shareholder value maximization rebuts the internal affairs presumption and justifies corrective intervention.[145] As we have seen, they also argue that this can be done in such a way as to force the states to change their strategies, accommodating the shareholder interest and changing their strategy without cutting off the rent incentive. Others take the position that the stable equilibrium holds out such benefits that any shortcomings must be forgiven. They point out that political agenda at the federal level is highly contestable. Management remains a more concentrated group than the shareholders and thus more able to wield influence. It could co-opt a federal reform process, for example procuring legislation making takeovers more expensive still.[146] That risk, together with the possibility of perverse effects stemming from the federal habit of governance by mandate,[147] implies a preference for the states' enabling equilbrium, with its high degree of accountability within the corporate community.[148]

The corporate federalism question devolves into an assessment of the weight to be accorded those warnings. To assist that appraisal, the next part of the Article inquires into the political dynamics that trigger federal intervention into internal affairs. It shows that the notions of the public interest that motivate national level regulators have over time synchronized better and better with the state equilibrium.

## III POLITICAL ECONOMY AT THE NATIONAL LEVEL

The federal government took the lead in regulating the securities markets when it added disclosure, antifraud, and insider trading mandates in 1933 and 1934.[149] Under the internal affairs norm, as thereafter articulated, markets and disclosure were federal subject matters, while other corporate subject matters were presumptively left to the states and the stable equilibrium. Despite the norm, the federal government and the stock exchanges since that time have progressively, albeit episodically, entered into internal affairs. These inteventions are historically contingent, occurring when political demands are registered nationally.

Despite this contingent and episodic nature of these federal entries, the federalism has evolved toward an equilibrium balance. Where the exchange of a product for rents describes the state equilibrium, the federal equilibrium is political. Where the state equilibrium is self-enforcing, federal actors have a range of strategies at their disposal and a zone of discretion. They could play uncooperatively, intervening so as to terminate the rents and the state equilibrium. They also could be wholly cooperative, leaving

[145] See notes _- __ supra and accompanying text.
[146] Choi & Guzman, supra note __, at 975.
[147] Id. at 977.
[148] Romano, supra note __, at 4-5, 48-50, 75-76.
[149] The federal disclosure regime less displaced the states than it did the New York Stock Exchange listing requirements, which had required annual financial reports in 1907, semiannual financials in 1917, quarterly financials in 1923, and independent audits in 1932.Thompson, supra note __, at __. Gilbert W. Cooke, The Stock Markets 340 (rev. ed. 1969).

internal affairs to the states. Strategies actually chosen depend on political norms and pressures, which in turn depend heavily on the environment in which the game is played. Given the stability of the state equilibrium, we can expect federal actors accurately to predict state level responses to events. But we should not expect the federal state game to replicate the stability we see in the states because the federal game is political and driven by exogenous events. Even so, four patterns can be discerned in the history of federal incursions on internal affairs. Together they suggest the evolution of a stable, cooperative strategy at the federal level.

The first pattern concerns subject matter. Interventions tend to address topics, legal compliance most prominently, as to which unilateral action by Delaware would be inadequate fully to satisfy national political demands. This follows in part from the federal structure: National demands create a need for parallel action across all 50 states. It also follows from the properties of the state equilibrium. In the charter market, the evolutionarily stable strategy is fidelity to the management interest. If Delaware shifted to a strategy of imposing hard wired accountability and enforcement mechanisms, it would be viewed as a defection against management and would disrupt the equilibrium, reducing Delaware's rents. The same thing would happen if Delaware mandated particular governance processes. It follows that not only does federal intervention accomplish results unavailable at the state level, the stable equilibrium disables the states from preemptively anticipating federal strategies. The states' evolutionarily stable strategy embeds the legal regime. At the same time, because the federal government never makes full use of its constitutional preemptive authority, the federal-state equilibrium has a cooperative aspect.

The second pattern concerns political substance. Federal chartering, the public interest strategy holding out the greatest threat to the state equilibrium, never reached the top of the federal political agenda after 1920. More generally, initiatives implicating sharp ideological partisanship do not find their way into federal level mandates. Neither the trust paradigm (broadly or narrowly stated) nor the market paradigm motivates national level interventions. But a third approach, which we call the "governance agenda," does carry descriptive weight. Under this, the federal government intervenes to adjust state equilibrium results for the benefit of the shareholders, largely restricting itself to governance instruments found on the self regulatory menu. Once again the pattern implies a norm of cooperation.

The third pattern concerns the relative influence of shareholders and managers. The presence of the SEC hardwires an influential voice for the shareholder interest at the federal level, even as the management interest at times also proves influential. Either way, federal interventions are stock market sensitive, with shareholder directed interventions coming in the wake of adverse economic shocks and management directed interventions occurring during buoyant markets.

The fourth pattern manifests the operative federalism. Even as the federal government and the stock exchanges cross the internal affairs line and mandate governance strategies, they have never disrupted the state equilibrium. National

intervention has impacted neither the basic terms of the state settlement nor Delaware's rent flows, once again implying a cooperative strategy. Contrariwise, even as federal moves have prompted Delaware to adjust its strategies on occasion, Delaware never goes so far as to imitate federal strategies.

Section A looks at the counterfactual empty set, federal level agendas under the trust and market paradigms and the failure of both federal chartering and the protakeover agenda. Section B looks at the political climate surrounding the two most extreme federal interventions into internal affairs since 1934, Foreign Corrupt Practices Act and the Sarbanes-Oxley Act. Section C contrasts the political climate surrounding the Williams Act and other management directed federal interventions. Section D summarizes.

## A. The Trust and Market Paradigms at the Federal Level

Federal incorporation proposals antedate the federal government itself -- James Madison mooted the idea at the Constitutional Convention.[150] Federal incorporation went on to reach the top of the national policy agenda as a first reaction to the appearance of charter competition. But its proponents in successive administrations never managed to put together the broad-based coalition needed to secure passage in Congress.[151] After 1920, federal chartering never regained comparable political salience, even as the trust paradigm's adherents brought it back to the national agenda on two later occasions. This section takes the benefit of hindsight to explain those later failures, drawing a parallel to the later failure of the market paradigm's proponents to invoke federal preemptive power to protect the hostile takeover.

1. *The New Deal*.

Federal incorporation had a place on the agendas of a number of prominent New Dealers, President Roosevelt and SEC Chairman William O. Douglas not least among them.[152] They were joined by Senators Joseph O'Mahoney and William Borah, who promoted the idea in Congress during the second Roosevelt administration. Borah and O'Mahoney wanted to make federal incorporation the vehicle for an omnibus progressive assault on management discretion. O'Mahoney's proposed bill[153] revived old antitrust agenda items, adding to them Berle and Means' rule of trusteeship and other current items from the governance agenda. O'Mahoney also included the labor agenda, mandating compliance with the National Labor Relations Act as an internal corporate duty.[154]

Unfortunately for O'Mahoney, prominent actors in the administration were

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[150] See James Madison, Notes of Debates of the Federal Convention 638 (W. Norton & Co. ed. 1966).
[151] Brabner, supra note __, at 162-63.
[152] Joel Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance 205 (1982).
[153] S.B. No. 10, 75th Cong., 1st Sess.
[154] Brabner, supra note __, at 164.

opposed. Even Douglas had other matters at the top of his agenda and in any event opposed the inclusion of antitrust and labor compliance.[155] The best that O'Mahoney could get from Congress was the formation of a study committee, the Temporary National Economic Committee. This brought together six members of Congress and six agency representatives under O'Mahoney's chair. The committee held hearings but never got behind O'Mahoney's omnibus approach. Its final report in 1941 had no impact.[156]

The bundling of the labor agenda has been accorded a causal role in the failure of the O'Mahoney initiative.[157] To second the point, reference can be made to the labor movement's Congressional agenda since World War II, which has never targeted empowerment in corporate internal affairs. Under an enduring American political settlement, labor works within the model of contractual engagement, where, since the enactment of the Taft Hartley Act in 1947,[158] it has been fighting a rearguard political action.[159] Organized labor works to improve its rights to organize shopfloors, empower the NLRB (or nominate a stronger enforcement agent), and secure the power of the secondary boycott.[160] State law also shows up on the agenda, but labor wants right to work laws preempted rather than state corporate codes.[161] When managers went to state legislatures to procure antitakeover statutes in the 1980s, organized labor sat out the political event, preferring to husband its political capital for its own agenda items.[162] Today, even as union pension funds use their shareholdings for antimanagerial initiatives, they tend to stick to items on the institutional investors' governance agenda, avoiding labor movement issues in order to retain plausibility.[163]

2. *The Watergate Era.*

When federal chartering returned to the political stage in the 1970s, labor figured in only incidentally.[164] The antitrust agenda of the day also was separately pursued,

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[155] Seligman, supra note __, at 207-08.
[156] Id. at 209-10.
[157] Id. at 211.
[158]The Labor Management Relations Act of 1947, Pub. L. No. 80-101, codified in 29 U.S.C. §§ 141-187 (2004).
[159] See Nelson Lichtenstein, Taft-Hartley Symposium: The First Fifty Years: Taft-Hartley: A Slave-Labor Law?, 47 Cath. U.L.Rev. 763, 765 (1998) (arguing that "the Taft-Hartley law stands like a fulcrum upon which the entire New Deal order teetered" and that, since 1947, the labor movement in the United States has been "forced into an increasingly defensive posture"); Michael H. LeRoy & John H. Johnson IV, Death by Lethal Injunction: National Emergency Strikes Under the Taft-Hartley Act and the Moribund Right to Strike, 43 Ariz. L. Rev. 63, 126-130 (2001) (claiming that "Taft-Hartley contextualizes strikes as a harm to the public" and that "Taft-Hartley injunctions played an important role in the long-term decline of industrial unions.").
[160] Mark A. Smith, American Business and Political Power 1-2, 77-78(2000)
[161] Id. at 77.
[162] Roberta Romano, The Political Economy of Takeover Statues, 73 Va. L. Rev. 111, 134-37 (1987)(discussing events in Connecticut and asserting that evidence on other states is consistent).
[163] Randall Thomas Mich.
[164] Two items from the contemporaneous labor agenda show up on one piece of proposed legislation. Representative Rosenthal's Corporate Democracy Act of 1980, H.R. 7010 (introduced April 2, 1980)

resulting in the Hart-Scott-Rodino Antitrust Improvements Act of 1976.[165] Federal chartering proponents, who this time came from outside of government, pursued a more general notion of the "public interest." Social reformers like Ralph Nader linked the conduct of corporate business to a range of social problems.[166] It was thought that the benign, pluralist vision of government had failed. Legislative results were not protecting the public interest because business had overwhelming political influence. Indeed, under a theory in circulation at the time, business did not even need to lobby aggressively to get results: Politicians automatically backed anything that encouraged investment because they were terrified of the political consequences disinvestment during of economic downturns.[167] Alternatively, it was argued that the regulatory state had proved dysfunctional, even as corporate externalities remained a critical problem.[168] Either way, the proponents sought to surmount the problems and enforce the public interest through legal control over internal affairs. This public interest agenda came in from the fringe when news of improper political contributions and foreign payments made management's conduct of business a national political issue in the post Watergate environment.[169]

But only a handful of legislative proposals materialized. Only three bills mandating federal chartering were introduced between 1972 and 1980.[170] Of these, the focal point initiative was Senator Howard Metzenbaum's Protection of Shareholders' Rights Act of 1980,[171] a bill that drew on the narrow version of the trust paradigm, omitting the broader public agenda and focusing on the shareholder interest and the governance agenda. Following Cary, it imposed federal fiduciary standards,[172] adding a series of process mandates including an independent director board majority,[173] audit and nominating committees entirely made up of independent directors,[174] a shareholder nomination mechanism,[175] and cumulative voting.[176] But time was running out for antimanagerial politics in 1980. When the Reagan administration came in the following year, the federal agenda shifted to the market paradigm. Federal chartering has not been heard of since on Capital Hill.

The trust paradigm did better in the federal courts of the era than it did in

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contained a plant closing notification provision and would have amended the NLRA to add a good faith termination provision.

[165] Pub. L. No. 94-435.

[166] See Ralph Nader, Mark J. Green & Joel Seligman, Taming the Giant Corporation (1976);.Donald E. Schwartz, Federalism and Coprorate Governance, 45 Ohio St. L. Rev. 545, 548-49 (1984).

[167] See Charles Lindblom, Politics and Markets: The World's Political-Economic Systems, ch.13 (1977).

[168] See Elliott J. Weiss, Social Regulation of Business Activity: Reforming the Corporate Governance System to resolve an Institutional Impasse, 28 UCLA L. Rev. 343, 347-55, 422-26 (1980)(suggesting imposition of a norm of "altruistic capitalism").

[169] Schwartz, supra note__, at 548-49.

[170] Corporate Citizenship and Competition, H.R. 7481 (introduced May 22, 1975)(reintroduced as H.R. 9076, July 29, 1975); Democracy Act of 1980, H.R. 7010 (introduced April 2, 1980); Protection of Shareholder Rights Act of 1980, S. 2567 (introduced April 16, 1980).

[171] Id.

[172] Id., sec.4.

[173] Id., sec. 5.

[174] Id. secs. 6, 7.

[175] Id. sec. 8.

[176] Id. sec. 9.

Congress. Federal courts of appeals expanded the implied right of action under Rule 10b-5 to cover equitable fraud and breaches of fiduciary duty.[177] Had the expansion been sustained, the states' fiduciary regime might have been rendered superfluous as plaintiffs opted for a more hospitable federal venue. But, in 1977, a Supreme Court majority rejected the expansive reading of 10b-5,[178] emphatically employing the internal affairs presumption into its interpretation of the securities laws.[179]

3. *The Takeover Era*

The political tables turned in 1980. Now adherents of the market paradigm dominated the SEC. Although friends of the internal affairs presumption, they soon ran into their own problems with the states. The states, still following the evolutionary stable strategy, which were moving to chill hostile takeovers. The market paradigm supported preemptive intervention. Although generally committed to regulatory devolution, the paradigm also counseled central regulatory intervention to the extent necessary to protect a market by keeping transactional lanes open and policing externalities.[180] The paradigm's adherents won a single great victory when the same Supreme Court that had protected the states from the federal antifraud regime invalidated first generation antitakeover statues as a burden on interstate commerce.[181] Unfortunately, the states took advantage of the court's interpretive preference for state control of internal affairs and redrafted their statutes, winning the second round in the Supreme Court.[182] It accordingly was up to Congress to protect the market for corporate control. Unfortunately, the takeover wars of the period left Congress inundated with antitakeover constituent pressure. Most proposed bills were antitakeover.[183] The interest group alignment in Washington tracked that in the states, with the management voice sounding louder than the shareholder voice and the shareholders showing no cognizable public support for preemptive intervention against the states.[184] Administration opposition sufficed to block the antitakeover initiatives,[185] leaving the federal government in gridlock. The outcome accordingly was decided at the state level.

