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## DELAWARE'S POLITICS

Mark J. Roe

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# **Delaware's Politics**

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April 15, 2005

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## Delaware's Politics

### Abstract

*Delaware makes the corporate law governing most large American corporations. Since Washington can take away any, or all, of that lawmaking, a deep conception of American corporate law should show how, when, and where Washington leaves lawmaking authority in state hands, and how it affects what the states do.*

*The interest groups and ideas in play in Delaware are narrow, the array in Congress wide. Three key public choice results emanate from this difference. First, interest groups powerful enough to dominate Delaware lawmaking forgo a winner-take-all strategy because federal players may act if they see state results as lopsided. Second, the major state-level players usually want to minimize federal authority in making corporate law, because a local deal cuts in fewer players; a federal deal splits the pie with outsiders. Third, we can delineate the space where the states have room to maneuver from where they risk federal action.*

*Delaware law typically represents the status quo. It's when its law is the first on the ground—as it often is because the federal agenda is large and Delaware's small—that it gains most of its discretion vis-à-vis the federal authorities. When it moves first, especially when its two main players—managers and investors—agree on what to do, it sets the initial content of American corporate law. Federal authorities might then change the state-made result, and players and ideologies absent in Delaware but big in Washington affect the federal result. Those new players and ideas give the original Delaware players reason to resist federal action. Doctrines that limit federal effort are public-regarding justifications for deferring to interests that prevail on the state level. But when Delaware cannot act first—either because media saliency puts the matter on the federal agenda or because its primary players disagree—Delaware loses its dominance.*

*I analogize the relationship between Delaware and Congress to that between federal agencies and Congress. Federal agencies have discretion and first-mover advantages, but their independence even when wide is not without limits, ending when they provoke Congress. So it is with Delaware.*



# DELAWARE'S POLITICS

Mark J. Roe

Introduction .....	1
I. The Race.....	4
A. States Fight for Chartering Revenues .....	4
B. The Federal Trump .....	5
C. Delaware as a Quasi-Federal Agency .....	5
II. Making American Corporate Law: Differing Ideas, Differing Interests.....	6
A. In Delaware: The Franchise Tax.....	6
B. In Congress .....	8
III. Sequence.....	10
A. Abstractions .....	10
1. <i>The narrow result when Delaware acts</i> .....	10
2. <i>The wide space in which Congress acts</i> .....	12
3. <i>In the federal shadow: Why don't managers fully dominate Delaware?</i> .....	14
4. <i>How Delaware diminishes the congressional deal space</i> .....	16
5. <i>Congress: Wide interests, broad ideas</i> .....	18
6. <i>The tax code and the corporations code</i> .....	19
7. <i>Shareholders' and managers' joint interest in minimizing federal influence</i> .....	20
8. <i>Delaware's interest in minimizing federal influence</i> .....	22
9. <i>Efficiency?</i> .....	23
B. Examples .....	24
1. <i>Federal displacement: actual and potential</i> .....	24
(a) <i>Antitrust</i> .....	24
(b) <i>Foreign corrupt practices</i> .....	25
(c) <i>Takeovers</i> .....	25
(d) <i>Sarbanes-Oxley</i> .....	26
(e) <i>Shareholder access</i> .....	26
2. <i>Analogous larger jurisdictions</i> .....	27
(a) <i>CalPERS</i> .....	27
(b) <i>Constituency statutes</i> .....	29
(c) <i>Europe</i> .....	30
3. <i>Regulatory method</i> .....	31
(a) <i>Ex post fiduciary duties vs. encompassing regulation</i> .....	31
(b) <i>Arbitration vs. prosecution</i> .....	32
IV. Political Theory and the Delaware-Federal Relationship.....	32
A. Triggering Federal Action .....	32
1. <i>Scandals, and public-oriented action</i> .....	33
2. <i>Police patrols vs. fire alarms</i> .....	34
B. Parallels to the Federal Reserve System: Delaware as the Accidental Agency .....	34
1. <i>In Delaware's insulation</i> .....	34
2. <i>In its porosity</i> .....	36
3. <i>In separating policy domains</i> .....	37
4. <i>In reducing the time inconsistency problem</i> .....	37
5. <i>In processing information</i> .....	37
C. And How Delaware Affects Congress .....	38
1. <i>In justifying strong regulation</i> .....	38
2. <i>In facilitating anti-corporate posturing</i> .....	39
3. <i>In giving Congress cover and deniability</i> .....	39
4. <i>In avoiding a full federal corporate takeover</i> .....	39
V. Corporate Theory Meets Political Theory.....	40
A. The Contractarian Paradigm .....	40
1. <i>What is it?</i> .....	40
2. <i>How the public choice structure makes the contractarian paradigm plausible</i> .....	40
3. <i>Limits to the contractarian model</i> .....	41
B. The Internal Affairs Norm .....	42
1. <i>What is it?</i> .....	42
2. <i>The internal affairs norm as crude interest group public choice</i> .....	42

VI. Is Delaware Cause or Effect?.....	43
A. Means and Ends .....	43
1. <i>The median voter and the institutional structure</i> .....	43
2. <i>Does the American voter want conservative corporate law?</i> .....	43
B. Restraining the Corporation: External Bumpers vs. Internal Brakes .....	44
Conclusion .....	44
Figure 1: One Issue in Delaware .....	11
Figure 2: The Trade-off of Autonomy and Efficiency .....	12
Figure 3: The Ease of a Federal Counter-Coalition if Delaware is Immoderate .....	13
Figure 4: Moderation in Delaware Stymies an Easy Federal Counter-Coalition .....	15
Figure 5: The Delaware Deal in the Federal Shadow .....	15
Figure 6: The Constricted Deal Space in Congress After Delaware Acts .....	17
Figure 7: When Federal Policymakers Demean Efficiency .....	19
Figure 8: When Entering the Federal Arena Hurts Managers and Shareholders .....	21



# Delaware's Politics

Mark J. Roe<sup>\*</sup>

## INTRODUCTION

Corporate law analysts have grappled with the nature of interstate competition for corporate charters since the large modern corporation appeared a century ago. Are states racing to the bottom, demeaning the public interest by pandering to firms and their organizers, just to sell corporate charters for a few dollars? Or are they racing to the top, competing to make better corporate law, like businesses struggling to sell a better product? As important as the race might be, I argue that its direction—to the top or the bottom—may well be no more important to the content of American corporate law than Delaware's relationship to the federal government. Here, I analyze the public choice structure of that federal-state relationship.

Delaware writes most state corporate law. Yet Washington can take away all of Delaware's corporate law. Because Washington has this power, the principles, political interests, and institutional structures that determine what it takes over, and what it leaves alone, influence the shape, content, and scope of American corporate law. And Delaware's scope, freedom, and power is similar to, albeit wider than, the scope, freedom, and power of federal agencies, which Congress can control. Even if Congress doesn't act day-to-day, the parameters of Delaware's freedom to act are potentially defined by Congress, as they are for federal agencies.

The private interests and the conceptions of the public interest in play at the state level differ from those in play at the federal level. How the two levels interact can determine whose interests and which ideas dominate American corporate law. Delaware in effect provides a caucus for managers and investors, yielding a status quo that federal authorities could later change. When Delaware fears a federal trump, Washington can affect what it does. When it acts in a way both managers and shareholders find satisfactory, it resembles a caucus. Neither calls on Congress to act, and federal policymakers find it hard to put the issue on the congressional agenda. And, when Congress is quiet, broad political concerns stay out of American corporate law.

Delaware's primary interest groups are shareholders and managers. One common view is that managers and insiders have the upper hand in determining Delaware's corporate law. Even if true, we'd want to explain why Delaware doesn't always capitulate to them. The federal overlay helps us to understand why. Delaware

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could goad federal policymakers into acting. An unbalanced state result, or a disgruntled state-level loser, would make federal action more likely. That possibility pushes Delaware to arbitrate—often via fair-minded judges—between its two main groups, not just because it's plausible policy, but also because to do so gives good cover if corporate law gets onto the federal agenda.

Federal authorities, Congress in particular, can crush Delaware. Yet they don't. We need to explain when, where, and why Delaware gets autonomy, and what the limits of that autonomy are. At times Congress, subject to wider interests than is Delaware, takes over corporate lawmaking. Can we draw the parameters that delineate where and when it acts?

Because Delaware can often act first, its interest groups can create a fait accompli that differs from what Congress would do if it had acted first. They just can't move so far and so vividly that they goad Congress to act. And, even if elements in Congress stir, since Congress usually needs to be pushed to act; if the two primary groups favor the status quo, Congress may acquiesce. When Delaware acts slowly—because, say, its primary interest groups disagree, or the correct policy resolution is unclear, or scandals call for quick action and Congress moves faster than Delaware—then Delaware's agenda-setting authority ends, its autonomy shrinks, and American corporate law goes national. The Sarbanes-Oxley Act of 2002—Congress's response to the Enron-class scandals—is the latest such instance.

\* \* \*

We can build this federal-state public choice story from the ground up, with Delaware's franchise tax as the foundation. The tax is the prize for winning the interstate race, with many seeing it as bonding Delaware to make good corporate law. But bonding isn't the whole story: The tax shapes who counts in making American corporate law. It enhances managers' and shareholders' joint authority—they're the players who can take that \$500 million annual pot of gold away from Delaware—while demeaning outsiders' influence. Those outsiders often have a regulatory agenda. Excluding them weakens that agenda, making possible a contractarian model to American corporate law. National ideologies and policy goals of enhancing capital markets and competition (potentially at the expense of managers and shareholders), or of fostering a populist-style leveling of corporate authority, have little weight in Delaware because they do not directly threaten the franchise tax. Congress though is not so limited, and these ideas weigh more in Congress than in Delaware.

Traditional analyses look at who, between managers and shareholders, has more muscle in bestowing those franchise tax revenues on Delaware, through their ability to control reincorporation decisions. These inquiries are important, but incomplete. *Both* managers and shareholders—and no one else—must approve reincorporation for firms to move out of or into Delaware. Thus I reinterpret the franchise tax in public choice terms: it empowers managers' and shareholders' interests in Delaware, and denigrates everyone else's. It sets, or helps to set, the initial agenda for making American corporate law. If a rule works for managers and shareholders, it'll fly in Delaware. If a proposed rule offends them both, it won't.

\* \* \*

The role of the federal lawmaker differs in each view of the race. In the typical race-to-the-top view, the federal lawmaker is a monopolist, unconstrained by competition. It adapts less well than do competing states because it doesn't get signals and pressures from other jurisdictions. In the typical race-to-the-bottom view, the federal lawmaker, unconcerned with losing franchise tax revenue, acts in the public interest.

But the basic issue here is *not*, or not just, federal monopoly vs. state-to-state competition. Differing results would arise even if *both* primary lawmakers—Washington and Delaware—had monopolies in their spheres, i.e., even if *no* state competed with Delaware. The key issue here is *who* makes federal law and *who* makes state—even a monopoly-state's—law. More players have voice and power in Congress than in Delaware. Competition and monopoly are not the only determinants; the differing public choice array may well be as important.

In Part I, I review the race literature and show how a full story must bring in the federal authorities. I conclude Part I by analogizing Delaware to the so-called independent agency: it appears to be a free agent, but it is free only so long as it does not provoke Congress.

In Part II, I examine the interest groups behind the institutional structure. The interest groups in play differ at each level: shareholders and managers at the state level, and a wider array at the federal level. First, even if a player dominates Delaware, Congress can trump Delaware, and an unbalanced result there can attract attention. That prospect alone induces Delaware not to give either side full victory. Second, and more importantly, shareholders and managers—often at odds in the race literature—usually both want to deter federal authorities from intervening. Federal action will bring to the table other players who are cut out in Delaware. Ideologies also differ: some federal public policymakers have competition and strong capital markets in mind. Others seek a populist power-leveling. Neither ideology is important to most Delaware players. I end Part II by returning to Delaware's similarity to the independent agency, analogizing its corporate lawmaking to Federal Reserve monetary policy: an independent agency with expertise, but one susceptible to congressional influence.

In Part III, I look at situations most likely to induce federal action: scandals and poor economic performance. Scandals and economic weakness signal that something could have gone wrong with the normal science of corporate lawmaking. The system gives an incentive—albeit a weak one—for Delaware and its interest groups to make corporate law close enough to the national interest that it survives federal scrutiny when scandal or economic reversal hit the headlines.

In Part IV, I compare and contrast Delaware with the federal agencies. I analogize the signals that induce Congress to displace the agencies—fire alarms from debacles and police patrols that uncover problems—to the signals in corporate governance that induce it to displace the states in corporate law. I also compare Delaware's independence to that of the federal agencies; it is as independent as any of them, actually much more so, and the controls Congress has over federal agencies are stronger than those it has over Delaware. But Congress can control the corporate law results if it wants; and at critical times it has.

In Part V, I relate this analysis to key theoretical issues. I show how this federal-state structure makes corporate law's contractarian paradigm—that corporate law is, or should be, the contract that investors and managers want—plausible. The internal affairs norm—that states should make the rules governing a corporation's internal relationships—is a public-regarding concept that, when respected, limits federal interest groups and ideologies from shaping American corporate law.

Then in Part VI, I look briefly at causality, asking whether it's the federal-Delaware structure that produces American corporate law, or whether that structure persists because of a polity dedicated to property-oriented corporate law. That is, the Delaware-federal relationship, in stabilizing a conservative corporate law, may be the kind of institution that a conservative, property-oriented polity would set up to steady corporate law expectations. The polity might have built an independent agency for the task, but since chance events set up a state with roughly the same functionality, then it has little reason to alter the accidental institutional arrangement.

Finally, I conclude. For too long the interstate race has been corporate law scholars' sole institutional focus. But it's not the only governmental relationship that counts. The public choice differences between Delaware and Washington are large and key to understanding American corporate law. They are in the abstract as important to the making of American corporate law as that interstate race. Maybe more so.

## I. THE RACE

Corporate law, according to longstanding academic tradition, is made in a market—one of competing states.