4. *Summary*.

Now comes the question as to what these accounts teach us about the content of corporate federalism. More specifically, to what extent should we infer that the internal affairs norm played a causal role in these federal level outcomes? Drawing causal

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[177] See Ruckle v. Roto Am. Corp,, 339 F.2d 24 (2d Cir 1964); Shell v. Hensley, 430 F.2d. 819 (5th Cir. 1980); Santa Fe Indus. v. Green, 533 F.2d 1283 (2d Cir. 1976), rev'd 430 U.S. 464 (1977). But see Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968), cert. denied, 395 U.S. 906 (1969)(refusing find a violation in a sale of treasury stock to a related party at a deflated price).
[178] Santa Fe Indus. v. Green, 430 U.S. 464 (1977).
[179] Cort v. Ash, 422 U.S. 66, 84 (1975)(asserting that state law governs internal affairs).
[180] Bratton & McCahery, supra note __, at 211-12.
[181] Edgar v. MITE, 457 U.S. 624, 640-46 (1982).
[182] CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987).
[183] Romano, supra note __, at 458-60.
[184] Id. at 488-90.
[185] Id.

inferences from an historical pattern of inaction is a risky business, so we take a flexible approach in addressing the question. Three contrasting inferences may be drawn.

a. *No Federalism.* Nothing in these cases compels the inference that federalism concerns played an operative role. The events plausibly can be read narrowly, as a series of federal level political failures acted out against an inherited state level default condition. Such a default persists so long as the actors at the higher level of government fail to agree, and can persist even though the terms of state regulation no longer embody a preferred outcome due to changed conditions.[186] No inference of respect for the states need be drawn. O'Mahoney acted at the moment in history when intervention against the states and corporate management had a comparatively high level of political plausibility. But he asked for too much in challenging the political settlement that excludes labor from internal affairs, a settlement long embedded at both the national and state levels. Metzenbaum asked for less, but taking advantage of hindsight, we can see that in 1980, the trust paradigm did not command a political base adequate to push business law reform past the management interest and into law. (The Reagan SEC and the market paradigm encountered the same problem a few years later.) Indeed, by 1980 the trust paradigm probably lacked the political gravitas to reach the top of the Congressional agenda, much less to defeat the opposing interest group.

Both the trust and the market paradigms emerge in this description as political failures. Whatever their substantive merits, they were the projects of narrow networks of academic and policy elites. Neither resounded strongly enough, either with the median voter, or alternatively, the partisan agenda setters, to get to the top of the agenda and override interest group opposition.[187] No general observation about the political influence of narrow, elite networks is intended. Academic paradigms help shape political agendas, perhaps even contributing a focal point solution in a case where a problem has multiple competing solutions.[188] But the likelihood of such influence decreases as the distributional consequences of the competing outcomes increase.[189] Here, given such high stakes, it is unsurprising that the politics failed to work out for the proponents.

Significantly, both paradigms did better in the courts. There, given interpretive slack, network members in positions of authority can find room to maneuver. At the same time, the judicial rulings show us the only points in the sequence of events implying that respect for the states operates as an independent and causative value. There may have been members of the *CTS* court who preferred the market for corporate control and economic federalism as a policy proposition but who also felt bound by a conflicting juridical tradition of reserve, here bound up in the internal affairs notion.

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[186] See Frtiz Scharpf, The Joint Decision Trap: Lessons from German Federalism and European Administration, 66 Pub. Affs. 239 (1988).
[187] The discussion draws on Kevin M. Murphy & Andrei Shleifer, Persuasion in Politics, 94 Amer. Econ. Rev. 435, 435-37 (2004)(Papers & Proceedings).
[188] See Geoffrey Garrett & Barry Weingast, Ideas, Interests, and Institutions: Constructing the European Community's Internal Market, in Judith Goldstein & Robert Keohane (eds), Ideas and Foreign Policy (1993).
[189] Id.

b. *Parallel Politics*. Alternatively, we can read these events as a product of parallel normative views at the state and federal levels. On this view, no federal intervention occurred because actors controlling federal outcomes saw nothing amiss in state corporate law. This view can be restated in public choice form: Whether or not most federal actors approved of state results, the federal interest group *gestalt* paralleled that of the states,[190] with the management interest proving sufficiently dominant to protect the state regime. An astute federal actor would anticipate an all out interest group assault on any legislation that threatened the state equilibrium. Management and related interest groups like the corporate bar and the financial intermediaries have a significant investment in Delaware law. Quite apart from any policy preferences, such investors can be expected to fight (or pay) to protect the yield from their sunk cost[191] and federal politicians can be expected to settle in their favor, perhaps exacting tribute.

c. *Federalism*. Finally, it remains possible that independent federalism considerations operated to deter federal intervention. The operative federalism notions could have been either juridical or economic. We prefer an economic reading. The next sections of this part look at a number of high profile cases where Congress did cross the internal affairs line, suggesting that any barrier posed by constitutional traditions yields easily. As to economic notions of federalism, a different inference arises. None of these incursions on internal affairs have disrupted the state equilibrium, permitting an inference of respect for state control over internal affairs, viewed from an economic perspective.

## B. Federal Incursions on Internal Affairs under the Governance Agenda

In 1934, William O. Douglas, then still a Yale law professor, published an article in the *Harvard Law Review* in which he described the shortcomings of the about-to-be enacted federal securities statute.[192] He noted scandals that had come to light in the aftermath of the Great Crash, variously involving secret loans, undisclosed profit sharing plans, self dealing contracts, and insider trading.[193] Disclosure would not be enough, he said, more in the way of regulation was needed to prevent the repeat of such sorry spectacles in the next cyclical market rise.[194] The problem, said Douglas, lay in the separation of ownership and control. Taking care to note a whole-hearted endorsement of the trust paradigm,[195] he articulated a second agenda. Control of the board of directors needed to be taken out of management's hands and placed in those of an independent

[190] See Romano, supra note __, at 475-76 (suggesting that federal and state level takeover politics paralleled one another).
[191] See Jonathan Macey, Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism, 76 Va.L.Rev. 265, 274-75, 278 (1990). Macey predicts that so long as existing state rents are greater than the rents created by federal regulation, the beneficiaries will pay Congress in return for retention of state control. Id. at 276. See also Fred McChesney, Rent Extraction and Rent Creation in the Economic Theory of Regulation, 16 J. Leg. Stud. 101 (1987)(showing that where private parties have created quasi rents through capital investment, politicians can extract payments in exchange for promising not to regulate).
[192] William O. Douglas, Directors Who Do Not Direct, 47 Harv. L. Rev. 1305 (1934). See also William O. Douglas, Protecting the Investor, 23 Yale L.J. 521 (1934).
[193] Douglas, supra note __, at 1306.
[194] Id.
[195] Id. at 1323.

director majority. He proposed a monitoring model – a board made up of independent shareholder representatives who supervised from a position of power.[196] Douglas also wanted more disclosure of conflict of interest transactions and maybe even a per se prohibition of loans to officers.[197] Finally, Douglas noted that the present legal structure did little to move corporate governance in the direction indicated. He was flexible about means to the end of improvement. Any of federal incorporation, self help by the shareholders (given a federally instituted organizational base on which to solve collective action problems), or improvement of state law, might move things in the right direction.[198]

Douglas' article set out the basic terms of the governance agenda that has guided corporate law reform ever since.[199] Where both the trust and the market paradigms have failed, this academic paradigm has influenced both actors in the corporate sector and federal legislators. Significantly, the agenda is narrow, viewed in the broad scale of things. It has two branches. The first branch goes to the board of directors' make up and institutional role. Here the agenda addresses only the management-shareholder relationship and eschews other constituents and unrelated notions of the public interest. Two categories of question come up. The first goes to the identification of best corporate governance practices. The second concerns whether a best practice, once identified, should be mandated, overriding the enabling state system. The agenda's second branch concerns compliance with law. This branch in part tracks state corporate law, looking to enforcement of fiduciary duties. But the compliance agenda has an independent federal side tied to the federal antifraud enforcement regime. This will be the point of entry against state control of internal affairs.

The rest of this section recounts the appearance of the two statutes that do most to carry the governance agenda across the internal affairs barrier, the Foreign Corrupt Practices Act of 1977 (FCPA)[200] and the Sarbanes Oxley Act of 2002 (SOX).[201] We will see that Congress traverses internal affairs on a fire patrol basis.[202] In both cases, a bi-partisan Congress acted in response to an external shock. In both cases, the state equilibrium precluded significant corrective action. In both cases, corporate compliance failures triggered broad-based political demands. And in both cases, the federal compliance regime reached more deeply into internal affairs.

1. *The Watergate Era.*

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[196] Id. at 1314-16. In a later address he would add boards should be smaller, salaries should be adequate, and outsider directors should acquire a thorough knowledge of the firm. Seligman, supra note __, at 207.
[197] Douglas, supra note __, at 1323-25.
[198] Id. at 1329.
[199] For a later, more thorough-going, exposition of points on the agenda, see Melvin Aron Eisenberg, The Structure of the Corporation: A Legal Analysis 137-211, 316-20 (1976).
[200] Exchange Act, §§ 13(b)(2), 30A, 32, 15 U.S.C. §§ 78m(b)(2), 78dd-1-2, 78ff, added by Pub. L. No. 95-213, 91 Stat. 1494 (Dec. 19, 1977).
[201] Pub. Law. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).
[202] See Mathew D. McCubbins & Thomas Schwartz, Police Patrols v. Fire Alarms, 28 Am. J. Pol. Sci. 165, 166 (1984).

During the Watergate investigations of 1973-74, the special prosecutor discovered corporate political slush funds that evaded normal accounting controls.[203] Payments included illegal domestic political contributions and bribes to officials abroad – termed "questionable foreign payments" -- made in connection with the sale of American goods and services.[204] In March 1974, the SEC announced a voluntary disclosure program, asking companies to admit to any questionable payments to foreign officials.[205] There resulted admissions by over 450 companies implicating over $400 million in payments.[206] The public, already disgusted with corruption in government and agitated by the media, now demanded a clean up of corruption in corporate America.[207] Corporate governance[208] became bound up with the politics of corruption in high places.

The SEC responded in 1977, taking up governance agenda items looking toward majority independent boards and committees. It held public hearings. But, unfortunately, the SEC had no statutory authorization to mandate committee structure. Aside from section 14 of the 1934 Act,[209] which authorizes the SEC proxy rules, the agency could only mandate disclosure. So the SEC worked the agenda into new disclosure rules concerning board and committee membership and structure. It wanted each director tagged as independent or affiliated, but, management made its voice heard and the SEC had to settle for less direct means of getting the pertinent facts into the public filings.[210] Movement toward board and committee process mandates shifted over to the American Law Institute, which was taking up a corporate governance project. But so averse to mandates was management that it raised its voice at the ALI as well, stifling even a mandatory statement encapsulated in a nonbinding principle.[211] Efficiency worries had come to the fore in the stagflating economy. The governance agenda was remitted to the less threatening venue of self regulation, where it prospered.

But a handful of mandates were forthcoming. The SEC pressured the NYSE to amend its rules to require an audit committee comprised solely of independent directors.[212] Putting the proxy rules to one side, this amounted to the first national level

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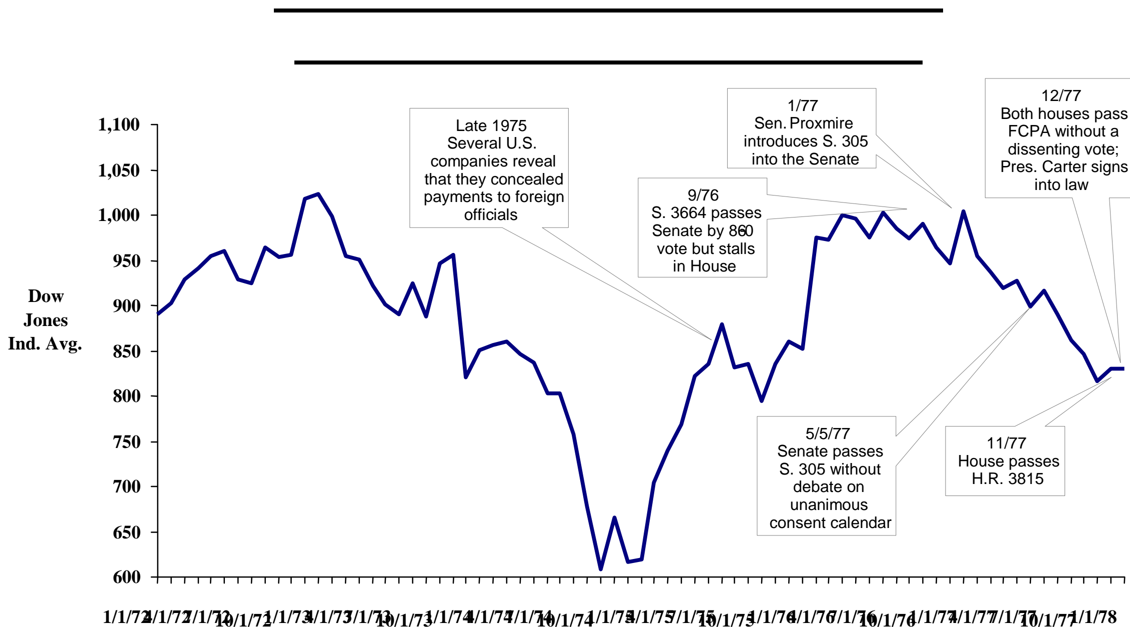
[203] See George C. Greanias & Duane Windsor, The Foreign Corrupt Practices Act 63 (1982).
[204] See Roberta Karmel, Realizing the Dream of William O. Douglas – The Securities and Exchange Commission Takes Charge of Corporate Governance at 10 (SSRN working paper 2004).
[205] Daniel Pines, Amending the Foreign Corrupt Practices Act to Include a Private Right of Action, 82 Calif. L. Rev. 185, 187-188 (1994).
[206] The lead item was the revelation of $22 million of bribes abroad by Lockheed Aircraft. Pines, supra note __, at 187-188.
[207] Donald R. Cruver, Complying With the Foreign Corrupt Practices Act 5 (2d ed. 1999).
[208] Schwartz, supra note __, at 549.
[209] 15 U.S.C. § 78n.
[210] Karmel, supra note __, at 12-13.
[211] Mandatory independent board structure was proposed in the first draft of the American Law Institute's *Corporate Governance Project*, but was cut back to precatory status in later versions. Compare ALI, Principals of Corporate Governance and Structure: Restatement and Recommendations § 3.03 (T.D. No. 1 1982)(mandatory majority of independent directors), with 1 ALI, Principals of Corporate Governance: Analysis and Recommendations § 3A.01 (1994)(majority of independent directors as practice suggestion). See also Melvin A. Eisenberg, The Structure of the Corporation: A Legal Analysis 170-85 (1976)(recommending mandate). On the politics of the ALI proceedings, see Jonathan R. Macey, The Transformation of the American Law Institute, 61 Geo. Wash. L. Rev. 1212 (1993).
[212] Karmel, supra note __ at 17.

mandatory push into internal affairs pursuant to the governance agenda.