### A. States Fight for Chartering Revenues

States, eager in the race-to-the-bottom view to grab the franchise tax from corporations, seek to please the managers of large firms by making corporate law that maximizes managers' wealth and discretion.<sup>1</sup> In the contrasting race-to-the-top view, states that burden their firms' operations raise those firms' capital costs, as eventually capital markets see that the firms are weaker and earn less than similar firms from states with better corporate law. Over the long-run, managers realize that they would weaken their firms by reincorporating into those bad-law states, the pot for managers and shareholders to split would shrink, and hence competitive markets push the corporate players to move to states with better corporate law.<sup>2</sup> Bad corporate law

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<sup>1</sup> The classic statement is still William Cary's, written after he finished chairing the SEC. William Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 701 (1974). See also Lucian Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437 (1992).

<sup>2</sup> Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977); ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 21 (1993); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913 (1982). Parallel political science work has powerful political centers damaging markets, while peripheral but competing political entities keep them. Barry R. Weingast,

might persist in a state, but one way or another the firms incorporated under that bad law would not.

## B. The Federal Trump

Federal authorities can, and do, confine state competition. They often make rules—such as vast parts of the securities laws—that are functionally part of America's corporate law. They could do more, were they so inclined. In nearly every decade of the twentieth century the decade's major corporate law issue either went federal or federal authorities threatened to take it over—from early 20<sup>th</sup> century merger policy, to the 1930's securities laws, to the 1950's proxy fights, to the 1960's Williams Act, to the 1970's going private transactions. That history gives Delaware good reason to fear federal preemption on big issues, and it's often shown itself to be aware that federal authorities might act. Even when it just reacts to national public opinion, it thereby suppresses its usual local contractarian mode for the larger concerns more common on the national level. Elsewhere I analyzed the frequency of federal action and of Delaware's consciousness that it risks federal action.<sup>3</sup>

## C. Delaware as a Quasi-Federal Agency

Let's drop the strong focus on state competition, for now, in these pages. It's not that the race has no import, but that it's not the only interjurisdictional game that counts. So, to ease our task, let's just examine the relationship between Delaware and the federal authorities and at a later time analyze the interaction between the two games.<sup>4</sup> Posit that Delaware wins a state-to-state race. No longer tightly confined by closely competing states, it has slack.<sup>5</sup> Then ask what its relationship would be with Congress. Think of Delaware as similar to a federal agency making corporate law. If we think this way, a new picture for corporate lawmaking emerges in the foreground: the dominant relationship in the sketch becomes not the horizontal one of the states competing, nor even of Delaware as a pure monopolist, but the vertical one of a vast

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*The economic role of political institutions: Market-preserving federalism and economic development*, 11 J.L. ECON. & ORG. 1 (1995).

<sup>3</sup> Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003). Others pointed to federal authority as tempering the race, although often dismissing its strength and persistence, or limiting its scope to one area of corporate lawmaking. William W. Bratton, *Corporate Law's Race to Nowhere in Particular*, 44 U. TORONTO L.J. 401, 419 (1994); 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, 768 (1987); Melvin Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1512 (1989); Arthur Fleischer, Jr., "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146 (1965) (federal disclosure rules control fiduciary behavior); Mark J. Roe, *Takeover Politics*, in THE DEAL DECADE 321, 340–47 (Margaret Blair ed., 1993) (federal influence on Delaware in making takeover law).

<sup>4</sup> See Mark J. Roe, Delaware's Advantage (working paper in progress, 2005).

<sup>5</sup> Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002).

federal authority that could, and occasionally does, displace the lawmaking of the little states below it.

I sketch that picture in the rest of this article. Instead of seeing corporate law as made in state-to-state close combat, imagine—in extreme contrast—that much of the time only Delaware and Washington count. Delaware usually sets the status quo. Federal lawmakers can then overturn what Delaware does. Usually they don't, but they always could, and that possibility limits state power in making corporate law. Delaware has autonomy, but only if it doesn't goad the federal behemoth. If we can conceptualize the bases for when and why federal authorities displace Delaware, we will have gone a long way to understanding the fundamental structure of American corporate law.

Thus Delaware could be reconceptualized as the first drafter of corporate law rules, with a dormant Washington having the Commerce Clause power to reject those drafts if roused. Or it could be an independent federal agency that national players could rein in via an act of Congress, via a stranglehold from a congressional committee, via the SEC inducing new stock exchange rules, or via a pointed inquiry from the White House. True, because Delaware is more independent than even the most independent federal agencies, we have to temper that analogy, or focus on the most independent of those agencies, like the Federal Reserve. This we do below.

Delaware could also be reconceptualized as a natural monopolist subject to a regulator's oversight—with Congress as that regulator. Or it could be seen as a monopolist whose limit pricing deters entry.

Delaware's freedom to act and its limits are not determined solely, and perhaps not even primarily, by its efficiency vis-à-vis other states, but by the line demarcating where the federal authorities leave it alone and where they won't. It has reason to position itself so as not to threaten the federal actors. And it does. Within the area that doesn't threaten federal authorities, it has autonomy. And our job here is to see where and when that slack exists, and how and why federal authorities pull it taut.

## **II. MAKING AMERICAN CORPORATE LAW: DIFFERING IDEAS, DIFFERING INTERESTS**

Delaware responds primarily and directly to managers and investors. The stability of the corporate enterprise and of the incumbent actors is uppermost in the Delaware decisionmakers' minds. Congress though deals with more interest groups and has a conception of the public interest wider than just boardroom stability and shareholder relations.

### **A. In Delaware: The Franchise Tax**

Delaware, in the usual view, draws lines and rules between managers and shareholders. The franchise-tax pot, which accounts for about 20% of the state's revenue, motivates its line-drawing. In the race-to-the-top view, Delaware must draw that line efficiently for capital markets or it'll lose the franchise tax; in the race-to-the-bottom view, managers get more because they have more control over the

reincorporation decision—and hence more control over that pot of gold—than shareholders.

The franchise tax doesn't just motivate Delaware in drawing the line between managers and shareholders, but also keeps out the other players. Why? Managers and shareholders, if united, can deny Delaware that franchise tax bonanza. No one in Delaware has that power. Only federal action can overcome the two primary Delaware players. Hence, the (until-now-unseen?) first effect of the franchise tax is not just to affect who wins between managers and shareholders, but to decide *who* gets to play. Managers and shareholders get to play. No one else does.

Consider these observations from an astute Delaware player:

Delaware corporate lawmak[ers] ... [are] acutely sensitive to constituency input. [They] amend the corporate law rapidly when there is a demonstrable [corporate] consensus ... . [T]his process breaks down when Delaware's corporate constituency is divided ... . [Yes,] Delaware responds reflexively to corporate managers, but ... [i]f Delaware law does not ... protect[] ... investors ... it will eventually lose its dominance.

... [And i]n areas where a consensus emerges that there is a need for greater clarity or certainty, Delaware's Corporate Law Council will generally draft and obtain swift passage of legislative amendments. When there is no consensus, however, they will not.<sup>6</sup>

The general polity is not usually involved in Delaware, even though the corporation affects parties beyond managers and investors. Employees or their unions can be interested in corporate law. Public interest groups of all stripes want to confine or channel corporate power. Financial institutions as creditors want to influence corporate law (usually to induce greater stability) and in other nations they are heavyweights in making corporate law. Not one of these four interests strongly influences day-to-day American corporate lawmaking.

Why they don't lobby Delaware is worth investigating, although I don't here. They might believe they couldn't outbid a united managerial-investor lobbying group. Or they might believe that no amount of normal lobbying could overcome the Delaware polity's goal of keeping that franchise tax bonanza; since they can't get to the minimum ante—\$500 million annually—they might think, why even try to lobby Delaware? And even if they did lobby successfully, they should expect to see firms slip away, exiting Delaware for a friendlier state. Whatever the explanation, we can observe that these groups don't influence Delaware corporate law directly.

General public opinion—important to senators running for re-election—is only a distant, indirect concern for the Delaware chancellor or legislator. National opinion polls might sway a president or senator worried about his or her overall program, or re-election. But Delaware players can disregard a national opinion poll about, say, executive compensation. When national opinion flares up and influences the Delaware decisionmakers, we may be seeing indirect federal influence at work, as Delaware

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<sup>6</sup> Cf. Leo E. Strine, Jr., *Delaware's Corporate-Law System: Is Corporate America Buying an Exquisite Jewel or a Diamond in the Rough?* 86 CORNELL L. REV. 1257, 1268-70 (2001). Leo Strine is a sitting vice chancellor of the Delaware Chancery Court.

suppresses its local contractarian model to avoid offending national opinion that might spur change from the top.

And national institutions attuned to the functioning of key parts of the American economy, institutions such as the Federal Reserve, the Council of Economic Advisors, Congress's General Accounting Office, and the SEC, are weighty at the federal level; there's nothing analogous in Delaware. Such public institutions, staffed by people with policy ideas and influenced by national interest groups, don't influence the Delaware legislature directly; Delaware has built no regulatory agencies that regularize public-oriented inputs. Its mode of regulation—*ex post* fiduciary duties, not constant oversight—reflects the desires of Delaware's key interest groups. Others might want continuous regulation, but neither populists nor economists count for much in Delaware.

The structure of Delaware corporate lawmaking doesn't bring in other groups. Bar advisory committees do propel the Delaware legislature, but the Delaware bar typically represents managers and investors (as well as themselves). Judges need a case or controversy in order to act, and it's the corporate players who have standing to sue, not the broader public. No regulatory agency makes forward-looking rules in Delaware. No Delaware prosecutor scrutinizes corporate America to throw wrongdoers in jail. Delaware could build a prosecutorial office or a regulatory agency to empower other interests or ideas, but it hasn't.

Hence, one could say that investors and managers make Delaware corporate law, and that they bring in the Delaware judges—selected by bar committees—to arbitrate their disputes. Other groups and visions are weaker there than they would be in an attentive federal forum. Delaware lawmakers do not have to placate employees or environmentalists or those with an affirmative-action agenda. Delaware citizens who might side with such interests see the financial import of the corporate industry to Delaware, so their dissenting views fade and politicians can ignore them. Nor need Delaware players consider policymakers' views of what kind of corporate law or what allocation of investor-manager authority is best for the American economy. Stated bluntly, if Delaware made corporate law that simultaneously offended investors and managers, then those players, who jointly fully control the reincorporation decision, could take the big franchise tax pot of money away from Delaware.<sup>7</sup> For Delaware in the long run, and perhaps even in the short run, everything else is secondary.

## B. In Congress

Switch to Washington. In Congress, the range of interests with the clout to influence policy widens beyond just investors and managers. And some of these wider interests would want to use corporate law to implement their public-regarding visions

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<sup>7</sup> More precisely, firms would exit if Delaware offended two groups of managers: those managing firms and those running stockholding institutions. The Delaware deal may not correspond to what ultimate investors would agree to with industrial managers. It is what investors' two types of managers—financial and industrial—want. See Roe, *Delaware's Advantage*, *supra* note 4.



for the corporation. Their agenda would often be contrary to the interests of managers and shareholders.

It's not that these outside groups could readily beat a managerial-investor alliance. Ordinarily, they couldn't. They're too weak. But if one-half of that managerial-investor alliance successfully allied with an otherwise out-group—with, say, populists, public policymakers or other national interest groups—American corporate law wouldn't be what it is today. In Delaware, those other allies are nowhere to be found, but in Congress they count and could crack open a manager-investor alliance.

Here's how a Delaware-style coalition could come apart in Congress: Imagine lawmakers are reviewing rules that would make managers more autonomous from shareholders. In Delaware the managers and institutional shareholders work out a deal between themselves. Or one—typically managers—completely gets its way.

But in Congress, the players and ideas differ. Managers and employees might ally to confine shareholder power. In a national democratic forum, managers might want an ally with many votes.<sup>8</sup> In a small local forum like Delaware that depends on corporate tax revenues, managers don't need those votes and, because employees in Ohio and Pennsylvania don't vote in Delaware, can't get them anyway.<sup>9</sup> Interest groups that can't take the franchise tax away from Delaware still can play a role in Congress. The AFL-CIO comes to mind, as do public interest lobbying groups.<sup>10</sup>

Or consider the alliances shareholders might try to make in Congress, alliances impossible to forge in Delaware. Shareholder activists might want rules to get them into the boardrooms. In Delaware, they'd have to make a deal with managers to get anywhere in the legislature. But in Congress, shareholder activists might ally with public interest activists who also want to confine managerial discretion. The two might unite to push for a law by which the first would get three seats and the latter one seat on the boards of major American firms.<sup>11</sup>

True, financial shareholders prefer pure shareholder primacy; they'd initially oppose any other group getting into the boardroom. But they'd need a coalition to get enough votes to win. In crude terms, rational shareholders might give something up to environmentalists, if they gave up less to them than they got back from managers. While this kind of coalition-building is hard in Congress, it's impossible in Delaware.

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<sup>8</sup> Cf. Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND J. ECON. 535 (1999) (wages higher in states with stronger, managerial-favoring antitakeover laws).

<sup>9</sup> Cf. William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 757 (1998) (“shifting [corporate] lawmaking to [Washington would facilitate] ... interest group rent-seeking [because Congress] is not constrained by the same competitive forces constraining state lawmakers”). Note that the AFL-CIO as *stockholder* could and probably does influence Delaware.

<sup>10</sup> By the late 1970s, political scientists “began to notice new phenomena—a proliferation of ‘public interest’ ... groups that monitored and publicized congressional behavior, [and] the growing ... role of PACs ... .” Morris P. Fiorina, *Afterword (But Undoubtedly Not the Last Word)*, in POSITIVE THEORIES OF CONGRESSIONAL INSTITUTIONS 303, 309 (Kenneth A. Shepsle & Barry R. Weingast, eds. 1995).

<sup>11</sup> See the discussion of the shareholder access debate *infra* note 52 & accompanying text.

More goes on in Washington than wider coalition possibilities. Public-regarding policymakers in Washington see themselves as custodians for the overall health of the American economy; they could conclude that tight managerial accountability—beyond that which even interests institutional investors—would be best for the economy. Congress wants strong capital markets and a healthy economy. The White House's Council of Economic Advisors influences the President, the GAO writes reports, and the SEC often proposes rules that managers and institutional investors dislike. Of course we shouldn't naïvely think that interests don't influence these players too, but the types of interests differ from Delaware's and sometimes the players have enough slack to be able to act on their ideological preferences. Public-regarding views can influence Congress when public servants at the SEC, the GAO, the Council of Economic Advisors, or the Federal Reserve weigh in. None of these players has the same clout in Delaware.

Public-regarding need not, as I am using it here, be identical to being in the public interest. Congress might react to headlines, might want to be seen as acting on the volatile issues of the day, and might not have long-term national well-being uppermost in mind. Reaching toward the public interest is only a subset of public-regarding actions. Nevertheless, two broad currents of thinking can flood through Washington and carry Congress away: populist public opinion and public-interested thinking. Neither is as important in Delaware.<sup>12</sup>

Thus we have our first result in the federal-state interplay. The interests and ideas at the two levels differ. Two main interests are in play in Delaware, and they'd usually like to have rules made in the arena where jointly they have more power. One might dominate in that arena, but usually doesn't. The possibility that Washington is more likely to act if Delaware seems unbalanced or that the loser in Delaware could move the rulemaking to Washington constrains the dominant Delaware player from pursuing a winner-take-all strategy. It wants to minimize the chances that Congress, with its own motivations and interest groups, takes notice of the issue, or that the loser appeals to Congress. The state's ideas soften, its preferences widen beyond a high regard for boardroom stability, and ideas that arise in the federal arena spill over into Delaware. Delaware has reason to be wary of moving into territory where Congress would act. So, our next task is to find the concepts that define those boundaries.

### III. SEQUENCE

#### A. Abstractions

1. *The narrow result when Delaware acts.* Managers and shareholders obviously have much in common. When their interests coincide, they get what they

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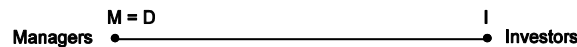
<sup>12</sup> “[W]hen issues are unidimensional and ... salient ... , the chamber-committee [read: Congress-Delaware] congruence in expressed preferences is especially high. [But] when issues are multidimensional and are not salient [in Congress], committees [i.e., Delaware players] are relatively autonomous and congruences in expressed preferences [between Congress and Delaware]... are low.” Forrest Maltzman & Steven S. Smith, *Principals, Goals, Dimensionality, and Congressional Committees*, in *POSITIVE THEORIES OF CONGRESSIONAL INSTITUTIONS* 253, 257 (Kenneth A. Shepsle & Barry R. Weingast, eds. 1995).

want in Delaware.<sup>13</sup> Presumably they can often succeed directly in Washington too, without Delaware as a first “caucus.” Even so, they would be wary of Washington, where they’d have to pay to pacify the national interests who’d want something from the corporation—even if it’s only by giving up something elsewhere on their agenda to push the corporate law that they want through Congress.

This simple result tells us a lot about Delaware’s importance. While I spend more time here abstracting contested corporate law issues—what happens when managers and investors disagree—the basic public choice result is straightforward: Managers and investors have much in common and powerful incentives to work together in Delaware. When their interests coincide, or are close, it’s easy to see why they prefer Delaware to Washington.

\* \* \*

Consider next what happens when they disagree and how the federal presence moderates Delaware. Even then the primary players have reason to find common ground and position themselves and Delaware to reduce the chance of federal action. Suppose Delaware is to decide an issue of managerial autonomy. Figure 1 illustrates a spectrum of autonomy. The right side is profit-oriented, representing only that much autonomy that produces profits; the left side is maximum managerial autonomy. Assume for now that Delaware favors managers, as represented by the point on the left, D. Were the policy arena purely local, managers could take it all and get Delaware’s law to reflect managers’ preference.<sup>14</sup>



**Figure 1. One Issue in Delaware**

A more realistic illustration would draw in Delaware’s corporate industry: the lawyers, government officials, and others who profit from Delaware’s corporate business.<sup>15</sup> Much Delaware corporate law reflects the interests of Delaware corporate lawyers. And it would more realistically recognize that Delaware pays attention to what other states are doing. But we leave these factors out of the picture to begin simply, and then add federal influence.

And, yes, it’s not just the legislature that makes Delaware law, but also its courts and its bar association committees that recommend results to the legislature. We simplify here too, collapsing all of Delaware’s lawmaking institutions into its legislature. Its judges cannot persistently offend the legislature; the legislature appoints the judges, whose propensity to play ball is known when they’re appointed. They’re vetted by bar association committees and have a prior career. Similarly, the SEC and federal authorities make federal law, but they cannot stray too far from congressional

<sup>13</sup> Cf. Strine, *supra* note 6, at 1268-70.

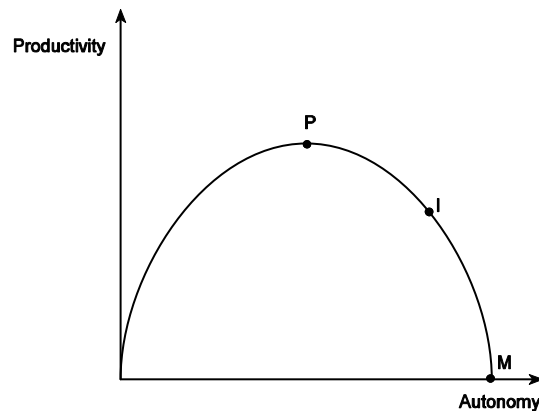
<sup>14</sup> I start with the race-to-the-bottom view, that Delaware panders to managers, and show how the federal presence can limit that race. The federal overhang can analogously restrict a race-to-the-top. See Figures 7 and 8.

<sup>15</sup> Jonathan Macey & Geoffrey Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEXAS L. REV. 469 (1987).

will. Those who want federal action might not run right to Congress directly, but to the SEC or the NYSE. This doesn't change the analysis. The SEC is Congress's creation. The NYSE can be—as Congress has commanded—indirectly controlled by the SEC. We thus simplify lawmaking to two bodies: The Delaware legislature and the United States Congress, each with loosely controlled affiliates.

2. *The wide space in which Congress acts.* Congress is more heterogeneous than Delaware. Managers and investors are important, but others also have clout. For a few in Congress, managers and investors are minor constituents. Broader concepts—of populism and of a public-regarding effort to maximize corporate productivity—are more strongly in play. To keep the image of an abstract policy space manageable, let's add to the congressional agenda just the two ideologies—populism and productivity—and associate some interest groups with them.

Begin with public policymakers by considering Figure 2. Managerial autonomy increases on the x-axis, productivity on the y-axis. We start at the origin with satisfactory productivity, at, say, 80% of what's technically possible. More managerial autonomy initially increases efficiency, because managers need more freedom to maneuver, to decide, and to take risks. But too much autonomy eventually isolates them from outside pressures. Corporate productivity declines. The curve rises, peaks, and then falls. The space inside the parabola is attainable in the economy; the space outside it is not. We posit public policymakers who seek to maximize productivity, do so capably, and are free enough from interest pressures that they can act on their own preferences. They prefer the maximum attainable corporate productivity, at point P. Self-seeking managers seek autonomy, at point M. Investors want profits.



**Figure 2. The Trade-off of Autonomy and Efficiency<sup>16</sup>**

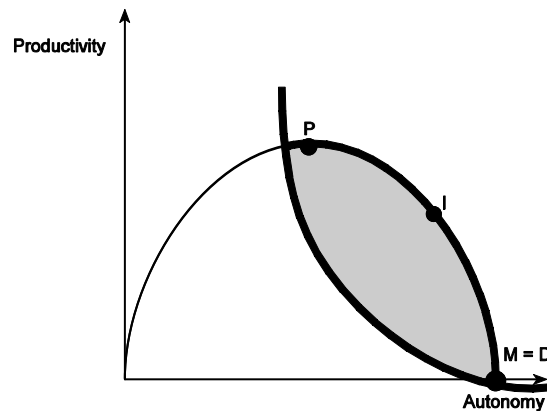
Under the federal policymakers' preferred policy, P, profits might not be as high as at other points on the parabola, and so shareholders would not want exactly what policymakers want. Profits and productivity are not identical. (Think of cartel arrangements and monopolies, which raise profits but are not necessarily efficient.) Moreover, managers run institutional investors, not the ultimate stockholders.

<sup>16</sup> I've blanché out much from firms and politics to get us to a two-dimensional graphic. If the graphic doesn't quite seem vivid on the Autonomy dimension, replace it with Executive Pay.

Policymakers might want engaged investors sitting in corporate boardrooms, in the hope that they could increase corporate efficiency.<sup>17</sup> But managers at institutional investors might dislike that burden. While they don't directly value managerial autonomy in their portfolio companies, they know that there's some spillover: if laws tightened the slack in operating firms, that would induce some tightening in the institutional investors' firms. And even if their engagement initially produced more profit, that profit would in time be competed away, to the benefit of the economy as a whole, not shareholders. Hence, although the investors don't seek to maximize productivity, they want profits more than do managers. Their ideal point is at I, between P and M on both axes, a bit closer to P than to M.

Figures 1 and 2 are related. Straighten out the right-hand side of the parabola in Figure 2: it yields Figure 1. Point I then matches up on both graphs. So, if managers have the upper hand in Delaware, as we initially assume here, they might seek and get a result that corresponds to points M in Figures 1 and 2. If the only players were those in Figure 1, that would end the game.

More concretely: Posit that the rule under consideration is a hostile takeover rule. The rulemaker chooses among many permutations, each of which yields the varying combinations of corporate productivity and managerial autonomy along and inside the parabola. On the left side of Figure 1 managers have low autonomy and aren't productive, because shareholders second-guessing them too often. On the right side they would have high autonomy and equally modest productivity because they would face no takeover threat. At the apogee of the curve, the policymakers would have chosen the moderate autonomy that maximizes corporate productivity. The rule could yield results inside the parabola; only  $y$ 's maximum value depends on  $x$ —but it's technologically impossible to move outside the parabola. But policymakers might be moderate on autonomy yet fail to get maximum productivity.



**Figure 3. The Ease of a Federal Counter-Coalition if Delaware is Immoderate**

<sup>17</sup> See MICHAEL E. PORTER, *CAPITAL CHOICE: CHANGING THE WAY AMERICAN INVESTS IN INDUSTRY* (1993) (a report to the congressional competitiveness council, recommending changing the rules covering how investors and managers interact).

Consider next the potential federal reaction in Figure 3 to the result in Figure 1. In Figure 3, managers get maximum autonomy via a Delaware rule, D, at M. We draw bold arcs, one along the productivity/autonomy curve, running from M=D up the curve through I to an equal length on the upper side of I. Investors want to move policy from D up along the bold portion of the trade-off parabola. Point I would be ideal, but anything along the curve would be better than M=D. And some points inside the parabola would be better than M=D, represented by the shaded region as we move south-east from I. (How an institutional investor's preference for profits and managers' preference for disengagement maps onto the x-y plane is uncertain; the curve is arbitrary.) If the status quo is M=D, then there's a large policy space—everything along the bold line and much that's near it—that would make I better off.

Federal policymakers would prefer almost all of that space to the Delaware rule down at the bottom of the productivity axis. Notice that P is just inside the end of the investors' indifference area. So policymakers could promulgate their ideal result and have investors support. Or, investors could start campaigning for their own ideal point, knowing that if policymakers just promulgated their own ideal preference—P—investors would still be better off than under the M=D status quo.

An M=D result in Delaware is unstable.

3. *In the federal shadow: why don't managers fully dominate Delaware?* Managers anticipate that counter-coalition in Figure 3 (or Delaware authorities fear being federalized), so they move up the trade-off parabola from M=D in order to deter federal action, as in Figure 4. Draw a new indifference arc around I, starting from the new D. The new arc in Figure 4 is closer to I than in Figure 3 and doesn't include point P. With investors now preferring D to P, policymakers and investors might not be able to cut a deal to change the status quo from D; the gains to each from their doing so are less in Figure 4 than in Figure 3; and investors see that instigating the policymakers is risky, because if policymakers promulgated their own preferred policy result—or anything in the P to x region—federal action would make investors worse off. P is farther from I than is D. Hence, investors might not call for federal action and just acquiesce in the new D. Or, perhaps more realistically, policymakers are less motivated to act and, if they act, find investors largely indifferent to their initiative.<sup>18</sup>

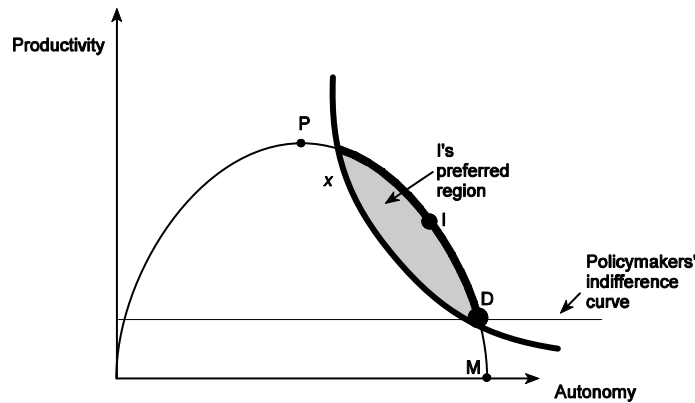
So, why doesn't Delaware just let the winner take all as in Figure 1? Managers we assume have enough power in Delaware to take all the marbles there, moving its law to the left-hand corner of Figure 1. Shareholders cannot reincorporate out of Delaware without managers' assent; Delaware already has 50 to 60% of the incorporations.

True, Delaware lawmakers may want to make good policy, and rules in the middle might be good policy. And, yes, there's a stream of future reincorporations that Delaware wants over the long run, so farsighted Delaware politicians have to keep

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<sup>18</sup> And consider coalition size. Posit that 50%+1 won't do. Coalitions need 65% of Congress to roll-over the veto points and lethargy. See KEITH KREHBIEL, *PIVOTAL POLITICS: A THEORY OF U.S. LAWSMAKING* 84 (1998). By moving up the curve, Delaware reduces policymakers' and investors' intensity in seeking federal action. Also, investors are not all located at I, but arrayed between M and P, and centered on I. Some investors toward the bottom of the curve would leave a coalition interested in federal action when Delaware moved up the curve (those few who were near M).

those new California corporations' shareholders happy about moving to Delaware. For a California-chartered firm to reincorporate to Delaware, it needs its shareholders' and not just its managers' assent, so Delaware has a long-run reason not to be seen as anti-shareholder. Perhaps these reasons are enough to explain why Delaware does not defer totally to incumbent managers.<sup>19</sup>

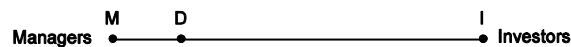


**Figure 4. Moderation in Delaware Stymies an Easy Federal Counter-Coalition**

But Figures 3 and 4 suggest another reason why Delaware moderates itself. If Delaware and the managers moved into the ultra-pro-manager segment in the bottom-right corner, a federal counter-coalition could readily form. Federal policymakers strongly dislike the Delaware result. (Perhaps they are policymakers with slack who think the result will degrade the economy. Or perhaps other interests active in Congress dislike the result and push the policymakers to act.) Investors dislike the result. But when Delaware moves to a spot outside the ultra segment, a federal counter-coalition is harder to build. Delaware is less likely to instigate Congress to act. The federal influence on Delaware pulls it away from where it would naturally come out on its own. Since Delaware law firms that represent managers and investors are key in legislating, Delaware players have the structure to find a satisfactory manager-investor compromise.