Additional mandates came with the FCPA, which prohibited bribery of foreign officials, making the "questionable" payments illegal. More importantly for present purposes, it amended the 1934 Act to go deeply into internal affairs, imposing record-keeping and internal control requirements on reporting firms.[213] The FCPA also gave the SEC oversight over the formulation of accounting principles. It was said to amount to the extensive application of federal law to the regulation of corporations since 1934.[214]

**Figure IV--Market Context 1972-78**




The FCPA grew out of a presidential investigation and spate of committee hearings conducted in 1976, an election year. There was significant political disagreement. The Ford Administration backed a disclosure-based statute; Democratic senators and their presidential candidate, Governor Jimmy Carter, wanted directives and criminal penalties. The Senate unanimously passed a weak bill before the election, but the House recessed before taking up the matter[215] When the new Congress convened in 1977, Carter had won and the new administration backed a strong bill. The strong version passed unanimously by the end of the year.[216] As Figure IV shows, the scandals unfolded against the backdrop of a volatile stock market in which long term investors made no money. The market crashed during the Nixon-Ford administration, to recover in the run up to the 1976 election. But, given the high inflation of the period, the recovery

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[213] See Walter Perkel, Foreign Corrupt Practices Act, 40 Am. Crim. L. Rev. 683, 683 (2003).
[214] See Greanias & Windsor, supra note __, at 1.
[215] Id. at 60-65.
[216] Id. at 63, 71; Daniel L. Goelzer, The Accounting Provisions of the Foreign Corrupt Practices Act – The Federalization of Corporate Recordkeeping and Internal Control, 5 J.Corp. L. 1, 17-18 (1979).

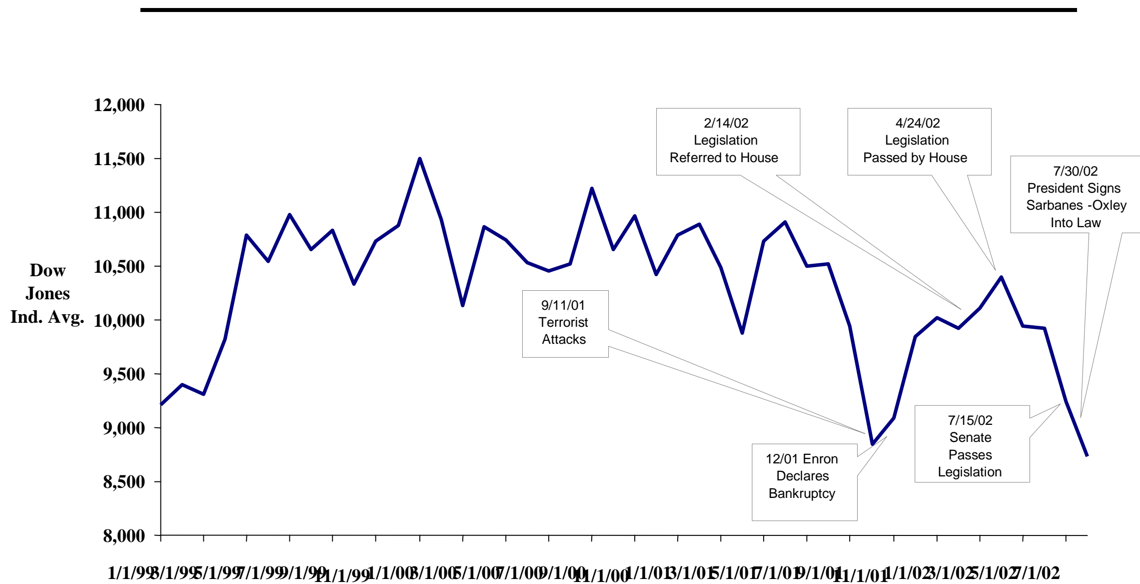
did not make whole the losses. As Congress finally took up the FCPA in 1977, the market again stumbled badly.

The FCPA's mandates would have been inconceivable in the state law framework. The stable equilibrium, with its enabling approach, excluded them. Compliance systems were not even on the states' formal enabling menu. In theory compliance with law fell within the regime of fiduciary review; in practice there was no enforcement commitment.[217]

2. *The Enron Era*

The scenario acted out in the mid 1970s repeated in 2002 in the wake of reporting failures at Enron, WorldCom, and other firms. Three ingredients once again combined -- a major and ongoing decline in the equity markets (depicted in Figure V), headline-grabbing stories of corporate corruption, and popular anger towards corporate management. Once again, legislation intended to "reign-in" corporations passed with bipartisan support. Once again, internal affairs were traversed without apparent concern for the federalism norm. The result was the Sarbanes-Oxley Act of 2002.[218]

**Figure V--Market Context 1999-2002**

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[217] The classic citation is Graham v. Allis Chalmers, 188 A.2d 125 (Del. 1963)(declining duty of care review of antitrust compliance breakdown). See generally, Cynthia A. Williams, Corporate Compliance with the Law in the Era of Efficiency, 76 N.C. L. Rev. 1265, 1384 (1998) (arguing that "corporate power is exercised with increasing freedom from state control, as both labor and capital become more global and mobile (and thus corporations are able to engage in "regulatory arbitrage" with respect to financial regulations, and "regulatory avoidance" with respect to safety, health, environmental, and labor regulations in the United States).").

[218] Pub.L. No. 107-204, 15 U.S.C. §§ 7201 et seq (2002).

SOX had a quick gestation. The Enron scandal and accompanying media frenzy began with news of paper shredding in January 2002. The House enacted its bill in April, by a vote of 334 to 80.[219] WorldCom fell while the Senate held hearings on the House bill, triggering an accelerated timetable and passage by voice vote on July 15. The Conference Report, passage by both Houses, and presidential approval all followed before the end of the month.[220] The Republicans disliked many provisions, but with an election coming up and a falling stock market (coming on the heels of a precipitous plummet two years earlier), they fell in line. Even the leading business lobbies were split, with the Business Roundtable saying yes and the Chamber of Commerce saying no.[221] So rapidly was the package cobbled together that little of its contents received much in the way of considered attention.[222]

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[219] See thomas.loc.gov. (report on Public Law 107-204).

[220], See Roberta Romano, The Sarbanes Oxley Act and the Making of Quack Corporate Governance, at 106-112, 128-29, 136(Yale University working paper, May 2004).

[221] Id.at 112.

[222] Id. at 111, 125. Mark Roe, Backlash, 98 Colum. L. Rev. 217 (1998), is the leading discussion of the politics that follow upon economic adversity. Sarbanes-Oxley has triggered a quite a bit of commentary subsequent commentary on the connection between legislative activity and market declines and scandals. Joseph Grundfest analogizes the development of the securities laws to the "punctuated equilibrium" theory of evolution, which argues that "species are relatively stable over long periods of time, but 'events of rapid speciation occasionally punctuate this tranquility.'" See Joseph A. Grundfest, Enron: Lessons and Implications: Punctuated Equilibria in the Evolution of United States Securities Regulation, 8 Stan. J.L. Bus. & Fin. 1, 1 (2002). For Grundfest, the stock market crash of 1929 was the "big bang" that was followed by several smaller crises, each causing a substantial transformation in existing securities laws. See id. at 2.

Vikramaditya S. Khanna, Corporate Crime Legislation: A Political Economy Analysis, 82 Wash. U. L. Q. 95, 105 (2004), focuses on corporate crime legislation:

> [C]orporate crime legislation [normally] comes on the heels of a large public outcry for greater regulation following the revelation of a number of events of corporate wrongdoing usually during or around a weak economy. This was the case for the federal securities laws, the Foreign Corrupt Practices Act, and other legislation surrounding Watergate, insider trading legislation in the mid-1980s, and the recent Sarbanes-Oxley Act. Against this backdrop of increased calls for regulation, Congress must act as a political matter, and the issue is what it will do . . . it could enhance corporate civil liability, enhance corporate criminal liability, enhance liability for other parties (e.g., managers, accountants, and so forth), increase direct regulation generally, or rely on some combination of these options. Which option Congress chooses depends to some extent on the lobbying efforts of corporate interests and other interested parties.

Id. at 104. Khanna believes that this argument explains the lack of strong opposition by corporate interests to the corporate criminal liability provisions in both the Sarbanes-Oxley Act and the Foreign Corrupt Practices Act. Id. at 116. In examining the motivation of legislators in passing strong corporate criminal liability statutes, Khanna hypothesizes that both corporations and legislators have a natural incentive in times of economic crisis and corporate scandal to pass headline-grabbing legislation that focuses on increasing corporate criminal liability but that avoids substantive changes to the underlying behavior. Id. at 125-26. Others concur. See Kai-Alexander Heeren & Oliver Rieckers, Legislative Responses in Times of Financial Crisis – New Deal Securities Legislation, Sarbanes-Oxley Act and Their Impact on Future German and EU Regulation, 11 Eur. Rev. Private L. 595, 623 (2003). (arguing that Sarbanes-Oxley "leaves the impression that its primary purpose was to calm down troubled investors by demonstrating that Congress was not idle in response to the recent corporate scandals.").

Gregory Mark offers a contrasting description, distinguishing between the economic downturn and the scandals and putting causal emphasis on the former. See Gregory A. Mark, Crisis in Confidence: Corporate Governance and Professional Ethics Post-Enron: The Legal History of Corporate Scandal: Some

Some of the SOX mandates pick up where the FCPA left off. For example, SOX requires that the CEO and CFO certify public reports, making them responsible for the maintenance of the firm's internal controls system,[223] along with accompanying criminal penalties.[224] While these go to internal affairs, the affairs they address long have been federalized. Moreover, the integrity of the disclosure system still stands out as the ultimate goal. In effect, the federal government, having instituted the mandatory system, reacts to successive compliance failures by reaching further and further back to cover the internal processes that generate the mandated reports. The federal political response resembles that seen with other regulatory regimes implicating criminal penalties: High profile noncompliance triggers a ratcheting up of duties and penalties, symbolically reassuring the public.[225] No one in Congress wants to be seen as soft on crime, of whatever variety.

SOX also traverses internal affairs in regulating auditor client relationships, forbidding a list of nonaudit services.[226] But here also the territory already had been federalized; the list of nonaudit services merely tracks a list already instituted by SEC rule.[227] The new audit oversight board instituted by the statute tracks regulatory templates already established for regulation of securities market professionals.

Federally speaking, SOX shocks in requiring audit committees composed entirely of independent directors, defining independent director, laying down audit committee duties and powers, and requiring disclosure respecting the expert status of committee members.[228] The shock does not follow from the regulation's terms. The committee-based governance agenda dates back to Douglas. The same goes for the other headline

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Observations on the Ancestry and Significance of the Enron Era, 35 Conn. L. Rev. 1073, 1086 (2003). Mark begins with the assumption that "corporations have been considered legitimate insofar as they fulfill the twin expectations of utility and responsibility" and, therefore, "[f]or a crisis in corporate governance great enough to trigger reforms so fundamental that they alter the nature of American business, then, the crisis would have to threaten the legitimacy of corporate existence in both spheres, utility and responsibility." See id. at 1083. In examining the history of major corporate governance legislation since the Great Depression, Mark asserts that "none of the major shifts in corporate power resulted from scandal . . ." Id. at 1086. Mark bolsters this argument by theorizing that:

> As long as corporate managers make us money we not only overlook practices that are a bit edgy, but we also make excuses for them and in many cases celebrate the genius that gave rise to the practices. But when the market goes down, the dark side emerges, and so does public outrage—it is the loss of money that triggers the outrage, not the practices themselves.

[223] Sarbanes Oxley Act, § 302.

[224] Id. § 906(a)(enumerating penalties for knowing violation of similar certification requirement). See Lisa M. Fairfax, Form Over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability under the Sarbanes-Oxley Act, 55 Rutgers L. Rev. 1 (2002).

[225] See Bruce T. Fitzpatrick, Congressional Re-election through Symbolic Politics: The Enhanced Banking Crime Penalties, 32 Am. Crim. L. Rev. 1, 3, 28 (discussing the response to the banking scandals of the late 1980s).

[226] Sarbanes-Oxley Act, § 201.

[227] See Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 76,008-01 (2000)(codified at 17 C.F.R. §§ 210.2-01, 240.14e-101).

[228] Sarbanes Oxley Act, §§ 301, 407.

internal affairs item in SOX — the ban on corporate loans to officers and directors.[229] When Douglas mentioned this one in 1934,[230] he was only restating a suggestion made many times in the early decades of the twentieth century.[231] SOX, then, is an ideal manifestation of Kingdon's model of a law reform idea that sits at the bottom of agenda for decades, waiting for a window of political opportunity to open and a normative entrepreneur to put it at the right spot on the agenda at that time.[232]

SOX's transformation of self regulatory process devices into mandates does not imply very much in the way of real world institutional adjustment. Most large firms were organized with audit committees and compliance systems already, reflecting the influence of decades of self regulatory conversations about best governance practices. National level audit committee mandates date from the Watergate era, albeit through the medium of exchange listing requirements. Indeed, amendments to NYSE listing requirements mooted in 2002 and approved in 2004 track the SOX audit committee provisions and extend them to the compensation and nominating committees before going on the final redoubt to the boardroom to mandate a majority independent board.[233] The stock exchange remains primary source of new mandates from the governance agenda.

The Congress' off-handed but emphatic revision of the internal affairs line drawn after 1934 does upset settled expectations. The present question is whether it implies anything further for corporate federalism. In addressing this question, we put standard cost benefit criticisms of SOX off to one side[234] to look at the political pattern. FCPA and SOX have sufficient similarities to suggest a template for federal traversals of internal affairs. First, both statutes respond to compliance failures by pushing federal regulation past the end product, the reports themselves, to the generative processes. Both concern compliance with law (or in the case of "questionable payments," quasi law), and respond to political demands appearing in the wake of high profile noncompliance. In both cases, the political demands could not have been satisfied at the state level, partly due to dispersion of response across fifty states and partly due to the stable equilibrium. Meanwhile, in both cases, the political demand stemmed from the general public, rather than from organized interest groups. (We think that the interest groups benefited, lawyers and accountants primarily, amount to incidental beneficiaries rather than prime movers.) Both statutes draw on a nonideological source, the governance agenda, and surmounted partisan politics in the course of their enactment. Finally, neither statute appears to have disturbed the state equilibrium. Isolated mandates from the governance

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[229] Sarbanes-Oxley Ac t, § 402(a).
[230] See supra text accompanying note __.
[231] See Mitchell, supra note __.
[232] John Kingdon, Agendas, Alternatives, and Public Policies (1984) See generally, Roberta Romano, The Sarbanes Oxley Act and the Making of Quack Corporate Governance, (Yale University working paper, May 2004).
[233] See NYSE Listed Company Manual ¶ 303A.
[234] The complaint is that SOX raises compliance costs more than more compliance benefits firms and shareholders. In particular, the costs bear more heavily on a marginal class of firms that will be discouraged from going public or, if already public, might be forced to go private. In addition, foreign listings may be deterred.

agenda do not amount to external shocks that force strategies to change at the state level. They apply across the board, putting no competitive pressure on Delaware. Because they supplement the states' enabling framework, no state level adjustment is necessary. It is management that has to adjust. Congress intervenes against management, not Delaware.