Hence, the initial result in Delaware is not that in Figure 1, but that in Figure 5.

Figure 5 can be extracted from Figure 4. It's the segment of the parabola on the right, from point M to point I, straightened out. With the federal power in the shadow, as in Figures 3 and 4, Delaware ends up at point D in Figure 5. If we only observed Delaware directly, it would appear moderate, considered, and careful. The federal shadow, the possibility of a disgruntled interest group appealing, or of federal policymakers intervening, encourages that moderation.



**Figure 5: The Delaware Deal in the Federal Shadow**

<sup>19</sup> ROMANO, supra note 2; Robert Daines, *Does Delaware Incorporation Improve Firm Value?* 62 J. FIN. ECON. 525 (2001) (Delaware law enhances shareholder value by as much as 5%).

Delaware's moderate takeover law exemplifies how the federal threat tempers its lawmaking. Delaware passed its takeover law in the late 1980s, after most other states had enacted tough antitakeover statutes. Delaware legislators asked why they shouldn't entirely shut down hostile takeovers for Delaware targets. Managers seemed to have a winning hand in Delaware, yet Delaware passed a moderate law. Consider how the law's primary drafter reacted when confronted with that question:

[W]hy ... moderate ...? Why [not] the most restrictive thing that we can pass? ... [If] our legislation is viewed either in the short run or the long run as unbalanced and unreasonable, *we all know* that ultimately ... we might have to pay the price ... of the *federal government coming in and taking ... that privilege from us.*<sup>20</sup>

Even when managers had the votes in Delaware, shareholders had clout in Reagan-era Washington; and, shareholders if defeated in Delaware on an issue of national importance, might have appealed to Washington, where the play of interests differed and the outcome was uncertain. At the time, powerful policymakers in Washington favored takeovers. Perhaps the shareholders and takeover moderates would have lost on the federal level—there's reason to think that by the end of the 1980s the federal array wasn't as proshareholder as it was earlier in that decade—but the antitakeover forces didn't want to take that chance.

This kind of Delaware-federal interplay has arisen before, and since: When the SEC disliked state rules on going-private transactions, it announced new rules of its own, took to the bully pulpit, and induced Delaware to change.<sup>21</sup> When it disliked Delaware's validation of a targeted buyback in a takeover, the SEC propounded its all-holder's rule that reversed the Delaware result.<sup>22</sup> When Congress considered massive corporate legislation in the wake of the Enron and WorldCom scandals, which it eventually enacted, Delaware's Chief Justice announced: “[if] we don't fix it, Congress will....”<sup>23</sup> These are some examples; there are more.<sup>24</sup>

4. *How Delaware diminishes the congressional deal space.* More is going on than just Delaware moderating itself in the shadow of potential federal action. Consider next *when* Congress displaces some Delaware deals and *why*. Return to

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<sup>20</sup> Hearing on H.B. 396 Before the Delaware H.R., 134<sup>th</sup> Gen. Assembly (Jan. 26, 1988) (testimony of A. Gilchrist Sparks III, chairman of the Delaware Bar Ass'n Corp. Law Council), audiotape, as reported in Kahan & Kamar, *supra* note 5, at 741 n.230 (2002) (emphasis added).

<sup>21</sup> RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 1256 & n.40 (2d ed. 1995); Roe, *Delaware's Competition*, *supra* note 3, at 616-21, and sources cited in both.

<sup>22</sup> *Proposed Amendment to SEC Tender Offer Rules*, 17 SEC. REG. & L. REP. 1320, 1321 & n.5 (1985).

<sup>23</sup> Charles Elson, *What's Wrong with Executive Compensation?* HARV. BUS. REV., Jan. 2003, at 68, 77 (comments of E. Norman Veasey, Chief Justice of the Supreme Court of Delaware). Whether the Chief Justice's “we” refers to Delaware or to the corporate world is unclear—he was speaking at a roundtable, not writing in a carefully considered judicial opinion. But either way, he is speaking consistently with the thesis here: either the corporate players or Delaware, or the first with the second's help, had better fix up corporate governance or Congress will act.

<sup>24</sup> See Roe, *Delaware's Competition*, *supra* note 3, at 607-34.



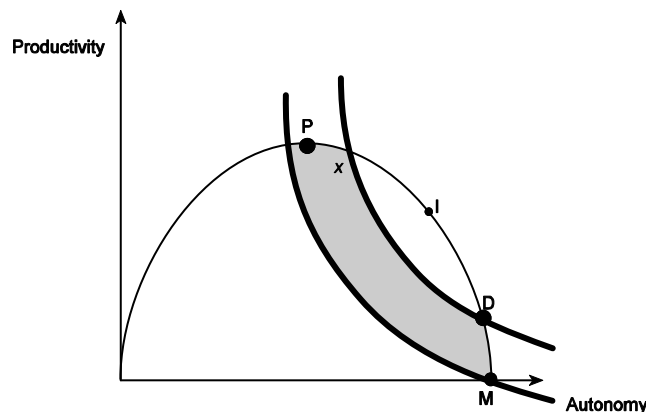
Figure 4, which illustrates a manager-investor compromise instead of a winner-take-all result. As John Ferejohn and Charles Shipan have said in a parallel context:

When congress delegates authority to an [administrative] agency, it permits the agency to make the first move: to establish a policy ... [that], if it is not preempted by legislation... , will be the policy that prevails. ...

... [T]he key to analyzing [this] type of policy-making is ... [to examine its] sequential structure.

... Given the sequential structure of decision-making, the agency will often be able to take an action that would not command a majority in the legislature, but ... Congress ... will [nevertheless not] do anything to affect the course of action.<sup>25</sup>

Begin with the Delaware compromise in Figure 4 and examine the space above the investors' indifference arc near P, marked by *x*. The *x*-P region is *no longer attainable in Congress*. Why? If the two big players reach a deal in Delaware, they do not want to move to any point further from their indifference limits. *The two can unite to defeat points like x in Figure 6*. The region close to P is out of bounds after Delaware acts. It's as if Delaware gave managers and investors the means to quickly caucus and set a status quo.



**Figure 6. The Constricted Deal Space in Congress After Delaware Acts**

If policy *x*, or indeed P, reached the national agenda *after* Delaware had acted, one would hear that it was beyond the SEC's authority, that it would upset the traditional federal-state divide, that it would violate internal affairs norms, that corporate law should be left to the states. Yet had *x* or P come up *before* Delaware

<sup>25</sup> John Ferejohn & Charles Shipan, *Congressional Influence on Bureaucracy*, 6 J.L. ECON. & ORG. SPECIAL ISSUE 1, 2 (1990).

<sup>26</sup> KREHBIEL, *supra* note 18, at 4-48; McNollgast, *Positive Canons: The Role of Legislative Bargains in Statutory Interpretation*, 80 GEO. L.J. 705, [720-21] (1992); Bradford R. Clark, *Separation of Powers as a Safeguard of Federalism*, 79 TEXAS L. REV. 1321, 1325-26, 1341-42 (2001). "A national government that can act only with difficulty, after all, will tend to leave considerable scope for state autonomy." Ernest Young, *Making Federalism Doctrine: Fidelity, Institutional Competence, and the Movement of History* (2004) (MS at 35).

acted, it would have been a possible outcome in Washington. Washington's slowness and its many veto gates make a real federal-state interplay possible.<sup>27</sup>

When managers and investors set the status quo in Delaware—the default result that persists if Washington does nothing—we get D. If federal policymakers set the initial agenda, we'd be more likely to get corporate rules approximating *x*. True, if investors could costlessly invoke federal policymakers against a D result, and then managers against a P result, policy should converge on I. But realistically, investors cannot keep the policymakers bidding. They act once or twice, and usually not at all. Delaware acts, and then at great cost federal policymakers might act.

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We now have two institutional results. First, Delaware, fearing federal action, won't be extreme. Even if corner results could pass in an isolated Delaware, they won't in a Delaware with its eye on Congress. The looming federal threat puts about half of the Delaware line in Figure 1—that portion which would most offend managers or investors—off limits. Second, once Delaware acts, a large fraction of what would previously have been reachable in Congress—where national interests and ideologies are important—is put off-limits, because *both* Delaware incumbents prefer the status quo to federal action.

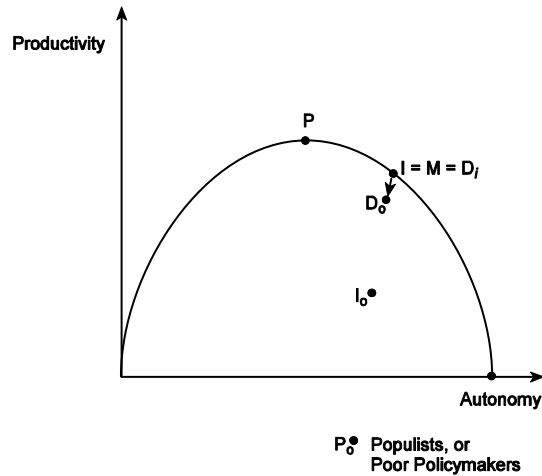
5. *Congress: Wide interests, broad ideas.* Figures 2, 3, 4, and 6 portray the federal policymakers favorably: They seek the public good and they are competent. But many observers don't think so favorably of them when they make corporate law.<sup>28</sup> Analogous results, however, arise even when federal policymakers make bad law, and especially when they make law that favors noncorporate interest groups.

So we now add other interests and ideologies, such as those of populists who want to level down power inside the corporation and give more incumbent employees. We add the new interests below the perfect productivity-oriented policymakers' point P at the top of the curve in Figure 7, at P<sub>o</sub>. The populists don't intrinsically dislike corporate productivity, but they are maximizing in other dimensions (raising wages, improving environmental quality, flattening corporate hierarchies, increasing affirmative action). These policies, even if they maximize social wealth, often take something away from investors and managers. Investors and managers, if P<sub>o</sub> policies trump the initial, default rule that Delaware makes, have to cut a piece of the corporate pie for others.

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<sup>27</sup> KREHBIEL, *supra* note 18, at 4-48; McNollgast, *Positive Canons: The Role of Legislative Bargains in Statutory Interpretation*, 80 GEO. L.J. 705, [720-21] (1992); Bradford R. Clark, *Separation of Powers as a Safeguard of Federalism*, 79 TEXAS L. REV. 1321, 1325-26, 1341-42 (2001). "A national government that can act only with difficulty, after all, will tend to leave considerable scope for state autonomy." Ernest Young, *Making Federalism Doctrine: Fidelity, Institutional Competence, and the Movement of History* (2004) (MS at 35).

<sup>28</sup> See, e.g., Romano, *supra* note 2; Winter, *supra* note 2, at 1529 ("we need . . . not a federal chartering statute but rather a second Delaware").



**Figure 7. When Federal Policymakers Demean Efficiency**

Posit also that state law race mechanisms push policy closer to the optimal rules for the corporate players. States race to the top, or at least Delaware does. Align managers with investors sufficiently closely so that  $I=M=D_i$ , which is well above  $P_o$ . Delaware is thus *more* efficient and productive here than would be the federal populist policymakers' preference. We could also posit that some investors, at  $I_o$  are inside the productivity vs. autonomy frontier, either because they are misguided, because they are headline-seekers without productivity in mind, or because they are captured by other interests who seek to divert corporate value from shareholders and managers. Some say that the public pension funds and the AFL-CIO funds fit this description.<sup>29</sup> If managers get their best result in Delaware ( $M=D_i$ ), then  $P_o$  and  $I_o$  might seek federal action. An uneasy coalition of populists and activist investors could displace the  $M=D_i$  result. We would reach the same result if we instead posited that federal policymakers were more often than not mistaken, thereby demeaning productivity when they acted. Wrongheaded policymakers at  $P_o$  could ally with  $I_o$  in Congress to try to overturn an  $M=D_i$  Delaware result in Congress. Either way, Delaware and some of its interest groups thus have a reason to move inside the parabola to reduce the intensity of federal opposition. They choose  $D_o$ .<sup>30</sup>

6. *The tax code and the corporations code.* An intuition behind the geometry is at hand. If Congress made most corporate law directly, America's corporate law would look more like the tax code the current corporate law in terms of the interests in play. Like the tax code, corporations and their governing law affect the broad mass of American citizenry, and Congress legislates public policy through whatever tools it has. It uses the tax code to promote exports, to promote research, to subsidize oil and

<sup>29</sup> See the discussion of the shareholder access debate *infra* note 52 & accompanying text.

<sup>30</sup> Superimposing the divided Washington from Figure 7 onto the earlier diagrams of a moderate Delaware can be reinterpreted in political theory's veto terms: As long as Delaware is moderate, polarized veto players in Washington either veto a major shift from  $D$ , or fear a counter-coalition (policymakers at  $P$  fearing populists and managers at  $P_o$ ,  $I_o$ , and  $M$ , say) that would shift the federal result farther from their preferred point. Philip Keefer & David Stasavage, *The Limits of Delegation: Veto Players, Central Bank Independence, and the Credibility of Monetary Policy*, 97 AM. POL. SCI. REV. 407 (2003).

gas exploration, to promote economic development in depressed areas, to better the environment, to subsidize medical care.<sup>31</sup> A national corporate code would be one more tool.