SOX may not be last such statute we see. It demonstrates the political implications of the rise of the shareholder class.[235] As the shareholder class rises, sharp stock market reverses and concomitant corporate misdeeds are more likely to hold out national political ramifications. Significantly, federalism concerns did show up prominently in the history of the FCPA – the Ford administration wanted to respect the post-1934 internal affairs boundary. But with SOX twenty five years later, federalism concerns did nothing to deter either the Congress or the Republican administration. The political demands, or at least Washington's perception of them, seem to have materially increased in magnitude. So, to the extent Delaware's management customers continue to behave badly, it can expect the zone of federal mandate to continue to expand. When this happens Delaware should blame its customers rather than the Congress, which is only responding to a highly representative politics.

Delaware does run a risk here. Future cumulative SOX-type mandates could so hard wire governance processes that firms decide that the choice of state of incorporation is irrelevant and stop paying Delaware's premium price. This seems a low probability contingency, however. Although the enabling code is a core component of the state equilibrium, it is not something Delaware sells today. Most of the state codes converged on key equilibrium terms decades ago.

### C. Federal Incursions on Internal Affairs at Management's Request

We complete the post-1934 description of federal traversal of state territory with reference to three interventions originating in management demands. The Williams Act of 1968,[236] the National Securities Markets Improvements Act of 1996 (NSMIA),[237] and the Securities Litigation Uniform Standards Act of 1998 (SLUSA).[238] All three pieces of legislation stem from management dissatisfaction with the state system. All three were enacted in rising stock markets. None of the three disturbed the charter market equilibrium, with which management presumably had no dissatisfaction.

#### 1. *The Williams Act.*

The Williams Act imposes, inter alia, disclosure and process constraints on tender offerors and target companies. It overlays the states' ex post affiliation terms, previously a zone of free contract between arm's length buyers and sellers of shares. The Act reduces the contracting space with process constraints on the conduct of tender offers. It should be described as management protective. Its mandatory waiting periods strengthen

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[235] For a description, see Hansman & Kraakman, supra note __, at 452-53.
[236] Pub. L. No. 90-439; codified in 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2004).
[237] Pub.L.No. 104-290, 112 Stat. 3416 (codified in scattered sections of 15 U.S.C.)
[238] Pub.L.No. 105-353, 112 Stat. 3227.

the hand of target management, importing a window of opportunity in which to employ defensive tactics.[239]

The Act stemmed from concern over the increasing impact of "corporate raiders," and was conceived as a device to curb cash tender offers.[240] Senator Harrison Williams introduced the legislation in 1965,[241] making clear his management protective motive:

> In recent years we have seen proud old companies reduced to corporate shells after white-collar pirates have seized control with funds from sources which are unknown in many cases, then sold or traded away the best assets, later to split up most of the loot among themselves . . . The leniency of our laws places management and shareholders at a distinct disadvantage in coming to grips with the enemy.[242]

Williams' pro-management draft failed to attract support from the SEC and therefore failed to gain traction in the Senate.[243] Then, as later, views on takeovers conflicted.

Williams tried again in 1967, with a less stringent draft.[244] This time he emphasized that the bill was not meant to discourage tender offers per se. Reflecting the view of SEC Chairman Cohen,[245] Williams assured that the bill was neutral towards both bidders and targets.[246] In this case narrow policynetworks had an impact: The final Act's modest compass stemmed in no small part from suggestions of the securities industry and academics, who took the bidder's part.[247] With support secured from the SEC[248] and the stock exchanges, the bill passed easily, by a series of voice votes.[249]

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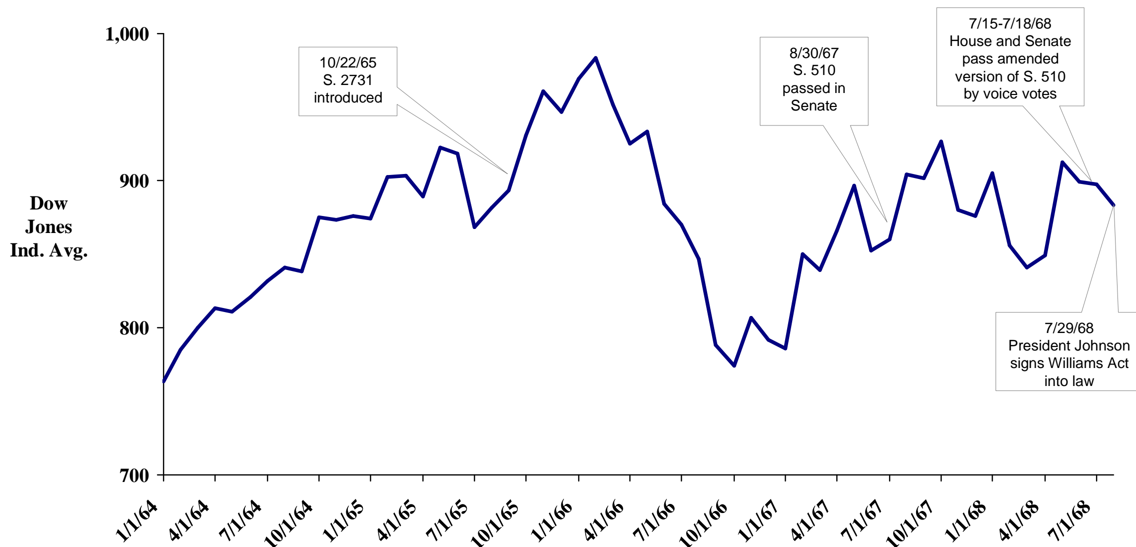
[239] David Haddock, et al., Property Rights in Assets and Resistance to Tender Offers, 73 Va.L.Rev. 701, 741 (1987). See also Jonathan Macey & Jeffrey Netter, Regulation 13D and the Regulatory Process, 65 Wash.U.L.Q. 131, 157-58 (1987)(arguing that rules requiring disclosure of bidders' intentions serve no public interest benefiting lawyers, accountants, and investment bankers in addition to defending managers).
[240] See Lyman Johnson & David Millon, Misreading the Williams Act, 87 Mich. L. Rev. 1862, 1891 (1989).
[241] Id.
[242]Ralph C. Ferrara, et al., Takeovers II: A Strategist's Manual for Business Combinations in the 1990s 8 (2d ed. 1993).
[243] Johnson & Millon, supra note __,at 1891.
[244] The Williams Act, as eventually passed, had reduced proration periods and limited withdrawal periods compared to those initially considered. See W. Brewster Lee III, SEC Tender Offer Timing Rules: Upsetting a Congressionally Selected Balance, 68 Cornell L. Rev. 914, 925 (1983). Overall, the Williams Act was considered to have been a product of great compromise between those—such as the bill's co-sponsors, Senators Williams and Kuchel—who sought to restrict corporate takeover activity and those—such as the securities industry and many in academia—who considered takeover activity to be beneficial to the economy. *See* Johnson & Millon at 1893.
[245] Id. at 1893.
[246] See Allen E. Kelinsky, Comment, Promoting Shareholder Equality in Stock Accumulation Programs for Corporate Control, 36 Am.U.L.Rev. 93, 95 (1986).
[247] See Johnson & Millon, supra note __, at 1897; Lee, supra note __, at 926-27.
[248] The SEC, while it put forward suggestions regarding the length of the proration and withdrawal periods that were ultimately rejected, broadly accepted the Williams Act as passed due to its desire for a bill that neither favored nor disfavored corporate takeover activity through tender offers. This attitude was evidenced by S.E.C. Chairman Cohen's comment that "[t]he Commission does not believe that any bill should be adopted which would either encourage or discourage takeover bids, nor does the Commission want to be involved in any way in passing upon the merits or conditioning the terms of [particular] takeover bids." *See* Richard W. Stevenson, Securities Bill Emerges in House As G.O.P. Drops Some Demands, N.Y.

The stock market correlation is interesting. Figure VI shows that Williams introduced the legislation at the height of the go go years. The period of inactivity in the legislative history coincided with a sharp downward correction. Then, the market having recovered in part and with the shareholder interest better protected, the bill finally passed.

**Figure VI--Market Context 1964-68** [250]




2. *Securities and Litigation Reform.*

The NSMIA of 1996 preempts much of the parallel state system of securities regulation, long called the "blue sky laws." More particularly, the NSMIA (1) preempts state level merit review and disclosure requirements for firms registered at the federal level, federally registered investment companies, and most private placements;[251] (2) preempts much state level regulation of broker-dealers;[252] and (3) provides for exclusive federal regulation of advisors to federally registered investment companies and other advisors with large portfolios. Thus constituted, the statute harmonizes and streamlines securities regulation. It does not traverse internal affairs, narrowly defined. Nor does it disturb the charter competition equilibrium: The Blue Sky laws apply to offers and sales of securities within each state, regardless of the issuer's domicile.

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Times, Mar. 8, 1996, at D1. Thus, the Williams Act's relatively unrestrictive limitations on takeover activity were considered quite acceptable to the S.E.C.

[249] See 113 Cong. Rec. 24,664 (1967); 114 Cong. Rec. 21,483-21,484 (1968); 114 Cong. Rec. 21,954 (1968).

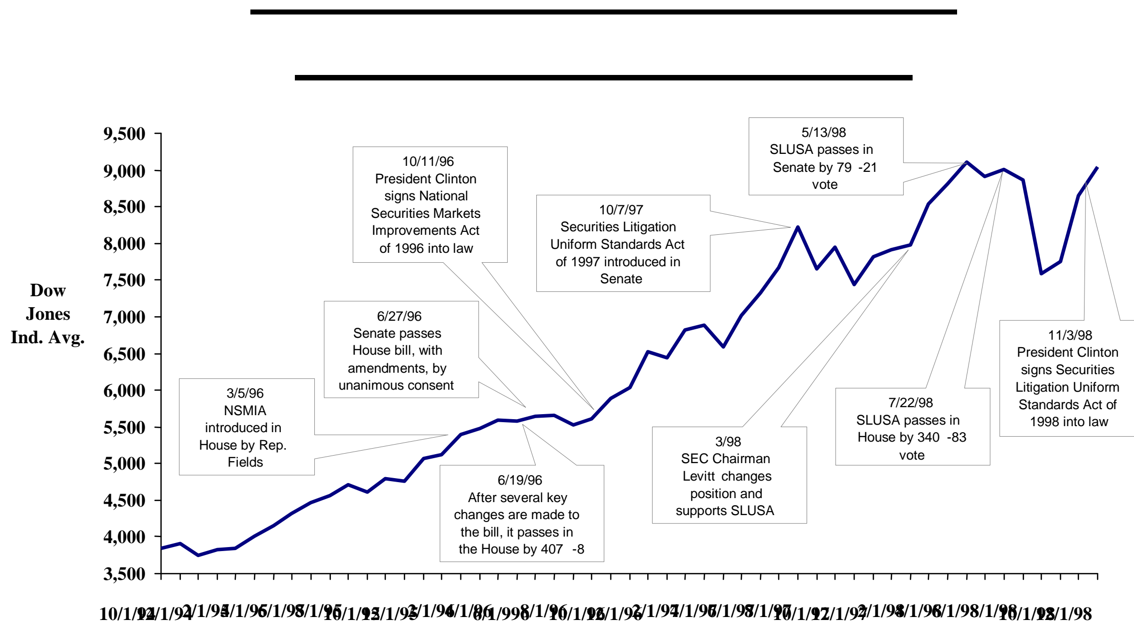
[250] Source: Yahoo! Finance (graph developed using the opening level of the Dow Jones Industrial Average on the first trading day of each month over the course of the cycle).

[251] 15 U.S.C. § 77r.

[252] 15. U,S.C. § 78o(h)(1).

The Act originated on the Republican side, as a deregulatory initiative.[253] The Democrats and the SEC both complained that it went too far in reducing protections for shareholders. The sponsors promptly dropped the most far reaching proposals.[254] Thereafter, the bill garnered bi-partisan support, passing the House by a 407 to 8 vote[255] and the Senate by a voice vote.[256] President Clinton made no objection.[257] As Figure VII shows, the stock market was rising throughout the sequence of events.

**Figure VII--Market Context 1994-98[258]**




The SLUSA was drafted to cover a perceived loophole in the Private Securities Litigation Reform Act of 1995. Forum shopping was alleged – plaintiffs were bringing securities fraud class actions in state court, avoiding new federal level process strictures.[259] The bill limited both state level class actions and fraud actions based on state law.[260]

[253] See Richard W. Stevenson, supra note __, at D1.
[254] Id. Included among these provisions were "requirements that would have limited the ability of states to enforce their own securities fraud laws and that would have removed from states the authority to regulate stocks of companies with small capitalizations and penny stocks [and] . . . a measure that would have made it more difficult for big investors like pension funds and municipalities to sue brokerage firms for investments that turn out to be unsuitable." See id. at D1.
[255] See thomas.loc.gov (report on Pub.L. 104-290.
[256] Securities Regulation Bill Is Cleared By Senate, N.Y. Times, June 29, 1996, at 34.
[257] See thomas.loc.gov (report on Pub.L. 104-290.
[258] Yahoo! Finance (graph developed using the opening level of the Dow Jones Industrial Average on the first trading day of each month over the course of the cycle).
[259] See Richard W. Painter, Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action, 84 Cornell L. Rev. 1, 2,4 (1998).
[260] Delaware was not a target: Under prevailing conflict of laws rules, the fraud actions are not decided under the law of the state of incorporation. See Romano, supra note -_, at 2402-2412.