We need not go far back to find a concrete example: In the 2004 election, one candidate, “[r]esponding to widespread anxiety about the movement of American jobs overseas,” asserted that the tax code should be used to discourage outsourcing.<sup>32</sup> A national corporations code would likely be a tool for similar public goals. Tax exemptions, deductions, credits, and rates are a fundamental part of American social policy. If corporate law were made in Congress, it would similarly reflect more general public policy concerns, and broader interest group politics, than it now does.

7. *Shareholders’ and managers’ joint interest in minimizing federal influence.* Another public choice perspective can be seen here. I began this Part with managers and most investors allied, then analyzed how Delaware might react when they disagreed. Posit that they know that in Delaware the two of them split up the corporate pie. Although I have analyzed here the federal-state interaction primarily when their goals differ, much of the time their interests are the same, and managers and shareholders are more likely to get their preferred results in Delaware’s simple interest group environment than in Congress’s complex one. True, when they differ on a particular issue, shareholders might conclude that they could do better vis-à-vis managers by going federal. But they might not try to make a federal case even then, because the price of beating managers at the federal level could be leakage to other groups absent from Delaware, in a way that would make shareholders’ net benefit zero, or even negative.

Figure 8 illustrates. The federal players are two: productivity-oriented, competent policymakers at the top of the parabola, and populists deep inside the parabola. The policymakers at P care only about productivity (think about them as representing consumers’ interests, if one has trouble thinking of public-minded policymakers), so their indifference curve is a horizontal line going through D. They prefer the entire space above that line. The populists have a simple agenda here—they simply wish to reduce corporate power, preferring less managerial autonomy

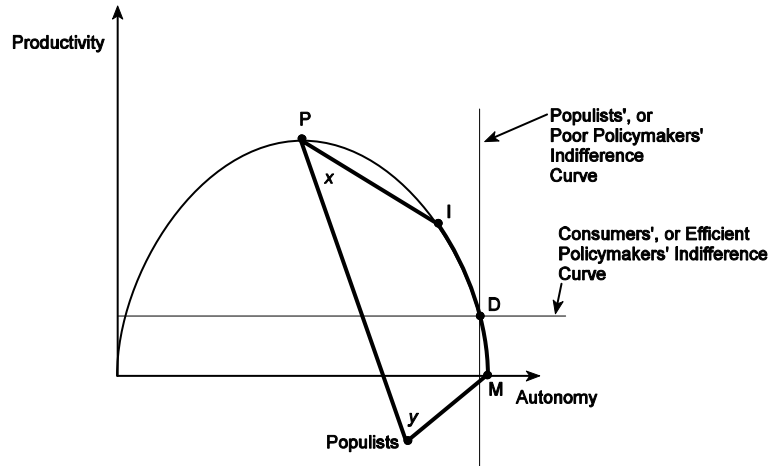
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<sup>31</sup> Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison With Direct Government Expenditures*, 83 HARV. L. REV. 705, 709-12 (1970); STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* (1985); CONG. RESEARCH SERV., *COMM. ON THE BUDGET, TAX EXPENDITURES COMPENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS*, 105<sup>th</sup> Cong., 2d Sess. (1998). Tax expenditures from the corporate tax are about \$100 billion per year. *Id.* at 7. Since the Treasury gets about between \$150 and \$200 billion each year from the corporate tax, U.S. TREASURY, *THE BUDGET FOR FISCAL YEAR 2004*, tbl. 2.1, at 29-30 (2004), the expenditure amounts to almost one-third of the potential total.

<sup>32</sup> Edmund L. Andrews & Jodi Wilgoren, *Kerry to Propose Eliminating a Tax Break on U.S. Companies’ Overseas Profits*, N.Y. TIMES, Mar. 26, 2004, at 12; Deborah McGregor, *Kerry pledges corporate tax policy reform*, FIN. TIMES, Mar. 26, 2004, at \_\_ (“Mr. Kerry presented his plan ... in Michigan, a politically important state where 6.6 per cent of workers are unemployed and many manufacturing jobs have moved abroad.”).

<sup>33</sup> This could be analogized to a standard prisoners’ dilemma game, with the prisoners able to coordinate and thus not defect. For how iterated prisoners’ dilemma games can lead to cooperation, see ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* 40-42, 53-54, 118-20 (1984). The status quo as impeding later change could also be illustrated with game theory’s theory of the core.

regardless of the effect on productivity.. Their indifference curve is a vertical line running through D.



**Figure 8. When Entering the Federal Arena Hurts Managers and Shareholders**

In this scenario, there is a possible policymaker-populist alliance, one that simultaneously increases corporate productivity and managerial autonomy. It runs approximately along the line between *x* and *y*. The primary corporate players oppose entering most of that space. If they fear that federal action would systematically push corporate policy deep enough into that space, investors and managers have reason to systematically oppose increasing the federal presence in corporate lawmaking.

And when managers' and investors' positions are the same, when  $M=D=I$ —or close—no federal action is normally possible. These two powerful interest groups cannot do better in Washington, so they resist moving the game to Washington. Only when overwhelming force—a major scandal or economic reversal—seriously empowers either the policymakers or the populists, or both, do the federal authorities act.

What's important conceptually about the geometry here is that the deal space in Congress is wider than that in Delaware. It encompasses all of the Delaware possibilities, and by adding new groups and ideas, the area of possible outcomes expands in ways that hurt managers and investors. The wider possibilities in Congress—either demeaning productivity or improving it in the name of fairness (or mistake), but hurting managers or investors or both—press the primary Delaware players to keep Congress quiet.

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The overall situation militates toward the two primary groups being reluctant to invoke federal authorities. Shareholders may on a particular issue conclude that they could do better enough in Congress to pay for the leakage to third parties who are weak in Delaware but strong in Congress. But they still might not go federal, fearing that if more corporate law were federal, more of the corporate pie would go to third parties on other issues.

Consider this report of federal activity in an era less conservative than our own: “A *national* coalition of union, consumer, liberal and leftist groups is emerging with the purpose of starting a broad, aggressive attack on what the activists regard as flagrant abuses of corporate power. The activists list several goals, including ... *citizen participation in corporate decision making*.”<sup>34</sup> And, more recently, William McDonough, chairman of the Public Company Accounting Oversight Board, told “a packed Washington ballroom ... at the National Association of Corporate Directors’ 2003 Annual Corporate Governance Conference” that

The way democracies work, if the people say they want something, they’ll get it. Nobody would have predicted Sarbanes-Oxley would have passed six months before it passed... . The American people are sufficiently angry that if the private sector doesn’t get its act together ... they’re going to get Sarbanes-Oxley No. 2, No. 3, No. 4, and it will curl your hair. I have been asked by many members of Congress if I could figure out a way that they could pass a law controlling compensation.<sup>35</sup>

Free rider effects might induce any individual Delaware player—an investor here, a manager there—to go federal on an issue especially salient to that player. But interest group associations temper individual action: the Business Roundtable for managers, the Council of Institutional Investors for one large class of stockholders, the Investment Company Institute for another. These associations can overcome free rider calculations of immediate interest. For shareholders or managers to go federal and be effective, at least one lobbying organization must swing into action. And even when one does go federal, it has reason to avoid institutionalizing easy federal action. It wants to win on the specific issue at hand, but it prefers not to institutionalize federal activity, which would make it easier for other interest groups to influence corporate law.<sup>36</sup>

8. *Delaware’s interest in minimizing federal influence.* Delaware though, as distinct from its primary interest groups, might not care that Congress federalized some corporate law. After all, if Congress federalizes a law, Delaware need not lose tax revenues; no one would flee Delaware because it lost an issue to Washington, because no other state could do better for managers and investors. Delaware loses corporate law, but not charters or taxes. And on some hot issues, Delaware’s state apparatus might even *prefer* federalization, which would level the state-to-state playing field by reducing other states’ opportunities on the contested issue, thereby letting Delaware compete and win where it’s stronger.<sup>37</sup>

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<sup>34</sup> William Serrin, *Coalition Forming for a 1980’s Drive Against Business*, N.Y. TIMES, Jan. 19, 1980, at 19 (emphases added). [See Zachary Gubler, Corporate Governance Seminar Paper Outline (Jan. 15, 2005)].

<sup>35</sup> Michael P. Bruno, *Exec Comp to Haunt Directors in 2004*, INSTITUTIONAL SHAREHOLDER SERVICES, THE FRIDAY REPORT (Oct. 24, 2003), available at [www.iss.proxy.com](http://www.iss.proxy.com).

<sup>36</sup> This could be analogized to a standard prisoners’ dilemma game, with the prisoners able to coordinate and thus not defect. For how iterated prisoners’ dilemma games can lead to cooperation, see ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* 40-42, 53-54, 118-20 (1984). The status quo as impeding later change could also be illustrated with game theory’s theory of the core.

<sup>37</sup> Roe, *supra* note 3, at 637.

But Delaware would be unwise to let a lot move to Washington. Letting it go would annoy its primary interest groups, who might want Delaware to protect managers and investors from federal action. Its reputation for good lawmaking would be hurt if federal authorities regularly displaced it. If the public or corporate America lost confidence in Delaware, the franchise tax would be threatened. If Delaware authorities lost their esprit, their lawmaking quality would suffer. If too much went federal, the bar and corporate America could conclude that Delaware had lost its relevance. If this occurred, fewer firms would want to go to Delaware, and Delaware's network externalities would weaken because it did less, thereby opening up competitive opportunities for other states. At the limit, if Washington made all corporate law, but states still chartered firms, then Delaware couldn't charge more because its charter wouldn't come with any local law. Delaware's tax bonanza would shrivel.

Moreover, Delaware's primary interest groups—managers and investors—usually do not want corporate law to go federal. Nor do its secondary interest groups—its corporate bar and its corporate industry. National law is litigated elsewhere; when Congress or the SEC makes the rules, the Delaware bar watches as corporate litigation moves to federal courts.<sup>38</sup> Delaware's interest groups can influence Delaware's politics even without threatening to remove the franchise tax.

9. *Efficiency?* Efficiency-oriented analysts who think federal action would usually push corporate policy to better, more cost-effective corporate governance, more competition, more rewards to innovation, prefer more federal action.<sup>39</sup> Others fear well intentioned but *inefficient* federal policymakers—or fear interest group gridlock that would cramp corporate agility and prove costly to the economy. Still others would prefer corporations to have a wider conception of the public good—and more interest group input—than Delaware gives them. Views on whether more federal action is wise may depend not only on which outcome the speaker *prefers*, but also on which federal outcome the speaker *anticipates*.

Could the multi-level federal structure improve on single-level governance? If the state-level is defective, a federal overlay can ameliorate that drop to the bottom. But if the federal level is defective, the de facto delegation may narrow the interest group input and cabin federal corporate lawmaking. By separating a proposal from ratification, the bifurcated structure could reduce the defects of each.<sup>40</sup> Congress

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<sup>38</sup> Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859 (2003); Robert B. Thompson, *Corporate Governance After Enron*, 40 HOUS. L. REV. 99 (2003).

<sup>39</sup> See Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 636-37 (2004); cf. Pierre Salmon, *Vertical competition in a unitary state*, in COMPETITION AND STRUCTURE: THE POLITICAL ECONOMY OF COLLECTIVE DECISIONS: ESSAYS IN HONOR OF ALBERT BRETON 239, 253 (Gianluigi Galeotti, Pierre Salmon & Ronald Wintrobe, eds. 2000). Cf. also Lucian Bebchuk & Allen Ferrell, *Federal Intervention to Enhance Shareholder Choice*, 87 VA. L. REV. 993 (2001).

<sup>40</sup> Cf. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 303-04, 308 (1983). See generally DAVID EPSTEIN & SHARYN O'HALLORAN, *DELEGATING POWERS: A TRANSACTION COST POLITICS APPROACH TO POLICY MAKING UNDER SEPARATE POWERS* (1999).

cannot decide everything; Delaware, with money to protect, has reason to avoid losing that money.

Such theories are hard to test. The two-tiered structure might not propel Delaware to do better. True, if federal actors are usually good lawmakers when they are attentive, then their looming power ought to induce Delaware to be better. But if they're usually worse, Delaware would head them off with bad law, not good law. And, if it's the random scandal that induces federal action, then Delaware has reason to market that it can control scandalous corporate matters. Public relations, not good lawmaking, would become the issue. Conceivably the recent well-publicized trial on Michael Orvitz's \$125 million paycheck from Disney is a Delaware show trial, one that shows that it's getting the corporate scandals—Enron, WorldCom, and executive pay—under control.

## B. Examples

Thus far we've generated two major results from the abstractions of federal-state relations in making American corporate law. Delaware has reason to temper its dominant interest group due to the federal overlay. When Delaware's interest groups are unified such that it can act first, they can set the status quo and sometimes deflect federal action. Its interest groups jointly do better in Delaware than in a federal forum.

Here we look for concrete examples that fit these two federal-state public choice interactions. We've seen one already: the wide array of interests and ideas that work their way into the tax code, as would be common if corporate law were made in Congress.<sup>41</sup> There are others: antitrust, foreign corrupt practices, takeovers, state-law constituency statutes, and the incentives and actions of big-state public pension funds each point out how moving a corporate issue from Delaware to the federal arena would change the players and pressures. Some moved, some did not. And whether they did or did not move affected who won and who lost.

*1. Federal displacement: actual and potential – (a) Antitrust.* During the late 19<sup>th</sup> and early 20<sup>th</sup> century corporate law and antitrust issues intertwined, and states decided both. Several industries sought to stabilize shaky cartels with trusts, in which a centralized trustee held the stock of constituent companies and coordinated their production quotas. The trust form arose at the end of the 19<sup>th</sup> century because states barred their corporations from owning stock of other states' companies. This trend reversed in 1889 when New Jersey, and then later Delaware, passed corporate law that helped integrate disparate producers into a single company. This led the antitrust forces to call for a federal incorporation law and for federal antitrust enforcement.<sup>42</sup>

The key state players were insiders and investors. Both wanted corporate law to facilitate monopolization and cartelization. They initially got favorable organizational law, via the trusts. But the trusts were clumsy, and some states—states like Ohio with players beyond managers and investors, progressive players who preferred public-

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<sup>41</sup> See supra p. 19.