In 1997, the bill was reported out on a bipartisan basis in both the House and the Senate. SEC Chair Arthur Levitt and Senator Paul Sarbanes both voiced opposition at hearings, and the matter stalled for a few months.[261] In 1998, the legislation moved forward with renewed vigor, due in no small part to the steadily-rising stock market and the resultant increasing political muscle of Silicon Valley.[262] As Dan Schnur, Political Director of The Technology Network, a lobbying group, said, "One neat thing about our community is that it is filled with people who don't take 'no' for an answer."[263] High-tech companies and other corporations interested in pursuing the new legislation created a lobbying group, the Uniform Standards Coalition.[264] Said Coalition counsel Mark Gitenstein, "People in policy are attracted by the new economy. The percentage of jobs they are creating dwarfs the smokestack industries. That's what this is all about. There is no question that the very mechanism by which they flourish is chilled by litigators."[265] Joining the chorus of support for the SLUSA were the National Venture Capital Association, the American Institute of Certified Public Accountants, and the American Electronics Association.[266] Several organizations, including some consumer groups and organizations representing state and local governments, lobbied against the bill. But they lacked the political muscle of their opponents.[267] But then, the stock market was going through the roof, as Figure VII attests.

Silicon Valley got what it wanted. Levitt and President Clinton dropped their opposition in exchange for legislative history making it clear that no prohibition of federal suits for recklessness was intended.[268] Although there were significant numbers of dissenters in both houses, the bill went through with strong majorities. But before passage, a Delaware-oriented carve out was added in the Senate, assuring that state litigation in respect of breach of fiduciary duty would be unaffected.[269]

**D. Summary**

Douglas astutely warned in 1934 that scandals stemming from management shenanigans in bull markets were going to remain a problem. The FCPA and SOX fulfilled the prediction, both responding to political demands for management

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[261] In mid-1997, there were many who questioned the need for a uniform standards act for securities litigation. In hearings, S.E.C. Chairman Levitt declared that it was still too early to assess whether or not a Uniform Act was needed; several senators, led by Senator Sarbanes, agreed with this assessment. See Eugene P. Caiola, Comment: Retroactive Legislative History: Scienter Under the Uniform Security Litigation Standards Act of 1998, 64 Ala. L. Rev. 334, 337 (2000) The SLUSA thereafter stalled due to a lack of support. Id.

[262] See Leslie Eaton, The Silicon Valley Gang: An Influential Industry With Lots of Money Is Getting Its Way on Capitol Hill, N.Y. Times, June 11, 1998, at D1.

[263] Id.

[264] Matthew Greco, Wait 'Til 1998 for Uniform Standards Bill: Congress Adjourns Early without Bringing Measure to the Floor, Investor Rel. Bus., Nov. 17, 1997.

[265] Eaton, supra note __, at D1.

[266] Painter, supra note __, at 49.

[267] Id. at 50.

[268] Id. at 7, 53.

[269] Id. at 57.

accountability in the wake of scandals. In the case of the FCPA, the public responded to the scandal in the mode of the trust paradigm, casting managers as public actors. Power meant responsibility. Corruption was unacceptable, even corruption in pursuit of shareholder value. With the public proving willing to pay for ethical behavior,[270] Congress moved to impose responsibility in law. In contrast, Enron, WorldCom, and SOX were shareholder value centered. Managers whose stocks had collapsed had failed to comply with law, with the compliance failure bound up with the losses of many investors. Congress felt compelled to toughen the compliance regime.

The broad-based political demands that led to FCPA and SOX occur only rarely. For the public to have an opinion, the public first has to be informed and then has to deliberate.[271] This rarely occurs on corporate governance matters, particularly so as to register political demands so strong as to surmount ideological divisions.[272] But well-publicized corruption and noncompliance bring about the exceptional case. Stock market reverses also figure in. When stocks are rising, people tend not to worry about compliance and politicians are loath to rock the boat. Given market volatility due to noise trading and a widening pattern of equity investment, we can expect to see more such national political demands in the wake of compliance breakdowns.

FCPA and SOX reflect a cooperative strategy as they respond to the demands. Neither significantly disrupts the post-1934 division of subject matter between national and state levels. They do traverse internal affairs. But they do so largely toward the end of strengthening compliance with law, and the law in question for the most part is federal. The entries onto state territory occur as incidents to federal government's maintenance of the integrity of its own system, and the federal system in the first instance remains directed to the national securities marketplace. Nor do the FCPA and SOX appear to have disrupted the state level equilibrium. Viewed from an economic perspective, then, they substantially respect the state system. The issue with SOX is not federalism but costs and benefits at the national level.

Even when SOX breaks an historic federal-state subject matter pattern with its audit committee mandate, it only tracks more extensive mandatory interventions coming from the stock exchange, acting independently. Only the per se rule on loans to officers arguably takes SOX outside the national level box onto state fiduciary territory. But, in fact, executive compensation has always been a federal topic, with a strong interest in the matter reflected in the insider trading regime. In any event, federalization of conflict of interest transactions has a long way to go before it materially impacts the states. There is no risk of that happening in the present context. Indeed, with SLUSA, we saw the

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[270] See Andrei Shleifer, Does Competition Destroy Ethical Behavior? 94 Amer. Econ. Rev. 414, 418 (2004)(papers & proceedings)(noting that as societies grow rich they prove more willing to pay for ethical behavior through enforcement).

[271] Smith, supra note __, 28.

[272] FCPA and SOX thus can be distinguished from what White terms 'unifying issues"—issues that unite all business interests. According to White, as to such issues, ideological divisions matter and partisan politics make the issues visible. White, supra note __, at 25-26. Success on such issues correlates with national political shifts, with business doing better in the early 1950s, the early 1980s, and the mid 1990s. Id.at 85.

Congress take special care to avoid impairment of Delaware's litigation business. With FCPA and SOX, the loser is not Delaware, but management, which loses freedom of action in the shift from enabling to mandatory.[273]

We conclude, then, that FCPA and SOX do not significantly violate or reconstitute prevailing federalism norms. Instead they follow from a political equilibrium within which federal and state regulatory authority has been allocated for more than a century. Recall that, under the state equilibrium, corporate law responds directly to the demands of corporate principals and agents acting within their corporate capacities, with the system positioning the dominant chartering state's law to apply across the wider national political and economic geography. The equilibrium holds out a possibility of externalities, particularly to the extent that agent demands register more loudly than those of the principals. The states' stable strategy also makes them unresponsive when national political demands concerning compliance arise in the wake of external shocks. Any response must be national.

If Delaware were to shift strategies and compete with the SEC in taking the shareholders' part on matters such as voting rights and rights of initiative, the shift would be viewed as a defection against the management interest and would disrupt the equilibrium. The same is true of the public interest in compliance with law. Delaware has never and cannot take the public's part on matters of executive compliance with law and ex post punishment. Delaware does not criminalize; it neither jails nor fines. We do get rhetoric from Delaware on the importance of compliance.[274] But we have not seen Delaware apply its duty of care so that directors of firms with compliance breakdowns are required to pay money judgments. We are highly unlikely ever to do so. There is no strategy available to Delaware that lets it protect its interest in subject matter territory by anticipating federal intervention and addressing and defusing the federal concern.[275]

FCPA and SOX show us the federal strategy followed when political demands flow against management. The Williams Act, NSMIA, and SLUSA show us a different class of federal play, the play that follows from the same sort of influence activity that determines results in the states. Here the general public has no knowledge and hence no opinion on the subject matter. The issues are what Mark Smith calls particularistic, that is, reflecting the interests of one business interest group, or conflictual, that is, triggering a difference of opinion within the business community.[276] Here Democratic and Republican positions often blend into one another and elective politics has no direct bearing.[277] Interest group influence tends to register more directly, giving management the same advantage at the federal level that it enjoys in the states. As at the state level,

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[273] Whether the shareholders won or lost is an open cost benefit question.

[274] See In re Caremark Int'Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).

[275] The embeddedness point can be restated in terms of vetoes. In Delaware, management, along with the state bar, acts as a veto player. The larger the number of veto players in a lawmaking institution, the more policy becomes locked in and the more serious the status quo bias in the face of adverse shocks. Nouriel Roubini & Jeffrey D. Sachs, Political and Economic Determinants of Budget Deficits in the Indsutrial Democracies, 33 Eur. Econ. Rev. 903 (1989).

[276] Smith, supra note __, at 21.

[277] Id. at 24, 31.

such management political operations tend to succeed against the backdrop of strong stock markets. But the federal-state political overlap is not complete. The difference lies in the SEC, which skews the federal agenda to weight the shareholder interest more heavily than the shareholder interest is or could be weighted at the state level under the stable equilibrium.

## IV. DELAWARE

Delaware's competitive position gets stronger all the time. We have seen that its market share has increased steadily since its 1967 code revision. Delaware has done equally well by other measures. Major reincorporations to Delaware peaked at the height of the takeover wars of the 1980s, with 56 in 1987.[278] The numbers fell thereafter, but remained steady – there were 135 reincorporations between 1995 and 2001.[279] In 1983, the total number of firms chartered in Delaware was 153,044, in 1990, the figure was 202,893, and by 2000, the figure had grown to 322,971 to fall off slightly in the recession years that followed.[280] Table I shows that revenues from franchise taxes and corporation fees, taken as percentage of all state revenues, an historically volatile figure, regained the twenty percent level in 1992 and hovered around 20 percent ever since.

**TABLE I –REVENUES FROM FRANCHISE TAXES AND CORPORATION FEES AS A PERCENT OF ALL REVENUES IN DELAWARE[281]**

| 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 |
|---|---|---|---|---|---|---|---|---|
| 16.2% | 15.3% | 17.3% | 14.4% | 13.0% | 12.1% | 12.2% | 12.2% | 12.2% |

| 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|---|---|
| 11.9% | 12.0% | 13.7% | 14.8% | 15.7% | 17.6% | 17.4% | 17.1% | 17.5% |

| 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|
| 22.9% | 21.3% | 20.8% | 20.4% | 21.0% | 21.8% | 21.1% | 21.2% | 22.8% |

| 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|
| 24.9% | 22.1% | 20.0% | 20.8% | 19.6% |

In this part we look at Delaware's evolution in the wake of the federal incorporation threat of the 1970s and the takeover wars of the 1980s, both of which destabilized the state equilibrium. Delaware's courts emerge as model strategic players. Given a threat from a federal or state opponent, they pause between plays for rational

[278] Demetrios G. Kaouris, Note: Is Delaware Still a Haven for Incorporation? 20 Del. J. Corp. L. 965, 1011 appendix tbl.1 (1995).
[279] Guhan Subramanian, The Influence of Antitakeover Statutes on Incorporation Choice: Evidence in the "Race" Debate and Antitakeover Overreaching, 150 U.Pa.L.Rev. 1795, 1821 (tbl 1)(2002).
[280] Source: Email to author from Richard J. Geisenberger, Assistant Secretary of State, State of Delaware, June 25, 2004.
[281] Id. The Table picks up where the figures in Nader et al., supra note __, at 535 leave off, bringing the data to date.

introspection and adjust their strategies for future rounds of play. Even as they adjust, they tend to do everything possible to leave the state equilibrium undisturbed. In only one case do we see the judges experiment with a strategy that turns out to be inconsistent with the equilibrium expectations of management. The courts then learn from the mistake, successfully remaking Delaware's profile in an era obsessed with law compliance by empowered actors.

In Section A, we show how Delaware's bench dealt with the federal incorporation threat by taking fiduciary law more seriously. In so doing it experimented with and then rejected the trust paradigm, with its template of fairness review. Drawing on the governance agenda to substitute process scrutiny, the Delaware courts reinvented corporate fiduciary law. Their new strategy makes fiduciary review compatible with the management's preference for a self regulatory approach. At the same time, Delaware's judges have emerged as leaders in ongoing discussions about corporate best practices, strengthening the state's tie to its corporate constituents. Delaware emerges as a national leader, the good corporate cop that contrasts with the federal bad cop. It should follow, in the event of an external economic or political shock that triggers questions about the charter system, that Delaware has a powerful base of support in Washington. As result, the federal-state equilibrium should remain relatively stable even as political demands respecting governance continue to show up nationally.

Section B discusses Delaware's takeover problem. Here Delaware dealt with incompatible demands: Management wanted antitakeover legislation and threatened to exit the state, while the federal government threatened to intervene to protect takeovers. Delaware responded by sticking with the evolutionarily stable strategy and staring down the federal government. It made the right political choice. The 1980s federal preemptive threat lacked political credibility and would not have disrupted the state equilibrium in any event.

Section C turns to Delaware in the era of shareholder capitalism. Time has been on Delaware's side. The federal government has lost all interest in takeovers. And, even as institutional shareholders remain dissatisfied with takeover defenses, their complaints register only in a narrow network. Ironically, their primary role at the state level has been to strengthen Delaware's position in the charter market. Today, due to the activist institutions, the shareholder veto on reincorporations means more than in the past, making even less likely the emergence of a competing state marketing a more management favorable product.

Section D concludes by asking whether it is helpful to analogize Delaware to a federal administrative agency. The discussion admits the power of the analogy, but questions whether it assists us at the bottom line, where the question goes to the strength to be accorded to the internal affairs presumption.

**A. Fiduciary Law**

Rent extraction, when visible, can come at the cost of diminished reputation.[282] Cary imposed that cost on the Delaware courts when he accused them of monolithic support of management rent seeking, citing a cluster of cases as evidence.[283] The Delaware courts proved sensitive to Cary's allegations of corruption,[284] becoming more noticeably responsive to the shareholder interest in the three decades since 1974.[285] Most of the cases Cary cited are no longer good law.[286]

The break with the past first manifested itself in 1977, when *Singer v. Magnavox Co.*[287] imposed strict fiduciary standards on parent firms in cash out mergers. *Singer* is famous for having come down just after the Supreme Court removed the threat of federal preemption of state fiduciary rules under the antifraud rules of the securities laws.[288] The

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[282] Persson & Tabellini, supra note __, at 18.

[283] Cary, supra note __, at 673-98. The cases were: (1) Cheff v. Mathes, 199 A.2d 548 (Del. 1964), which permitted management "with impunity" to spend corporate money to entrench itself against tender offers; (2) American Hardware Corp. v. Savage Arms Corp., 136 A.2d 690 (Del. 1957), which refused to enjoin a defensive shareholders meeting called on short notice or to act respecting a proxy statement the court acknowledged to be incomplete; (3) Federal United v. Havender, 11 A.2d 318 (Del. 1940), which permitted firms to use charter amendments effected through common shareholder voting power to strip preferred stockholders of contract rights and first articulated the doctrine of independent legal significance; (4) Hariton v. Arco Electronics, 188 A.2d 123 (Del. 1963), which extended the doctrine of independent legal significance to mergers and acquisitions so as to assure a literal rather than purposive and policy-driven reading of the code; (5) Sinclair v. Levien, 280 A.2d 717 (Del.1971), and Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883 (Del. 1970), both of which left the burden of proof on complaining minority shareholders in conflict of interest situations; and (5) Graham v. Allis-Chalmers Manufacturing Co., 188 A.2d 125 (Del. 1963), which absolved management of a duty of care respecting subordinates' criminal conduct absent actual knowledge.

[284] Cary, *supra* note __, at 684, 696-98.

[285] For empirical confirmation, *see* Douglas M. Branson, Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law, 43 Vand. L. Rev. 85, 104-108 (1990). Branson's study of Supreme Court cases decided between 1974 and 1987 finds a larger number of proshareholder results than promanager results.

[286] *Cheff*, a mainstay of management takeover defensive practice, fell to Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985)(reversing *Cheff* and applying an expanded review of tender offer defensive tactics under proportionality test) and Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1985)(inventing a duty of management defending tender offer to auction company in limited circumstances), during the takeover wars of the 1980s. *Graham* fell more recently, untenable in light of a generation of contrary management practice under the monitoring model of corporate governance. See In re Caremark Int'l Derivative Litigation, 698 A.2d 959 (Del.Ch. 1996). A similar fate could be suggested for *Getty v. Skelly.*[286] See E. Norman Veasey & William E. Manning, Codified Standard–Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared to Delaware Law, 35 Bus. Law. 919, 929-30 (1980)(discussing *Graham*). *American Hardware* might well come out differently today, given *Unocal* and other cases more closely scrutinizing management procedural manipulations, see Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988), and misrepresentations. See Zirn v. VLI Corp., 621 A.2d 773 (Del. 1993)(confirming director duty of full disclosure of shareholders in connection with merger) *Havender* and *Hariton* are still good law, but operate in a less relentlessly management-favorable context. A good faith duty to preferred stockholders has been acknowledged, see, e.g., HB Korenvaes Investments, L.P. v. Marriott Corp., CCH Fed Sec. L. Rep. ¶ 97,728 (Del. Ch. 1993), and mergers are subject a more broad-ranging fiduciary scrutiny. Only *Levien* stands unqualified, and few today complain about it.

[287] 380 A.2d 969 (Del. 1977).

[288] See text accompanying note __ supra. The case was Santa Fe Industries v. Green, 430 U.S. 462, 479-80 (1977).

story told at the time was that the brush with preemption at the hands of the federal judiciary and the critical atmosphere provoked by Cary, Nader, and others prompted the Delaware Supreme Court to reverse its direction so as to better accommodate the interests of investors and thereby diminish the possibility of future threats of intervention. The federal threat thus had impressed upon the Delaware courts the practical importance of solicitude to shareholder interests.[289]

The post-Cary behavior pattern persisted as the courts articulated unexpected new shareholder-protective applications of basic fiduciary rules. The most famous examples concerned takeovers -- *Unocal Corp. v. Mesa Petroleum Co.*,[290] and *Revlon, Inc. v. MacAndrews & Forbes Holdings*, Inc.,[291] which established a regime of fiduciary scrutiny of takeover defensive tactics. Friendly mergers also came under scrutiny -- *Smith v. Van Gorkom*[292]and *Cede & Co. v. Technicolor, Inc.*[293] surprised everyone with surprisingly aggressive applications of the duty of care to board approvals of proposed mergers. *Paramount Communications, Inc. v. QVC Network, Inc.*,[294] later brought the takeover and the merger cases together with a broadly-phrased directive to managers under hostile attack to enhance shareholder value.[295]

But the pattern has been volatile. Equally famous cases restrict the application of the new rules. In fact, the *Singer* rule did not last long, being in turn rejected in 1983 for a looser, process based approach to cashout mergers in *Weinberger v. UOP, Inc*.[296] *Weinberger* later was itself cut back, when short form mergers were excepted from the category subject to fiduciary scrutiny.[297] The promises of *Unocal* and *Revlon* also went unfulfilled. Under *Moran v. Household International*[298] and its progeny, the poison pill remains a potent and largely unregulated defense.[299] In the eyes of critical observers,

[289] Note also that judicial reputations depend on comparisons with the performance of judges on other courts, state and federal. Thus a critical atmosphere can arouse reputational concerns even with a less immediate federal threat.
[290] 493 A.2d 946, 954-55 (Del. 1985)(reversing *Cheff* and applying an expanded review of tender offer defensive tactics under proportionality test).
[291] 506 A.2d 173, 182 (Del. 1985)(inventing a duty of management defending tender offer to auction company in limited circumstances).
[292] 488 A.2d 858, 873-81 (Del. 1985)(suddenly expanding the duty of care to cover board approval of arm's length merger).
[293] 634 A.2d 345, 366-71 (Del. 1993)(applying a heightened duty of care scrutiny of boardroom merger decision and suggesting expanded remedial concept inclusive of post-merger gain).
[294] 637 A.2d 34 (Del. 1994)(holding that management has an obligation to achieve best value reasonably available for shareholders).
[295] Less surprising but equally important is the recent invalidation of a delayed-redemption poison pill in Quickturn Design Systems, Inc. v. Shapiro, 721 A.2d 1281 (Del. 1998).
[296] 457 A.2d 701, 704, 715 (1983)(overruling *Singer* in favor of less restrictive process scrutiny of cash out mergers).
[297] See Glassman v. Unocal Exploration Corp., 777 A.2d 242(Del. 2001).
[298] 500 A.2d 1346, 1356-57 (Del. 1985)(sustaining poison pill defense under Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1150-54 (Del. 1989), made this clear with its allowance of extraordinary latitude to managers defending a tender offer that disrupts preexisting plans for a friendly merger. *Unocal*).
[299] Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1150-54 (Del. 1989), made this clear with its allowance of extraordinary latitude to managers defending a tender offer that disrupts preexisting plans for a friendly merger.

Delaware's cases amount to little more than a conjuring trick. The courts garnered publicity in a handful of highly-publicized cases, ruling against management and announcing vague standards that held out the prospect of shareholder value enhancement. But in less well-publicized subsequent cases, they used the camouflage of complex facts to refrain from applying the standards in management-constraining ways.[300] The full set of results tallied by the lawyers signaled considerably more room for management maneuver than did the public profile signaled by the leading cases.

Whatever the merits of the cases' holdings, Delaware's judges have transformed the state into a respectable lawmaker. This partly results from the quality of the bench – even when ruling for management in cases of palpable shareholder injury, its analyses are thoughtful. The bench's awareness of its national role also figures in. As judges, they have an independent reputational incentive to advocate for their system's policy legitimacy.[301] They now maintain a dialog on governance issues with the bar, the financial intermediaries, and the academics.[302] Outsiders when Cary wrote, they are now important players in the elite governance policy network. They make a convincing case, explaining that they pursue the state's interest in balancing conflicting interest group demands, acting in a meditative capacity. They take care to point out that they not only mediate between management and shareholders, but as also protect market risk-taking even as they impose ethical constraints.[303] It has become hard to imagine a bench that could do a better job, given the constraints imposed by the state equilibrium.[304]

Two facets of the case law demonstrate the astuteness and innovation that the Delaware bench brings to its mediations.

The first is the special committee of independent directors, which can be traced to a footnote in *Weinberger v. UOP*.[305] The predecessor case, *Singer,* had effected Delaware's fiduciary about face, employing substantive review directed to the fairness or

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[300] For a readings of the cases after *Unocal* along these lines, see Victor Brudney & William W. Bratton, Brudney & Chirelstein's Cases and Materials on Corporate Finance 1087-95, 1129-30 (4th ed. 1993); .

[301] See Eric Rasmussen, Judicial Legitimacy as a Repeated Game, 10 J. L. Econ. & Orgs. 63, 72-74, 78-80 (1994)(offering a repeat game model of judicial motivation with infinite time horizons resulting in a multiplicity of equilibria in which the outcomes depend on the players' expectations and showing that judges follow precedent if there is a self-enforcing system based less on compulsion than the need to uphold systemic legitimacy). See also Thomas J. Miceli & Mertin M. Cosgel, Reputation and Judicial Decisionmaking, 23 J. Econ. Behav. & Org. 31, 44-49 (1994)(modeling the preferences of judges on a utility function that includes both a private and a reputational component, with the decision as to whether to follow precedent turning on a trade off between the two components, and the equilibrium rate of adherence to precedent depending on the distribution of preferences across the population).

[302] See Kahan & Rock, supra note __, at 31.

[303] See Andrew G.T. Moore, II, State Competition: Panel Response, 8 Cardozo L. Rev. 779, 779-800 (1987)(at the time a Justice of the Delaware Supreme Court). They also have acknowledged the federal threat. See William T. Quillen, The Federal-State Corporate Law Relationship--A Response to Professor Seligman's Call for Federal Preemption of State Corporate Fiduciary Law, 59 Brooklyn L. Rev. 107, 129 (1993).

[304] For a contrasting approbation of the Delaware courts, see Kahan & Rock, supra note __, at 29 (comparing Delaware case law to 19th century jurisprudence and explaining that structural weakness causes Delaware cases to take on a neutral, technocratic gloss).

[305] 457 A.2d 701, 709 n. 7.

unfairness of the corporate action taken, very much in the mode of the trust paradigm. *Weinberger* dropped that to draw instead on the process-based governance agenda in scrutinizing transactions impacting the rights of minority shareholders. The court held out relaxed scrutiny provided that a committee of independent directors was constituted to negotiate on behalf of the minority. It was a brilliant compromise: Judicial scrutiny of the transaction still would be necessary, but scrutiny would extend only of the conduct of the constructed negotiation; this in turn obviated the need for direct, mandatory review of the transaction. Process was better than substance for two reasons: first, it diminished the likelihood of confrontation with the salient question whether the majority was robbing the minority; secondly, it avoided confrontation with fact questions concerning the value of the firm. Since *Weinberger*, the independent committee device has been widely drawn on in Delaware fiduciary cases.[306] An additional, incidental benefit has appeared over time. Issues about the composition of special committees and their conduct of proceedings bring the Delaware courts to the forefront of debates about corporate best practices and the governance agenda.[307] The Delaware bench emerges as a focal point in the self regulatory discussion. This is exactly the right strategy.

The second salient aspect of Delaware's cases is the habit of making normative pronouncements on a prospective basis and avoiding imposition of damages. Delaware judges use their cases' complex fact patterns to make moral pronouncements about management behavior. The culpable manger is not, however, necessarily hit with an injunction against his or her deal; a money judgment is still less likely.[308] Instead, the court announces its dissatisfaction with the manager's conduct in the course of denying an injunction against the transaction or dismissing the complaint. It is the actor in the next deal who replicates the disapproved conduct that faces a litigation risk.[309] Edward Rock argues that this works well: Delaware judges communicate normative standards to the business community through a network of lawyers and investment bankers. Significantly, the resulting behavioral deterrent is reputational rather than financial.[310]

The Delaware courts learned to take this kid gloves approach the hard way. The Delaware Supreme Court's innovative and aggressive application of the duty of care in *Smith v. Van Gorkum* did hold out an immediate prospect of a money judgment against independent directors. The result was nervousness in boardrooms, a substantial increase in insurance premiums, and much criticism of Delaware. The legislature had to intervene to undo the result of the strategic misfire. Prompted by the corporate committee of the state bar, it amended Delaware's code to permit firms to opt out of the duty of care by charter amendment.[311] The courts would not make the same mistake again.

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[306] See, e.g., Kahn v. Lynch Communication Systems, 638 A.2d 1110 (Del. 1994).
[307] See, e.g., In re Oracle Derivative Litigation, 824 A.2d 917 (Del.Ch. 2003)(expounding on the meaning of directorial independence).
[308]Edward B. Rock, Saints and Sinners: How Does Delaware Corporation Law Work? 44 UCLA L.Rev. 1009, 1015 1039 (1997). Although a money payment (probably in the form of a settlement) may follow where the injunction against the deal is denied but the complaint is not dismissed. Id. at 1039.
[309]Id. at 1023-39.
[310] Id. at 1012-1016.
[311] Del. Gen. Corp. L. § 102(b)(7), Del. Code Ann., tit. 8 (2001)(permitting opting out of personal liability for directors for duty of care violations).

With this prospective, dialogic approach, the Delaware courts break out of the conventional pattern of legislation and adjudication. In the conventional set up, only the legislature acts prospectively; common law is applied by judges on a present basis, even if the ruling is unprecedented. The litigant who breaches an extant duty on a new fact pattern loses the case and pays a judgment or has its course of conduct enjoined. From an abstract perspective, it is hard to see what makes corporate managers such delicate beings that they require an exemption from the ordinary rules of the game. The point must be that the exemption has been purchased, and solicitude is expected within the state equilibrium. The system appears to satisfy management, which is happy to pay attorneys to churn litigation that rarely entails more substantial costs in terms of money judgments or lost deals. Clearly the lawyers also are satisfied. For the shareholders, the system remains problematic even in the era of shareholder capitalism.

But it still is clearly superior to the system pre-Cary. In the 1970s, the Delaware courts decided that they would have to police in order to maintain the state's credibility as a national lawmaking center. Police they have, but in a unique fashion. In the federal state context, they have become the good cop to the federal government's bad cop. Delaware's courts try to avoid falling into the conventional judicial role of enforcing positive law, even as the federal government's role as compliance officer expands and extends deeper into state territory with mandates and prosecutions. This distinguishes Delaware not only from the federal government, but from the other states, the judges of which cannot be expected to play the game with such finesse.

Summing up, the Delaware courts responded to the instability, criticism, and challenges of the 1970s with a new strategy that merged fiduciary review with the self regulatory governance agenda. To look only at the case holdings is to see an unstable body of law.[312] To look at the cases in the wider equilibrium context is to see a stable strategy. The Delaware courts have learned that the salient part of the case can be the remedy rather than the holding. At the federal level, Delaware's prominence as a governance and dispute resolution center diminish its vulnerability to attack. With Delaware now holding a prestigious place within elite governance networks, federal agenda setters are unlikely view it as a problem. As its value increases in its customers eyes, Delaware will have more than adequate political support in Washington. Thus did Congress except Delaware from the SLUSA in 1998. The same did not follow with

[312] Some of this indeterminacy creeps in because the corporate client pushes against the process envelope and the matter is later litigated in front of a court disinclined to find liability. If the client/customer that has gone over the edge is indeed to be let off the hook, the statement of the rule evolving in the cases is bound to become somewhat convoluted. This problem is compounded by the fact that judicial role integrity requires that the result of such a case be justified in terms of the fiduciary principle. When management-favorable results are smuggled in under a haze of fiduciary verbiage, fiduciary rule statements look indeterminate because they do not in fact determine the result of the case. Arguably, this rhetorical skill is an important aspect of the Delaware courts' expertise. It has been suggested, Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 Colum. L. Rev. 1908, 1919, 1927-28, 1931, 1935 (1998). that Delaware cases' indeterminacy stems from strategic concerns and amounts to an abuse of the state's dominant position in the charter market. We are unpersuaded. See William W. Bratton, Delaware Law as Applied Public Choice Theory, 34 Ga. L. Rev. 447, 469-72 (2000).