<sup>42</sup> See generally James B. Dill, *National Incorporation Laws for Trusts*, 11 YALE L.J. 273 (1902); [Lincoln Steffens, *New Jersey: A Traitor State, Part I*, MCCLURE'S, May 1905, at 46–47.]



regarding policies—attacked them.<sup>43</sup> The smaller states, though, like New Jersey and Delaware, streamlined their holding company rules, thereby allowing holding companies to overcome the trusts' organizational weaknesses. Owners and insiders got what they wanted. On the small-state level, the progressives, public interest advocates, and anti-big-business players (T.R., Sherman, and Brandeis) were weaker than they were in bigger states and in Washington.

In Washington, the progressive forces were eventually strong enough to upset the first (pro-trust) coalition with antitrust law and enforcement. In time, the antitrust forces won, and they won at the federal level.

The pro-trust forces prevailed for a time at the state level, because public interest players and the average American voter were underrepresented in key small states. The pro-trust forces thus got their monopolizing corporate law mechanisms, and it took a decade or two for federal authorities to catch up with them. During that time, players who could dominate a small state but not Congress reaped monopoly profits. The 1901 U.S. Steel merger built a monopoly that eroded by 1920, but J.P. Morgan and his syndicate made much money in the interim. The Standard Oil monopoly formed via a trust in the 1880s, benefited from New Jersey's corporate law in the 1890s, and persisted until destroyed at the federal level in 1911. Agenda sequencing counted. If federal authorities had acted first, and had later decided whether to defer to states, then the monopolies would not have won initially. The end result was not monopoly forever, but monopoly for two decades, which is plenty.

(b) *Foreign corrupt practices.* Corporate players had little reason to reduce American corporate bribery of foreign government officials. Bribery could backfire, but so could other investment or business decisions. In the narrow sense, managers and investors could see the corporate decision to bribe a foreign official to sell warplanes, to build a dam, or to get a tax concession as just another business decision.

But that bribery could undermine American foreign policy, so national policymakers might want to stop it for moral or foreign policy reasons. Moving the play from Delaware changed the range of players with power to decide and, via the Foreign Corrupt Practices Act of 1977, preempted the state law result.<sup>44</sup>

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Though the antitrust and corrupt practices examples have a negative connotation to state insulation, in other settings Delaware's first-mover advantage in setting a status quo could make for a corporate law could be different. Depending on one's views of the policy matters, some of the following examples might be positive ones.

(c) *Takeovers?* When hostile takeovers were important, managers—via the Business Roundtable and National Association of Manufacturers—opposed moving the decisionmaking to Washington, even though Delaware at the time was not producing strong antitakeover rulings and statutes they wanted.<sup>45</sup> Raiders favored preemption, but shareholders generally were silent. And in Delaware, managers—or at

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<sup>43</sup> State *ex rel.* Attorney Gen. v. Standard Oil Co., 30 N.E. 279 (Ohio 1892).

<sup>44</sup> Pub. L. No. 95-213 1494 (codified in scattered sections of 15 U.S.C.).

<sup>45</sup> *Witnesses at Takeover Bill Hearing Split on Preemption of State Regulation*, 19 SEC. REG. & L. REP. 851, 851 (1987).

least their lawyers—argued that Delaware should make moderate takeover law because something strong would risk federal intervention.<sup>46</sup>

(d) *Sarbanes-Oxley*. The statute overall illustrates a Congress swept by scandal and national opinion into regulating corporate organization in a way it usually leaves to state law. Delaware authorities did seek the chance to remedy the corporate governance debilities that the scandals highlighted,<sup>47</sup> but the state didn't act dramatically, perhaps because the concerned officials were judges, who need a case to act, or because Delaware's primary interest groups wouldn't have been able to agree easily on what to do.<sup>48</sup>

Two secondary aspects of Sarbanes-Oxley exemplify the interest group density in the federal forum: It bars executives and directors from trading their companies' stock during blackout periods when their companies' employees could not trade,<sup>49</sup> and it also requires executives whose companies later go bankrupt to return any profits made from bailing out of their companies' stock.<sup>50</sup>

Few managers, and probably not too many investors, were interested in either provision. Supporters in Washington, however, included players without much muscle in Delaware lawmaking, such as Local 125 of the Internal Brotherhood of Electrical Workers [and the Pension Rights Center, the Employee Benefit Research Institute, the American Association of Retired People, the Consumers Union, and the Consumer Federation of America].<sup>51</sup>

(e) *Shareholder access*. The SEC proposed recently that shareholders have direct access to public companies' proxy statements to nominate directors, thereby evoking both ends of the federal spectrum with productivity and, possibly, populist

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<sup>46</sup> Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 908 (1990) (describing the merger bar's concerns that "passing this [antitakeover] proposal would be the proverbial camel-back-breaking straw that would force Congress to enact national corporate chartering"). The well-known merger lawyer Joseph Flom lobbied against an anti-takeover law partly because it could provoke federal preemption. Martin Lipton, the well-known *anti*-takeover lawyer, also lobbied *against* that same anti-takeover law. *Id.* at 906.

<sup>47</sup> E. Norman Veasey, *The Role of the Delaware Courts in United States Business Litigation*, Address Before ALI-ABA Advanced Course of Study on United States Domestic and International Litigation and Dispute Resolution 1, 3 (Apr. 11, 2002) (on file with the Harvard Law School Library). See also E. Norman Veasey, *Musings on the Dynamics of Corporate Governance Issues, Director Liability Concerns, Corporate Control Transactions, Ethics and Federalism*, 152 U. PA. L. REV. 1007, 1017-18 (2003) (Sarbanes-Oxley should not induce state lawmakers to despair but "should inspire states to be a part of the solution").

<sup>48</sup> See Strine, *supra* note 6, at 1268-70 (quoted *supra* on p. 7).

<sup>49</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 306, 116 Stat. 779 (codified at 15 U.S.C. § 7244 (2003)). The bar applies to stock the executive acquired in connection with employment at the company.

<sup>50</sup> Sarbanes-Oxley Act of 2002, §§ 304, 306.

<sup>51</sup> Senate Comm. On Governmental Affairs, 107<sup>th</sup> Cong., *Retirement Insecurity: 401(k) Crisis at Enron 9-11* (2002); Sen. Comm. on Health, Education, Labor, and Pensions, *Protecting the Pensions of Working Americans: Lessons from the Enron Debacle* (Feb. 7, 2002) (2002-S431-23); House Comm. On Education and the Workforce: *Enron and Beyond: Legislative Solutions* (Feb. 27, 2002) (CIS-NO: 2003-H341-13); Sen. Legislative History of Title VIII of HR 2673: *The Sarbanes-Oxley Act of 2002* (July 26, 2002) (148 Cong Rec S 7418).

considerations. The SEC sought greater managerial accountability, to make American companies better run. Said its SEC champion: the commission's goal here should be to better control "a small minority of lazy, inefficient, grossly overpaid and wrongheaded C.E.O's."<sup>52</sup> Here is the productivity motivation for federal action.

Managers opposed the SEC. They said that greater shareholder access would play into the hands not of shareholders, but of groups that wanted to influence the corporation. The Business Roundtable—managers' principal lobbying organization—charged that access would empower state and labor union pension funds to advance their collateral agenda, one not tied tightly to corporate profitability.<sup>53</sup> For similar reasons CalPERS' support as stockholder for labor unions in the Safeway strike—discussed next—was cast as a harbinger of what would happen if such shareholders had direct access to corporate America's proxy statements.<sup>54</sup> Here was the populist, new interest group motivation or result perceived to be part of federal action, just as it was part of big state investments.

2. *Analogous larger jurisdictions.* -- The basic thesis here is an analogy: Delaware is like an independent agency in several respects, although much farther from the congressional orbit. With the analogy in mind, we can better our understanding of American corporate lawmaking. Such an analogy doesn't directly yield disprovable statements: Differences between agencies and Delaware just weaken the analogy. But no one would say Delaware is *just* like an agency, so differences don't disprove the analogy.

But the analogy yields implications that are themselves testable and refutable. While Delaware can't go so far from congressional preferences that it goads them to act, we'd expect it to use its slack for its own and its dominant interest groups benefit. So, we'd expect that its rules would differ from those made in larger jurisdictions with more heterogeneous interest group inputs. In theory this yields refutable implications—if we turned Delaware off for two decades while Congress made corporate law directly or through a normal agency, we'd expect a differing tilt.

That test can't be run before this Article is published. But we can look to other polities larger than Delaware and see if when make corporate or similar law they resemble Delaware or evince greater interest group inputs.

(a). *CalPERS.* State public pension funds, an institutional close cousin to state corporate law, are subject to the wider pressures I say would be in play if Congress were more active in making American corporate law

California is a big state; its huge public pension plan—one of the biggest stockholders in America—faces the mix of interests that would emerge if American corporate law were made primarily on the national stage instead of in little Delaware.

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<sup>52</sup> Stephen Labaton, *S.E.C. Members Says Agency Has Bowed to Executives*, N.Y. TIMES, Oct. 9, 2004, at C1. The quotation is of Harvey Goldschmid, an SEC Commissioner. The words could also be turned into a populist statement too.

<sup>53</sup> John J. Castellani & Amy Goodman, *The Case Against the SEC Director Election Proposal*, in *SHAREHOLDER ACCESS TO THE CORPORATE BALLOT* \_\_ (Lucian Bebchuk ed. 2004) (forthcoming) (MS at 9-10, 18-19). John Castellani is the president of the Business Roundtable.

<sup>54</sup> Joann S. Lublin & Jonathan Weil, *Gadfly Activism at CalPERS Leads to Possible Ouster of President*, WALL ST.J., Dec. 1, 2004, at A1. See Part 2.(a).

Consider CalPERS' "double bottom line." When running its stock portfolio, it looks first at the return to shareholders. But it also looks, says its president, to "producing some other good for the citizens of California."<sup>55</sup> New York's Governor appointed a task force during the takeover-era that endorsed similar policies.<sup>56</sup> Roberta Romano has shown that politically-motivated investment policies fall short of the market rate of return.<sup>57</sup> Said a recent conservative chair of the SEC, after his tenure was over, state pension fund influence on the American corporation is to be avoided: "I think we will all be better off if we were spared the extension of our flawed political system to our corporate boardrooms[.]"<sup>58</sup> Meanwhile, Washington players have "advocated using public pension funds to finance infrastructure projects..."<sup>59</sup>

Consider this excerpt from a recent CalPERS letter to one of its portfolio companies, Safeway, regarding a labor there that had become a public controversy. The letter uses the language of shareholder value, but one wonders whether shareholder value or public policy was primary:

CalPERS currently owns \$77,181,120 worth of equity shares in your company. ... As a long term investor we believe that fair treatment of employees [including providing a reasonable health plan] is a critical element in creating long term value for shareholders. ... [Y]our corporation's blatant disregard for quality of life issues ... is having a significant impact on our investment in your corporation. [W]e urge you in the strongest terms possible, to negotiate in good faith with the UFCW [the United Food and Commercial Workers union] and to provide a benefit package that enhances the productivity of your employees as well as the long term value for shareowners.<sup>60</sup>

CalPERS then sought to block reelection of Safeway's President and CEO to the Safeway board. The press, or at least the conservative press, thought that CalPERS was not acting in its beneficiaries' interest as stockholders, but was motivated by a desire to change Safeway's labor policy.<sup>61</sup> But CalPERS' leaders—selected by

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<sup>55</sup> Simon London, *The Boardroom Burden: Calpers chief relaxes in the eye of the storm*, FIN. TIMES, June 2, 2004, at 12.

<sup>56</sup> GOVERNOR [CUOMO]'S TASK FORCE ON PENSION FUND INVESTMENT, OUR MONEY'S WORTH 45-48 (1989).

<sup>57</sup> Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 826-27 (1993).

<sup>58</sup> Adrian Michaels, *Former SEC Chairman Attacks Plans to Let Investors Nominate Directors*, FIN. TIMES, Apr. 28, 2004, at 1. The former chair, Harvey Pitt, was commenting on an SEC proposal to extend shareholder authority, which he feared would further empower state pension plans.

<sup>59</sup> Romano, *supra* note 57, at 796.

<sup>60</sup> Cf. Letter from CalPERS to Steven A. Burd, Chairman, President & CEO Safeway Inc., dated Dec. 17, 2003, re United Food and Commercial Workers Labor Negotiations. This and similar CalPERS letters are at [www.calpers.ca.gov/eip-docs/about/press/news/invest-corp/ufcw-supermarket-ltr.pdf](http://www.calpers.ca.gov/eip-docs/about/press/news/invest-corp/ufcw-supermarket-ltr.pdf).

<sup>61</sup> See also *Calpers Comeuppance*, WALL ST. J., May 24, 2004 (editorial) ("most shareholders ... concluded that the real Calpers agenda [in opposing Safeway's CEO for reelection] was political—namely to punish [him] for driving a hard bargain with his unionized work force. Eleven of Calpers's 13 board members have strong ties to organized labor ..."). Cf. Deborah Brewster, *Unions discover how to get a voice in the boardrooms*, FIN. TIMES (London), May 4, 2004, at 22 (AFL-CIO finding state pension funds as allies, with "[t]he more activist funds tend[ing] to be ... from Democratic states, such as California and New York, and those with union representatives on their boards.").

ordinary pensioners and California politicians<sup>62</sup>—could be seen as representing a broader constituency. For similar reasons, CalPERS also invests in California's economically depressed areas and promotes environmental and other social issues in its portfolio firms.<sup>63</sup> Conservative legislators, unhappy with CalPERS' activities now seek to allow California's pensioners to manage their own pension monies, which would erode CalPERS' power.<sup>64</sup>

(b) *Constituency statutes.* Other interests are not always on the periphery of state corporate law, as they are in Delaware.<sup>65</sup> It depends on which state, and what issue. Consider constituency statutes, which bring public forces into corporate governance, via the rhetoric of managerial discretion to consider interests beyond shareholders and managers.<sup>66</sup> True, their effect has largely been to give managers a rhetorical basis for opposing takeovers. State constituency statutes can thus be seen as managers going up from the baseline of the trapezoid in Figure 8, allying with employee and locality constituencies to get rules that favor themselves over shareholders.<sup>67</sup> It's the kind of alliance Congress could produce.

Or, consider the following: A committee in California's legislature recently considered but dropped an amendment to its corporate law give corporate constituencies a derivative action to sue directors for violating environmental, labor, and affirmative action law.<sup>68</sup> Although passage wasn't a real threat, it's at the extreme end of what's considered in big states and could be considered in Congress.<sup>69</sup>

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<sup>62</sup> CAL. GOV. CODE § 20090 (2005).

<sup>63</sup> Romano, *supra* note 57, at 804, 809; Jayne E. Zanglein, *High Performance Investing: Harnessing the Power of Pension Funds to Promote Economic Growth and Workplace Integrity*, 11 LAB. LAW. 59 (1995); Deborah J. Martin, *The Public Piggy Bank Goes to Market: Public Pension Fund Investment in Common Stock and Fund Trustees' Social Agenda*, 29 SAN DIEGO L. REV. 39, 46-47 (1992). See Press Release, [Cal.] Treasurer Angelides Wins CalPERS Approval of Innovative "Clean Technologies" Investment Program, A Key Part of His "Green Wave" Environmental Investment Initiative (2004), available at [www.treasurer.ca.gov/news/releases/2004/031504\\_clean.pdf](http://www.treasurer.ca.gov/news/releases/2004/031504_clean.pdf); Marc Lifsher, CalPERS to Start Green Investment Program, L.A. TIMES, Mar. 16, 2004, at C3.

<sup>64</sup> Mary Williams Walsh, *Calpers Ouster Puts Focus on How Funds Wield Power*, N.Y. TIMES, Dec. 2, 2004, at C1.

<sup>65</sup> Cf. 1 AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 6.02(b)(2) (1994) (target board may act in "regard for interests or groups (other than shareholders) with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long-term interests of shareholders."); Leo E. Strine, Jr., *The Social Responsibility of Boards of Directors and Stockholders in Change of Control Transactions: Is There Any "There" There?*, 75 SO. CAL. L. REV. 1169 (2002).

<sup>66</sup> Given the business judgment rule (and court decisions that give managers wide discretion even in Delaware, see Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. \_\_\_ (2005)), these acts are largely symbolic. But what is relevant that larger and more liberal states enact symbols that differ from smaller and less liberal states.

<sup>67</sup> Jonathan D. Springer, *Corporate Constituency Statutes: Hollow Hopes and False Fears*, 1999 ANN. SURV. AM. L. 85, 96 (1999) ("[The] 1989 amendment strengthening [Pennsylvania's constituency] statute was co-sponsored by the local AFL-CIO. ...").

<sup>68</sup> Cal. SB 917 (2004).

<sup>69</sup> A cynic's view of Congress is sometimes that "there is no rule of corporate or financial law that is so bad tha the United States Congress with a little attention cannot make worse." Perhaps it comes from a conservative cynic. However bad the (semi-)private lawmaking in Delaware is from the managers' and investors' perspective, more groups are likely to be cut in if the rulemaking moves to Washington.

Most states' polities resemble the national polity more than Delaware's does, and forty-one of them have produced constituency statutes.<sup>70</sup> More liberal states tend to pass broader constituency statutes, which give lip-service to managers considering other constituencies in all corporate matters, not just takeovers. (Since managers have wide discretion with the business judgment rule, much that is in such statutes is symbolic.) And more populous states—where the interests in play are presumably wider than in Delaware—have a greater rate of reincorporation away and into Delaware than do smaller states.<sup>71</sup>

Delaware has no constituency statute.

(c) *Europe*. Consider this summary of William Carney's precise contrast of American state-made corporate law with European center-made corporate law:

Carney compared the law of the eight European Directives on company law with the corporate laws in the United States. For that, he ... divided [the directives] into 131 provisions, and searched ... for similar [U.S.] provisions. The result was that 95 provisions were in effect in no US-state, 14 were in effect in all 50 states, and the remaining 22 provisions were adopted by [some] states. The [95] provisions ... in effect in no US-state mainly consisted of protections for creditors, employees and other stakeholders. ... Carney concluded that ... European harmonization was strongly influenced by [outside] interest groups...<sup>74</sup>

Or consider the 2001 draft of the EU's Thirteenth Directive on takeovers. It would "require[] the board of a target company to 'act in the interest of all the

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<sup>70</sup> Ryan J. York, *Visages of Janus: The Heavy Burden of Other Constituency Anti-takeover Statutes on Shareholders and the Efficient Market for Corporate Control*, 38 WILLAMETTE L. REV. 187, 189 (2002).

<sup>71</sup> Data available from the author. Not all the results here are statistically significant or powerful. But they point in the direction of the thesis here. One could interpret the incidence of the broad constituency statutes in this way: a Democratic state insists on the symbolism of the corporation as run for constituencies. But in less Democratic states, managers can get a simple transactional constituency statute for takeovers without having to pay with wider rhetoric. Managers want maximum discretion in takeovers to protect their own jobs, but want minimal legislative intrusion—even rhetorical intrusion—into how they otherwise run the firm.

<sup>72</sup> Cal. SB 917 (2004).

<sup>73</sup> A cynic's view of Congress is sometimes that "there is no rule of corporate or financial law that is so bad that the United States Congress with a little attention cannot make worse." Perhaps it comes from a conservative cynic. However bad the (semi-)private lawmaking in Delaware is from the managers' and investors' perspective, more groups are likely to be cut in if the rulemaking moves to Washington.

<sup>74</sup> Mathias M. Siems, *Numerical Comparative Law*, at 3 (SSRN working paper, March 2004), summarizing William J. Carney, *The Political Economy of the Competition for Corporate Charters*, 26 J. LEGAL STUD. 303, 318-27 (1997). Cf. Carney, *supra* note 9, at 718 & n.7 ("other interest groups [beyond the organized corporate bar] do not play a significant role in influencing corporate law in the United States. ... This phenomenon is in distinct contrast to the situation in Europe."); Alan Cowell, *Oslo Journal: Brewmaster Breaks One Tradition but Upholds Another*, N.Y. TIMES, Dec. 24, 2004, at A4 (the slowness of promoting women in "the clubby world of Norwegian business ... prompt[ed] the government to tell companies that if women do not constitute at least 40 percent of corporate boards by July 2005, they will be required by law to hire more women as executives."). Norway is not a member of the EU; the nation's central political body is in Oslo.

Below I consider cause-and-effect. More EU corporate law may be made centrally because the EU is overall less conservative on such matters than is the U.S. See Part VI (Is Delaware Cause or Effect?).

company, including employment' when responding to a bid ... . [consideration was given to require[ing] both the bidder and the target companies to ... consult[] with employee representatives during the course of the bid.”<sup>75</sup> Other EU laws require this kind of jaw-boning consultation during downsizings and prior to asset transfers.<sup>76</sup>

An American big-state analogue is New York's corporate law, which makes a New York corporation's ten biggest shareholders personally liable for employee wages.<sup>77</sup> The provision has been described as “the single most important reason why New York shareholders decide to incorporate in Delaware.”<sup>78</sup> From 1994 until 1997, the New York Senate “approved the bill [to repeal this liability] every year, but it had repeatedly died in the Assembly. Labor blocked the bill because [it would have deleted the shareholder guarantee] ... and legislators ... did not want to be seen as catering too much to business interests.... [In 1997, for example,] labor groups were adamant about retaining [the liability] and [eventually] corporate attorneys reluctantly acceded.”<sup>79</sup>

3. *Regulatory method — (a) Ex post fiduciary duties vs. encompassing regulation.* Delaware's judges are often celebrated in the corporate literature. The state's primary lawmaking mode is judicial interpretation of fiduciary duties, punctuated by occasional legislation. Yet the state could adopt another lawmaking strategy: it could use a regulatory agency with proactive, anticipatory rulemaking authority—one that uncovered problems, that investigated firms, their managers, and their owners, and that, like the SEC, often restricts activities of firms, managers, and owners prospectively.

But it hasn't. It acts via ex post judicial review of corporate actions, focusing on the fairness and efficacy of shareholder-board relationships. That's what one would expect if only managers and shareholders' representatives counted.<sup>80</sup> Why regulate if the primary parties can make a deal and the judges can arbitrate?

Federal authorities act at times through similar modes—the Second Circuit's use of the general anti-fraud rule, 10b-5, in the 1970s comes to mind—but they more often

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<sup>75</sup> Simon Deakin, *Regulatory Competition Versus Harmonization in European Company Law*, in REGULATORY AND ECONOMIC INTEGRATION: COMPARATIVE PERSPECTIVES 190, 214 (Daniel C. Esty & Damien Geradin eds. 2001).

<sup>76</sup> *Id.*

<sup>77</sup> N.Y. BUS. CORP. LAW, § 630 (McKinney 2002). Listed companies are exempt, but companies tend to de-list when they become insolvent. Kahan & Kamar, *supra* note 5, at 732 n.194.

<sup>78</sup> Frederick Attea, *State Has Hard Time Following a Lead*, BUS. FIRST IN BUFFALO, Apr. 17, 2000, at 30. Cf. Michael M. Membrado & Christopher J. Gulotta, *Navigating the Formation of Start-Up Companies*, N.Y. L.J., Sept. 18, 2000, at S6, S17. These sources are analyzed in Kahan & Kamar, *supra* note 20, at 732 & n.195.

<sup>79</sup> Dominic Bencivenga, *At Long Last, a Bill*, N.Y.L.J., July 31, 1997, at 5. Cf. Richard Siegler, *Impact of Business Corporation Law Amendments*, N.Y.L.J., Oct. 29, 1997, at 3, 4 (Section 630 not repealed due to “strong opposition from labor unions”).

<sup>80</sup> The rhetoric of the law covering board-shareholder relationships has analytic differences: is it a contract whose holes have to be filled in, or is it a fiduciary relationship? But in each analytic riff, the relationship that counts is between managers and shareholders, and the mode of regulation is narrow and ex post, not broad and prospective. Compare FRANK EASTERBROOK & DANIEL FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* \_\_ (1991) with Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985).

act through a regulator: the Securities and Exchange Commission. The SEC lacks full authority over corporate law, but where it can act, it regularly does so prospectively, via regulation, via civil fines, and—with other federal authorities' help—via incarceration. Further, consider Congress's Sarbanes-Oxley corporate governance reforms of 2002. That Act raised the obligations of managers, boards, and institutional investors. Yet, "[it] was viewed as ... too prescriptive and harsh to the financial community and corporations."<sup>81</sup> These directly affected groups, who pay the initial costs of these changes, are the very groups that dominate Delaware. Hence, one would not have expected such reforms to come out of Delaware. And they did not.<sup>82</sup>

(b) *Arbitration vs. prosecution.* Would managers and institutional stockholders want their disputes dealt with via criminal prosecution or via arbitration? Presumably the latter. While each side has reason to want to criminalize the other's derelictions, it would be hard to criminalize the other's without criminalizing its own. Both prefer to avoid criminal penalties, and favor having a wise arbitrator—called, say, the Delaware Chancellor—decide their disputes without criminal sanctions. And that's just about how Delaware law works.

Corporate and financial prosecutions emerge in big states, like New York (think of N.Y. Attorney-General Elliot Spitzer's recent prosecutions), or in a United States Attorney's office (think of Rudolph Giuliani's late-1980s prosecutions), not in Delaware. A franchise-tax motivated polity that responds to operating managers' and investment managers' preferences would not heavily use as its instrument of choice regulating and jailing—and Delaware has not.

#### IV. POLITICAL THEORY AND THE DELAWARE-FEDERAL RELATIONSHIP

##### A. Triggering Federal Action

Thus, the two main players in American corporate law generally want the game played in Delaware. What would move the game to Washington? A disgruntled Delaware player's appeal is the main trigger we've thus far examined. (Other states' actions are less likely to goad federal authorities into action, because other states are neither likely to strongly affect the national economy—since they aren't the home to half of corporate America—nor likely to motivate America's managers or its investors to seek federal help.<sup>83</sup>)

National political forces, when powerful enough to temporarily overcome Delaware's agenda-setting power, could also move the game from Delaware to Washington. Sarbanes-Oxley is one example. The public outcry over the Enron and WorldCom scandals disabled managers' ability to oppose federal legislation. In fact,

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<sup>81</sup> Rabiollah Rezaee & Pankaj K. Jain, *The Sarbanes-Oxley Act of 2002 and Securities Market Behavior: Early Evidence* 9 (SSRN working paper, Dec. 2003).

<sup>82</sup> Thompson, *supra* note 39. Cf. Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595 (1995) (analogous lawmaking results when interest groups dominate American Law Institute or state Uniform Law commissions).

<sup>83</sup> See Roe, *Delaware's Advantage*, *supra* note 4.



nearly every decade in the twentieth century had a corporate issue of such importance that the issue moved into the federal arena, or seriously threatened to do so.<sup>84</sup>

Political scientists have sketched the general characteristics of issues that burst onto the congressional agenda. An issue can sit on the policy agenda for years and go nowhere in Congress. Then a focusing event occurs and the issue moves onto the congressional agenda for action.<sup>85</sup>

*1. Scandals, and public-oriented action.* Congress sets aside Delaware-based, quasi-private lawmaking when the media show gross corporate wrongdoing or when poor national economic performance is plausibly tied to corporate governance.<sup>86</sup> Congress thus acts sporadically, but sporadic doesn't mean unimportant. Scandals serve as focusing events that motivate national politicians. True, Delaware can't fully control scandals. They don't always arise directly from corporate law lapses and, even when they do, the companies involved might not have been Delaware-chartered firms. Enron was not a Delaware company. Nevertheless, any corporate scandal induces scrutiny, and if Delaware seems incompetent or in its interests' pockets, stronger federal action is thereby made more likely.<sup>87</sup>

Or, in terms of the preference aggregation model from the earlier diagrams, at times a populist or a public-policy idea—or their underlying interests—gets enough power to dominate the congressional agenda, and the forces for managerial autonomy are weaker than usual. At that point, the populists or the productivity-oriented public-policy people can dominate without allied interest groups from inside the corporation. As Phil Gramm, the conservative anti-regulatory Senator, said when the Enron and WorldCom scandals hit and Sarbanes-Oxley was under discussion: “In the environment we are in, virtually anything can pass. Everybody is trying to outdo everybody else.”<sup>88</sup> The Business Roundtable at first opposed the legislation,<sup>89</sup> preferring self-regulation, but joined the bandwagon when legislation seemed inevitable and popular reaction made it too uncomfortable to stay opposed. Only later,

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<sup>84</sup> Roe, *Delaware's Competition*, supra note 3, at 610-34. See supra p. 5.