SOX. But SOX addressed political demands that Delaware's evolutionarily stable strategy makes it powerless to anticipate or confront. And, despite its entry into internal affairs, SOX in no way impairs the charter market or Delaware's rent flows. A counterfactual suggestion arises. Delaware's new respectability assured that the Enron crisis worked itself out as a federal enforcement event. No one suggested that state level self regulation bore responsibility.[313] Indeed, Delaware judges have taken to voicing complaints about SOX and SEC governance initiatives in national venues, extolling the virtues of their good cop system.[314] If they had serious worries about federal intervention, they would never do this.

### B. Takeovers and the Federal Threat

Now we backtrack to Delaware's response to the instability precipitated by the takeover wars of the 1980s. Six months after *CTS*, 34 other states had enacted antitakeover legislation.[315] Management was pressuring Delaware to do the same.[316] However, actors in the Reagan administration were pressuring Delaware not to do the same, threatening to preempt its takeover regulation if it did.[317] Delaware finally enacted a weak statute.[318] Commentators put contrasting glosses on these events. One view emphasizes that Delaware's weak response reflected shareholder side demands unique to the national chartering state. In other states the statutes followed from the influence of local firms; all potential targets. Delaware, in contrast, is home to bidders as well as targets.[319] The countervailing capital market interest also registers there.[320] The other view emphasizes the federal threat.[321] Under this view, the events of the era stand as an

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[313] This point can be restated in an institutional mode. From an institutional perspective, federal state relations are a function of socially constructed roles and institutional roles. Actors have mutable preferences that change due to socialization, learning or persuasion. Pollack, supra note __, at 57-59. Institutions are points of communicative interaction among actors socialized within common norms. They discover their preferences through processes of deliberation within these institutional frameworks. Kathleen McNamara, Rational Fictions: Central Bank Independence and the Social Logic of Integration, 25 West Eur. Pol. 47 (2002). Given deliberations about corporate governance and compliance in the wake of an external shock, Delaware's new respectability makes it much less likely that actors at the federal level will change their inherited preferences respecting the federal-state allocation so as to disturb the state equilibrium.

[314] See Former Del. Supreme Court Chief Justice: Federal Power Threatens Role of Del. Law, 36 BNA Sec. Reg. & L. Rep. 1493 (2004)(describing a speech by Norman Veasey at the ABA annual meeting); SEC Official, Delaware Chief Justice Don't See Eye-to-Eye on Federalism Issues, 36 BNA Sec. Reg. & L. Rep. 1478 (2004)(describing back and forth between Chief Justice Myron Steele and SEC Director of Corporation Finance Alan Beller at ABA annual meeting).

[315] See supra text accompanying note __.

[316] See Mark J. Roe, Delaware's Competition, 117 Harv. L. Rev. 588, 625 (2003)(noting that Martin Lipton was recommending reincorporation out of Delaware).

[317] Id. at 626-27 (noting that the White House Counsel of Economic Advisors opposed the Delaware statute, that an SEC Commissioner threatened to preempt, and that SEC Chair David Ruder said the same in a speech and also warned the statute's drafter that enactment would be imprudent).

[318] See Del 203.

[319] Romano, supra note __, at 467.

[320] See supra text accompanying note __.

[321] Roe, supra note __; , at 629-30. See also Bebchuk, *supra* note __, at 1455; Melvin Aron Eisenberg, The Structure of Corporation Law, 89 Colum. L. Rev. 1461, 1512 (1989); Cary, supra note __, at 688.

exemplar of constructive back and forth within the federation, with threatened federal intervention curbing Delaware's structural preference for the management interest.

Both perspectives figure into the overall picture. But we emphasize a third aspect. Under Delaware's evolutionarily stable strategy, it sometimes has to make concessions to management in the teeth of opposition at the national level. Even as Delaware enacted a weak statute on a slow timetable, it did enact a statute. Delaware thereby signaled its fidelity to the management interest and a determination to maintain state law's equilibrium tilt to management. The federal threat imported credibility to the signal, to the extent there really was a federal threat.

But the Washington actors who tried to protect the hostile takeover in the 1980s lacked the political wherewithal to follow through. As we have seen, Congress was gridlocked on the subject.[322] Moreover, even given Congressional support for takeover protection, it is not at all clear that federal intervention would have disturbed the state equilibrium. The takeover protection legislation introduced in the House in 1987[323] would have given the SEC authority to promulgate rules prohibiting defensive tactics and to create "standards for the fair conduct of contests for corporate control," subject to a shareholder "opt in" privilege.[324] The provision would have terminated Delaware's takeover case law under *Unocal* and *Revlon*, but otherwise would have left things in place. That result might even have benefited Delaware by removing the competitive threat posed by tighter antitakeover provisions enacted in other states.

The greater threat already had passed, the threat posed in the 1970s by the cases that would have federalized much of fiduciary law and the 1980 federal fiduciary standards bill.[325] But the 1980 bill ended the long series federal chartering threats with more of a whimper than a shot across Delaware's bow. To look at the longer history is to see federal chartering as a reform initiative that fell lower and lower on legislative agendas as the twentieth century unfolded. It lay at the top of the Taft administration's agenda.[326] It dropped to the second tier of the second Roosevelt administration's agenda.[327] By the 1970s, it remained alive only in the offices of a handful of congressmen.[328] After 1980, it disappeared. Even as actors in the Reagan administration threatened to preempt defensive tactics, they were committed to a cooperative federal-state equilibrium and had no truck with federal chartering. By 2002 popular demands completed the transformation of federal corporate politics. Now shareholder value

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Anecdotal evidence shows that Delaware lawmakers keep federal intervention in mind when they take politically sensitive steps. See Curtis Alva, at 906-08.

[322] See supra text accompanying note __.

[323] H.R. 2172, 100th Cong. 1st Sess. (proposed April 27, 1987).

[324] Id.§14. The statute also imposed a one share/one vote rule, id. § 3, prohibited greenmail, id. § 5; accorded shareholders access to the proxy statement to nominate directors, id. § 6; prohibited street sweeps, id. § 11, prohibited golden parachutes, id. § 12; and amended the Williams Act in numerous ways. Id. §§ 4, 7, 8, 9, 10, 13.

[325] See supra text accompanying notes __-__.

[326] See Brabner, supra note __, at 162-63.

[327] See supra text accompanying note __.

[328] See supra text accompanying note __.

triggers political emergencies.

None of this should be taken to deny the fact that Delaware's agents are averse to any exercise of federal preemptive power.[329] Moreover, federal rumblings certainly affected their behavior in the mid 1970s and mid 1980s. But similar rumblings have not been heard since, even as Congress made a significant intervention in SOX. But because the Enron crisis concerned compliance, the state equilibrium gave Delaware no room for maneuver.[330]

Federal chartering does remain in the bottom drawer, ready to be revived if Delaware ever steps out of line. A federal threat accordingly figures into Delaware's strategy at a deep structural level. To the extent it actively impacts Delaware's play, it presumably imports risk aversion respecting any state law innovation that disrupts the equilibrium in management's favor. This shows in the historical pattern. The last time Delaware initiated *sua sponte* a legislative process designed to catch management's eye by providing it new benefits was in the 1960s. Significantly, deteriorating market share made Delaware feel compelled to act. We also see such risk aversion in the historical pattern that ties legislative innovation to rising stock markets. Management favorable innovation is less likely to raise eyebrows in prosperous conditions. It follows that whatever the bottom is, Delaware will not go there, just as it will never tilt markedly in the shareholders favor. Finally, note that barriers to entry into the charter market have imported stability since Delaware regained market share after 1967. The barriers provide shareholders an incidental systemic benefit even as they block the analogy to a first best product market. If entry were easy, the competitor could cater to management, enervating the fiduciary regime or otherwise curbing litigation.

### C. Delaware in the Era of Shareholder Capitalism

The shareholder interest only nominally lost the takeover wars of the 1980s. Although legal innovations during the 1980s made tender offers more expensive and less likely to occur, the normative agenda of the hostile offerors and their proponents in policy discussions did win the day. The offerors demanded shareholder value maximization and the managers and state legislatures resisted. In the 1990s, management did an about face and assimilated the norm.[331] Incentivized by stock options, managers began building their careers by maximizing value. Disinvestment and conglomerate unbundling, which came by force in the 1980s, became an ordinary business agenda item. At the same time, institutional shareholders, outraged by the antitakeover triumph of the 1980s, learned to ameliorate the shareholder collective action problem by organizing and

[329] See William B. Chandler III & Leo E. Strine, Jr., The New Federalism of the American Corporate Governance System: Preliminary Reflections of the Residents of One Small State, 152 U.Pa.L.Rev. 953, 953-60 (2003)
[330] Congress in any event acted so quickly as to leave any window of opportunity closed.
[331] See **Error! Main Document Only.**Melvin A. Eisenberg, Corporate Law and Social Norms, 99 Colum. L. Rev. 1253,1278-87 (1999).

making their voice heard at in boardrooms and at the annual meetings.[332] Performance pressures on executives intensified. So did conversations about items on the governance agenda, leading to apparent improvements in practice

Many question the depth of these changes, now that the shareholder value era has given way to the Enron era. Whatever the quality of the change in the practice, there can be no question that the changes worked to Delaware's advantage. The diffusion of the shareholder value norm and the shift of interest group influence toward a more even balance between management and an emerging class of shareholders,[333] taken together, meant a better protected shareholder interest. There resulted a lessening in intensity of the ongoing debate over the separation of ownership and control. Where thirty years ago there prevailed a managerialist model of corporate governance that endorsed the delegation of substantial discretion to managers,[334] today the absolutist view represents a minority perspective.[335] The deflation of managerialism implies a concomitant diminution of antimanagerialism. As a result, corporate governance debates have lost much of their ideological coloration and corporate federalism has become depoliticized. Today debates tend to devolve on functional questions about value creation and agency costs, a context in which Delaware often comes up looking very good.

The federal threat accordingly recedes further into the deep structure of corporate federalism. The state enabling regime still remains vulnerable to federal mandates, perhaps even more vulnerable. Shareholder capitalism has brought the conduct of business and stock market results forward in the national consciousness,[336] making negative shocks politically salient in Washington. Yet, despite the notable incursion on internal affairs in SOX, it holds out no apparent disruption of the state equilibrium. Delaware being a business, only a threat to the state equilibrium matters to its bottom line. As to this, the federal government has proved surprisingly cooperative.

Shareholder activism also helps Delaware by reducing the threat of potential competition. Through much of the 1980s it remained conceivable that Delaware could suffer a significant number of outbound reincorporations to the stronger antitakeover states. To the extent shareholders rubber stamped shark repellant charter amendments, they also would rubber stamp a management protective reincorporation. That assumption has not been safe for some time.[337] Shareholders now vote "no" on such proposals. It follows that even as management retains agenda control over reincorporation, the shareholder veto has become meaningful. The exit door from Delaware to a neo charter

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[332] Cite. Ironically, Delaware's position is enhanced only because the primary avenue for shareholder intervention – the proxy rules – already has been federalized.
[333] See Hansman & Kraakman, supra note __, at 443.
[334] See id. at 444.
[335] Steve Bainbridge is the leading proponent. See Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 Nw. U. L. Rev. 547 (2003); Stephen M. Bainbridge, Director Primacy in Corporate Takeovers: Preliminary Reflections, 55 Stan. L. Rev. 866 (2002).
[336] Robert J. Shiller, Irrational Exuberance 71-95 (2000).
[337] Robert Daines & Michael Klausner, Do IPO Chaarters Maximize Value, 17 J.L. & Econ. & Org. 83, 87-88 (2001).

monger would certainly be sticky, and very well may be locked in most cases.[338] And even if an exit-seeking management could get the votes, it still might hesitate – the reincorporation process might send a bad signal to the financial markets. It follows that the only competitive threat to Delaware would come from a state that devised a superior strategy addressed to issues as to which management and shareholder interests stand aligned. That seems an unlikely event, given Delaware's ability to learn and modify its approach in response to changes in practice.

The foregoing points, taken together, also imply increased slack for the Delaware courts respecting the ongoing mediation between the management and shareholder interests. Widespread acceptance of the shareholder value norm frees the Delaware bench to intervene for the shareholders with less worry about the result disrupting the equilibrium. Such interventions have lost any public interest coloration. In any event, the genius of Delaware lawmakers lies in their ability to generate a thick fiduciary law without at the same time imposing a significant compliance burden.

Hostile takeovers are the sticking point in this description. Delaware remains an antitakeover state, with its poison pills, classified boards, and cooperative judiciary more than making up for the weakness of its antitakeover statute. Its continued adherence to the management side and rejection of short-term value maximization continues to occupy a top spot on the agendas of shareholder activists and academic commentators.[339]

But this appears to be another case of a narrow, elite political network fighting a rearguard action against a stable equilibrium. Takeovers have disappeared from the federal political agenda. In 1988, Roberta Romano published the results of a tally of all takeover related bills introduced in Congress during the period 1963-1987.[340] Replicating her methodology, we have continued the tally from the 100th Congress in 1987 to the 108th Congress in 2003.[341] We divide the proposed bills into the following categories: (1) Hostile takeovers, including any merger legislation that includes provisions concerning hostile takeovers and defensive tactics, legislation addressed to leveraged restructuring, and legislation directed to roll up transactions; (2) Other merger, including legislation concerning mergers generally, such as antitrust bills and amendments to the tax code, but not containing provisions respecting hostile takeovers; (3) Foreign acquisition, including legislation regulating acquisition of US assets by foreign firms, particularly in the defense industry; (4) Industry specific, including legislation directed to mergers and acquisitions in specific industries only, primarily concerning communications, electricity,

[338] Here we note that a negative inference arises from Lucian Bebchuk, Alma Cohen & Alan Ferrell, Does the Evidence Favor State Competition in Corporate Law?, 90 Cal. L. Rev. 90 Cal. L. Rev. 1775, 1783 (2002), which surveys reincorporation activity to find that competition does tend to reward the antitakeover states. But see Subramanian, supra note __, at 1843-44 (finding recapture antitakeover statutes and mandatory classified boards have hurt the ability of adopting states to retain companies).

[339] See, e.g., Lucian Bebchuk, John Coates & Guhan Subramanian, The Powerful Antitakeover Force of Staggered Boards, 54 Stan. L. Rev. 887 (2002).

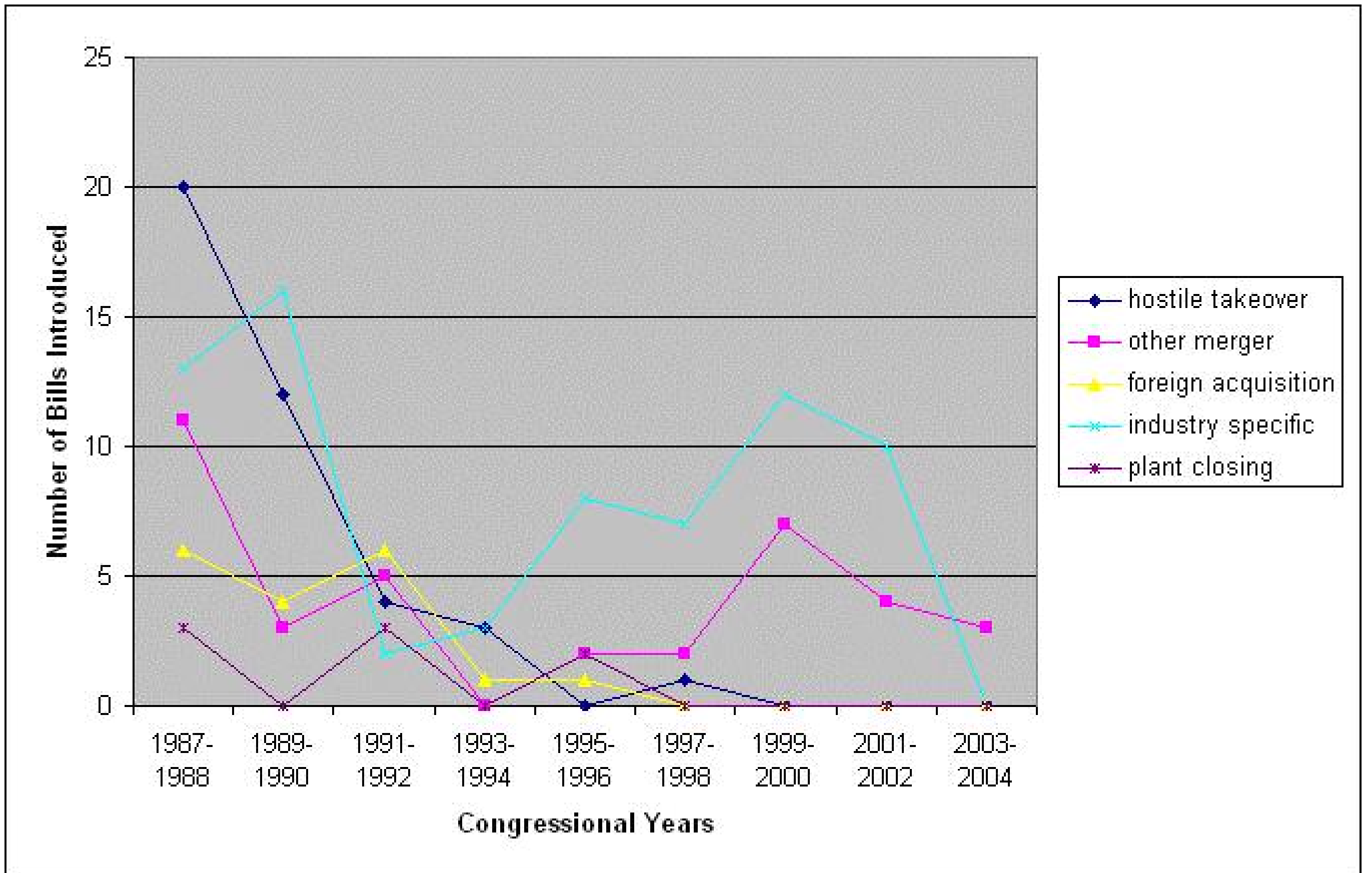
[340] Romano, supra note ___, at 470-86.

[341] See id. at 470 n.35. Like Romano, we reviewed all entries in the Commerce Clearing House Congressional Index and broke out those bearing in any way on mergers and acquisitions. Like Romano's talley, it is likely to be inexact due to shortcomings in the index.

transportation, and agriculture; and (5) Plant closing, including includes bills directed to labor and disinvestment.

**TABLE II**

| | 1987-1988 | 1989-1990 | 1991-1992 | 1993-1994 | 1995-1996 | 1997-1998 | 1999-2000 | 2001 2002 | 2003-2004 |
|---|---|---|---|---|---|---|---|---|---|
| Hostile takeover | 20 | 12 | 4 | 3 | 0 | 1 | 0 | 0 | 0 |
| Other merger | 11 | 3 | 5 | 0 | 2 | 2 | 7 | 4 | 3 |
| Foreign acquisition | 6 | 4 | 6 | 1 | 1 | 0 | 0 | 0 | 0 |
| Industry specific | 13 | 16 | 2 | 3 | 8 | 7 | 12 | 10 | 0 |
| Plant closing | 3 | 0 | 3 | 0 | 2 | 0 | 0 | 0 | 0 |




The tally in Table II shows that the hostile takeover has fallen off the federal agenda, leaving in place the state's antitakeover equilibrium. This political result is easily explained. Takeover protection never had much political traction in Washington, due to management opposition and public indifference or hostility.[342] The newly vocal shareholder interest apparently still makes for an insufficient counter. Nor is it clear that it would make sense for the lead institutions to direct their political energies to takeovers. Other governance matters, like committee practice and access to the proxy statement, take precedence today.

Other structural factors also can be cited. Federal intervention in internal affairs tends to follow stock market reverses, because losses trigger political demands. Merger and acquisition activity, including hostile offers, tends to coincide with rising stock

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[342] See Romano, supra note __,at 490-503.

markets,[343] a time when the management interest registers especially effectively. Red ink may speak more loudly than opportunity costs in any event. While the 1990s did yield clear cut cases of opportunity costs to shareholders due to tough management defensive play,[344] the cases were sporadic. The prevailing picture was one of free flowing premiums incident to friendly deals.[345] Hostile takeovers were politically salient during the 1980s, when they provided the shareholder interest a stick to yield against suboptimal earnings retention practices and conglomerate structures.[346] By the 1990s, norms and incentive structures had shifted. Managers in industries experiencing external shocks voluntarily responded by entering into restructuring transactions

**D. Delaware as a National Agency**

Several commentators,[347] including us,[348] have suggested that corporate federalism be understood by analogy to the relationship between the legislature and an administrative agency. This delegation analogy has attractive aspects. The spread of Delaware charters nationwide makes Delaware a de facto national lawmaker. As such it serves a harmonization function in the national marketplace. It also can be noted that Delaware owes its national impact to the Supreme Court's interpretation of the constitution to require states to admit firms chartered elsewhere, and accordingly collects rents only as a result of a federal dispensation of grace. Congress has the authority to federalize the subject matter in any event. It follows that even though Congress never formally delegated lawmaking authority to Delaware, it fairly may be viewed as an arm of the national government. Arguably, to the extent the analogy succeeds, the federal allocation is justified and with it Delaware's national role. We think that the analogy is descriptively robust, but that it has limited justificatory impact for federalism discussions.

Political theorists posit a menu of functions that agencies serve for legislative principals. Two stand out as candidates for describing Delaware. The first is substantive credibility. Sometimes the legislature cannot credibly commit to stick to policy choices, due to the vagaries of elective politics and constituent demands.[349] The legislature

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[343] Id.
[344] Bebchuk et al., supra note __ at 919-25.
[345] William W. Bratton, Cases and Materials on Corporate Finance 688-89 (5th ed. 2003). Even as the absolute number of hostile offers stay constant, see John Coates, Measuring the Domain of Mediating Hierarchy: How Contestable are US Public Corporations?, 24 J. Corp. L. 837 (1999), the percentage of overall activity involving a hostile bid dropped significantly, from 14 percent of all transactions in then1980s to 3 percent in the 1990s. Andrade, Mitchell & Stafford, New Evidence and Perspectives on Mergers, 15 J. Econ. Persp. 103, 104-09 (2001).
[346] Holmstrom & Kaplan, Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s, 15 J. Econ. Persp. 121, 127-132 (2001).
[347] See Macey, supra note __, 267-68 (using the agency analogy as the basis for a public choice explanation of the existence of state regulation); Roe, supra note __, at 18 (comparing Delaware to a central bank and noting limitations on the analogy).
[348] See Bratton & McCahery, supra note __, at 1867-72 (drawing on agency literature to suggest self regulatory strategies).
[349] See Pollack, supra note __,at 23-24. The legislature may want the agency to take the blame for unpopular policies. See Morris P. Fiorina, Legislative Choice of Regulatory Forms: Legal Process or Administrative Process?, 39 Pub. Choice 33, 55-58 (1982) (arguing that, when passing legislation, legislators often lack clarity regarding the actual manner in which that legislation will eventually be

delegates to an agent that can establish the desired credible commitment and develop the necessary expertise. The more insulated the agency from external political pressures the better it serves this function. The delegation of monetary policy to a central bank is the classic case.[350] Extending the point to Delaware, we see a need for a credible commitment from government in order to induce investment and can identify just that credible commitment in Delaware's evolutionarily stable strategy.

Does the analogy, thus drawn, carry through to import presumptive immunity from federal interference in internal affairs? We do not think so. The central bank analogy is descriptively problematic because the delegation's objective is the vesting of political property rights in the agency.[351] Delaware has no such rights and steadily seen its regulatory turf contained. Worse, we can go to back to the credibility concept and apply it to the SEC: The SEC vests a voice for the shareholders and insulates the mandatory disclosure system from compromise due to management influence, importing credibility for the purpose of encouraging investment. That the SEC was created in order to correct state level results bespeaks a state level adverse selection problem.

At this point, the analogy's proponent can fall back a step and restate the point, addressing the system as modified by the federal securities laws. Like all principal-agent relationships, those between legislatures and agencies implicate agency costs, and ex post legislative overruling is a standard disciplinary device.[352] Congress did just this in enacting the securities laws. To the extent that Delaware is easily overruled and a threat of additional incursions imposes ongoing discipline Delaware, [353] the agency analogy holds well.[354] It thereby comes to bear against those who argue for total preemption. But, politically speaking, that argument has fallen off the agenda. Today's federalism

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executed and that, therefore, an administrative solution often becomes the compromise accepted both by those fearing that a legal solution might offer "too much" regulation and by those fearing that such a solution might offer "too little" legislation). Macey draws on this literature in his federal-state agency discussion but does not apply the analogy to corporate law. See Macey, supra note __, at 284-86.

[350] See Giandomenico Majone, Two Logics of Delegation: Agency and Fiduciary Relations in EU Governance, 2 Eur. Union Pol. 103, 110-111 (2001) (discussing Kenneth Rogoff's theory that governments tend to delegate "monetary policy to a central banker who is more 'conservative' (i.e. more inflation averse) than the government" and commenting on the high level of independence bestowed upon the European Central Bank by the Maastricht Treaty); see also Kenneth Rogoff, The Optimal Degree of Commitment to an Intermediate Monetary Target, 100 Q. J. Econ. 1169, 1169-90 (1985).

[351] Majone, supra note __, at 114.

[352] Pollack, supra note __, at 26-28.

[353] See Barry R. Weingast & Mark J. Moran, Bureaucratic Discretion or Congressional Control? Regulatory Policymaking by the Federal Trade Commission, 91 J. Pol. Econ. 765, 768-69 (1983) (discussing the "congressional dominance" approach to principal-agent relations, which "assumes that congressmen . . . possess sufficient rewards and sanctions to create an incentive system for agencies" as the "threat of ex post sanctions creates ex ante incentives for the bureau to serve the congressional clientele.").

[354] See Arthur Lupia & Mathew D. McCubbins, The Democratic Dilemma: Can Citizens Learn What They Need to Know? 79-81, 85-92 (1998), which evaluates the success of a delegation in terms of two factors – knowledge and incentives. If the principal either knows what the agent is doing or the agent's action makes the principal better off than would the status quo. Delaware is transparent, making oversight easy; often Delaware's actions make the federation better off. Lupia and MCCubbins offer a tougher standard in the alternative, id. at 91-92. Under this the delegation succeeds only when the agent takes action that improves the principal's welfare. Viewed this way, the Delaware delegation fails in some instances.

discussion concerns the magnitude of the presumption against nonintervention. At this point the agency analogy works against charter market advocates, who argue for a strong restraint against federal incursions into internal affairs. Delegation analysis legitimizes such federal incursions on the ground that the principal's preferences should prevail. At this point in the analysis, federal intervention is judged in cost-benefit terms, with no special presumption skewing the analysis, at least so long as the intervention does not disrupt the state level equilibrium,[355] a result that federal authorities do not appear to prefer.

Now let us try a second line of political theory. Under this scenario, the agency serves a function analogous to that of a Congressional committee:[356] It sets the agenda, avoiding cycling, perhaps also skewing the agenda in a desired direction.[357] Mark Roe draws this analogy forcefully, pointing out that the delegation to Delaware orders the agenda and limits the players to the management and shareholder interests, relegating public interest advocates to secondary influence at the federal level.[358] This too is descriptively accurate. But its justificatory impact on the federalism discussion is similarly narrow. It provides an argument against total preemption, but it does not, for example, support an argument against federal intervention to preempt antitakeover legislation or invalidate corporate defensive devices. We also would add an historical caveat. The description works better and better as one goes back in time, and federal chartering motivated by a public interest agenda becomes an active agenda item under the trust paradigm. As one moves forward in time, the overall federal regulatory scheme more and more instantiates the strategy of contract and outside regulation for outside constituents and the public interest, with federal corporate law politics becoming more shareholder value oriented. To the extent federal corporate politics focuses only on the governance agenda, and it has been thus focused for 25 years, the structural importance of agenda control at the state level matters less and less for shareholder capitalism.

## V. CONCLUSION

Federal intervention that interferes with the state equilibrium could be justified if done for the purpose of encouraging keener charter competition and a more even-handed strategic balance between the shareholder and management interests. But we perceive no political incentives that might encourage federal micromanagement of the charter market. Failing that, corporate federalism remains robust, so long as the federal government and stock exchanges continue to refrain from allocating to themselves so much subject matter as to cause Delaware's customers to question the efficacy of their rent payments. Those who would prefer to see no further expansion of federal territory are likely to be frustrated. Pension fund socialism hard wires corporate law into national politics. Only

[355] At this point the proponent of state discretion can argue that Delaware should be insulated as if it were a central bank. But now the description has failed and the point merely restates the normative claim made in the federalism discussion.
[356] See D. Roderick Kiewiet & Mathew D. McCubbins, The Logic of Delegation: Congressional Parties and the Appropriations Process 22-25 (1991).
[357] Pollack, supra note __, at 25.
[358] Roe, supra note __, at 4-10.

two developments could change the pattern: Either managers assimilate a strong norm of financial truth telling and compliance with law, or shareholders assimilate the precepts of fundamental value investment. We predict no change.

Meanwhile, Delaware is safe in the present context. It would take a dramatic shift in federal policy preferences to threaten it. Such a development seems unlikely. We have seen striking changes in political preferences since 1888, yet these have given rise to few if any serious attempts to transfer corporate lawmaking in whole to the federal government. Positive political economy suggests that once an institutional structure has run in one direction for a long period, one is unlikely to see new constraints that alter the original understanding.[359]

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[359] Cite.