<sup>85</sup> JOHN W. KINGDON, CONGRESSMEN'S VOTING DECISION 264 (1973); JOHN W. KINGDON, AGENDAS, ALTERNATIVES, AND PUBLIC POLICIES 94-99 (2d ed. 2003). Cf. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance* (working paper, 2004) (MS at 2-3).

<sup>86</sup> See Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. 167 (1990).

<sup>87</sup> This process parallels a once-classic view of American political history in which private interests produce wealth, but become corrupt or incompetent (or corrupt the State), and then national reformers rebuild the private sector. Jacksonian democracy, the Progressive movement, and the New Deal are said to illustrate. E.g., RICHARD HOFSTADTER, *THE AGE OF REFORM* 234 (1955); ROBERT H. WEIBE, *THE SEARCH FOR ORDER* 45, 52-53 (1967); ARTHUR M. SCHLESINGER, JR., *THE AGE OF JACKSON* (1945).

<sup>88</sup> Rezaee & Jain, supra note 81, at 7.

<sup>89</sup> Letter, dated May 20, 2002, from John Castellani, President, The Business Roundtable, to Paul S. Sarbanes, Chairman, Sen. Comm. on Banking, Housing and Urban Affairs, Re: Public Company Accounting Reform and Investor Protection Act of 2002 (opposing key provisions of Sarbanes' bill); Arianna Huffington, *Fiscal Reforms? The Fix Is In: Nothing Will Change Without Public Outrage*, L.A. TIMES, July 11, 2002.

when the fires subsided, did the Business Roundtable start seeking to roll-back the regulation.<sup>90</sup>

2. *Police patrols vs. fire alarms.* Mathew McCubbins and Thomas Schwartz identify two main means by which Congress controls federal agencies: police patrols and fire alarms. Congress could continuously keep an eye on what the agency is doing, via regular police patrols. Or it could sit back and do nothing unless constituents scream, fire alarms go off, and the media spots a big issue—again, a focusing event.<sup>91</sup> Congress, I submit, primarily oversees Delaware's corporate law via the second mechanism; the fire alarm is a scandal or bad economic performance. And the SEC serves as Congress's secondary police patrol, keeping an eye on the American corporation via continuous monitoring.

## B. Parallels to the Federal Reserve System: Delaware as the Accidental Agency

The Delaware-federal relationship resembles the Federal Reserve-congressional relationship. The parallel is apt, in that the Federal Reserve is one of the more independent agencies, and Delaware clearly need not jump every time Congress moves. In fact, Delaware is freer than even the Federal Reserve. While Congress often structures agencies and their procedures to respond to congressional will,<sup>92</sup> Congress didn't build Delaware. It isn't in the loop in appointing Delaware officials, as it is for federal agencies. Congress often calls in agency personnel to testify, and thereby influences agency preferences and actions; while federal players do communicate with Delaware players, it's without the intensity of regular congressional hearings. Congress determines agency budgets, but it doesn't regulate Delaware's franchise fees.

1. *In Delaware's insulation.* Analysts often want to insulate monetary policy from unstable political demands. The polity prefers short-term monetary laxity, the usual story goes, and politicians facing an election in a few months would give voters that shortsighted policy at the expense of long-term growth.<sup>93</sup> This view puts a positive spin on insulating the Federal Reserve from day-to-day political pressure.

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<sup>90</sup> Dan Roberts & Adrian Michaels, *Sarbanes and Oxley Under Fire in US*, FIN. TIMES, June 14, 2004, at 16; John Castellani, *Editorial, Effective Reforms in Place*, USA TODAY, Mar. 22, 2004, at 20A.

<sup>91</sup> Mathew D. McCubbins & Thomas Schwartz, *Congressional Oversight Overlooked: Police Patrols versus Fire Alarms*, 28 AM. J. POL. SCI. 165 (1984). Cf. Arthur Lupia & Mathew D. McCubbins, *Learning from Oversight: Fire Alarms and Police Patrols Reconstructed*, 10 J.L. ECON. & ORG. 96 (1994); EPSTEIN & O'HALLORAN, *supra* note 40, at 25-27.

<sup>92</sup> Mathew D. McCubbins, Roger Noll & Barry R. Weingast, *Administrative Procedures as Instruments of Political Control*, 3 J.L. ECON. & ORG. 243 (1987); Mathew D. McCubbins, Roger Noll & Barry R. Weingast, *Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies*, 75 VA. L. REV. 431 (1989). Cf. Barry R. Weingast & Mark J. Moran, *Bureaucratic Discretion or Congressional Control: Regulatory Policymaking by the Federal Trade Commission*, 91 J. POL. ECON. 765 (1983).

<sup>93</sup> Cf. ALLAN DRAZEN, *POLITICAL ECONOMY IN MACROECONOMICS* 144 (2000), citing Kenneth Rogoff, *The Optimal Degree of Commitment to an Intermediate Monetary Target*, 100 Q. J. ECON. 1169 (1985).

Central bank independence, even if short of total independence, is seen as critical to implementing that policy. The public wants immediate economic gain, such as the highest possible immediate employment. Alan Blinder, a former vice-chair of the Federal Reserve, argues that a key reason for independence is that “monetary policy, by its very nature, requires a long time horizon.”<sup>94</sup> Presumably he means very long compared to the elected political institutions’ and the public’s usual short horizon:

So, if politicians made monetary policy on a day-to-day basis, the temptation to reach for short-term gains at the expense of the future (that is, to inflate too much) would be hard to resist. Knowing this, many governments wisely try to depoliticize monetary policy by ... putting it in the hands of unelected technocrats with long terms of office and insulation from the hurly-burly of politics.<sup>95</sup>

Ensuing analyses have looked at how much the Federal Reserve still defers on big issues to the elected branches’ wishes.<sup>96</sup> Some political scientists see the issue as even more basic:

The main mechanism by which democracy is thought to hinder growth [is] pressure[] for immediate consumption, which reduce[s] investment. Only [governments] that are institutionally insulated from such pressures can resist them, and democratic states are not.

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The heart of the neo-liberal research program is to find institutions that enable the state to do what it should but disable it from doing what it should not.<sup>97</sup>

Other have similarly asserted that:

Congress [sometimes wants] a policy that would not get majority support. The classic example is this: Congress [wants] a low-inflation monetary policy, knowing that it will have an incentive to renege. ... [So] Congress delegates authority over monetary policy to a conservative agency, and delegates monitoring to a conservative committee that provides political shelter for the agency’s decisions.<sup>98</sup>

The analogy to Delaware corporate lawmaking needs little stretching. When Delaware, like the Federal Reserve, decides first, Congress often acquiesces. American corporate law, by usually giving Delaware first crack at making the rules, reduces political pressure on America’s corporate lawmakers. Unelected Delaware chancellors

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<sup>94</sup> ALAN BLINDER, *CENTRAL BANKING IN THEORY AND PRACTICE* 55 (1998); see sources cited in DRAZEN, *supra* note 93, at 142 n.19, 143.

<sup>95</sup> BLINDER, *supra* note 94, at 56-57.

<sup>96</sup> For indicators of deference, see Thomas Havrilesky, *Monetary Policy Signaling from the Administration to the Federal Reserve*, 20 J. MONEY, CREDIT & BANKING 83, 84, 86 (1988), and sources cited therein; Nathaniel Beck, *Elections and the Fed: Is There a Political Monetary Cycle?*, 31 AM. J. POL. SCI. 194, 194 (1987); John T. Williams, *The Political Manipulation of Macroeconomic Policy*, 84 AM. POL. SCI. REV. 767 (1990); George A. Krause, *Federal Reserve Policy Decision Making: Political and Bureaucratic Influences*, 38 AM. J. POL. SCI. 124, 124 (1994).

<sup>97</sup> Adam Przeworski & Fernando Limongi, *Political Regimes and Economic Growth*, 7 J. ECON. PERS. 51, 51, 65 (1993) (adding that “[i]n our view there are no such institutions to be found”).

<sup>98</sup> Ferejohn & Shipan, *supra* note 25, at 9.

with long tenure, who are structurally insulated from hurly-burly of national politics, typically first make corporate rules. The Delaware legislature acts next. It listens to a corporate bar committee, which is just about as insulated from national politics as are the Delaware courts: the bar committee represents managers and shareholders (and themselves), and the Delaware legislature is less worried than Congress might be about, say, general environmental policy or labor relations, and more concerned about that franchise tax.

2. *In its porosity.* In most democratic polities the central banker can be dismissed, much as the federal authorities can oust Delaware from making American corporate law:

Lohmann (1992) suggest[s] appoint[ing] a conservative central banker, but [keeping] the option to dismiss him at a cost. Her argument is that the high variance of unemployment with ... [a] conservative central banker ... is much like using a rule with an escape clause [for extreme circumstances]....<sup>99</sup>

The Federal Reserve watches and reacts to election returns, and can thereby falter in making good long-term monetary policy; thus the independent agency's insulation can dampen, but not eliminate, politics' short-term influence. Delaware is similar: Federal authorities sometimes take corporate lawmaking power away from Delaware. Delaware, seeking to stymie federal action so that the state maintains its authority, sometimes goes just far enough to deter the federal authorities from acting.<sup>100</sup> It considers general public opinion, which could influence elected federal lawmakers. Both the Fed's and Delaware's positioning here resembles a monopolist's limit pricing: not so high as to attract entry.

Delaware, like the Federal Reserve, is autonomous, but not fully so. It cannot get too far out from political currents, because if it does, federal authorities can, and do, intervene. The President appoints the chair of the Federal Reserve every four years and appoints a few Fed governors every few years. The Federal Reserve normally buffers policy from the general polity, but it cannot readily defeat a determined polity.<sup>101</sup>

Moreover, just as the Federal Reserve enhances its independence by linking itself to "a supportive constituency in the financial services industry,"<sup>102</sup> Delaware can keep some autonomy from Congress by linking itself to managers. But linking themselves to powerful interest groups can distort policy: Bankers, to the detriment of

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<sup>99</sup> DRAZEN, *supra* note 93, at 145. See also GØSTA ESPING-ANDERSON, *THREE WORLDS OF WELFARE CAPITALISM* 14-15 (1990).

<sup>100</sup> See examples and structure discussed in Roe, *Delaware's Competition*, *supra* note 3, at 607-34.

<sup>101</sup> Cf. Pablo T. Spiller & Rafael Gely, *Congressional Control or Judicial Independence: The Determinants of U.S. Supreme Court Labor-Relations Decisions, 1949-1988*, 23 *RAND J. ECON.* 463, 465 (1992): "[The Supreme] Court is restricted [because] ... Congress [can] overturn its decisions. The Court, then, cannot deviate too much from what Congress's independent legislative outcome would be without facing a reversal. So even though Congress may not be actively legislating, it does not follow that it has actually relinquished legislative responsibility to the Court, or that the Court is dictatorial." See also John M. de Figueiredo & Emerson H. Tiller, *Congressional Control of the Courts: A Theoretical and Empirical Analysis of Expansion of the Federal Judiciary*, 34 *J.L. & ECON.* 435 (1996).

<sup>102</sup> Havrilesky, *supra* note 96, at 84-85.

others in the polity, could overly influence the Fed. Similarly, although Delaware's insulation usually lets managers and investors work out a contractarian result by themselves, there are times and issues when the contractarian result isn't in the public interest. While agencies are often captured by those they regulate, it's not likely that Congress would create an agency that directly depends on interest groups the way Delaware does for \$500 million of franchise taxes.

And lastly, Delaware, like the Fed, often serves Congress's interest by taking primary responsibility for corporate regulation—and the heat that comes with it—from Congress. If something goes wrong, Congress isn't the first to be blamed.<sup>103</sup>

3. *In separating policy domains.* Congressional creation of the SEC raises the issue of whether Congress, when it acts in corporate law, also tries to separate corporate policy from other policies. Once when it acted powerfully in the corporate area, in 1933 and 1934, it created the SEC for corporate issues, and put the American corporation's labor issues in another venue, the National Labor Relations Board. Thus, we could say that Delaware's interest groups need not worry too much about Congress expanding the agenda: when Congress acts on corporate matters, it keeps the other players outside of the corporate action. It implements general policies via external arrangements—a National Labor Relations Board, an Occupational Safety and Health Administration, an Internal Revenue Service—not within the corporate governance structure.

This observation does not make the Delaware-federal institutional divide irrelevant. For Congress to shield the corporation from the swarming interest groups, it needed an institutional means to do so. Creating the SEC was one way; tolerating Delaware another. One can speculate that had Delaware not evolved as it has, Congress might have built a federal agency to somewhat insulate corporate lawmaking from the hurly-burly of national politics. With Delaware available, Congress was able to use it as a distant, quasi-federal agency.

4. *In reducing the time inconsistency problem.* A reason for Federal Reserve autonomy is the need to maintain a consistent economic policy over time without succumbing to short-term political payoffs. A legislature can't, say, easily stick to a low-inflation policy, if political pressures develop in an election year favoring an inflationary policy.<sup>104</sup> Corporate policy could be similar. Over the long run a business-oriented policy could produce more investment, more growth, and better economic performance. But political pressures might push policymakers to attack shareholders. A polity where the initial corporate decisions are made by a state like Delaware dependent on shareholders and managers for tax revenues reduces this prospect.

5. *In processing information.* The federal-Delaware institutional structure affects legal outcomes, because some interest groups have more muscle in Delaware than they

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<sup>103</sup> Cf. Jonathan R. Macey, *Regulatory Competition in the US Federal System: Banking and Financial Services*, in REGULATORY COMPETITION AND ECONOMIC INTEGRATION: COMPARATIVE PERSPECTIVES, supra note \_\_, at 95, 98-99 (“where Congress can avoid potentially damaging political opposition from special-interest groups by allocating the responsibility for a particularly controversial issue to state and local governments (as is the case with the issue of abortion)”).

<sup>104</sup> BLINDER, supra note 94, at 55-56.

have in Congress. But there's more than just interest group differences between the two lawmaking levels; there are informational differences as well. "[I]nstitutional arrangements may reflect the need to acquire and disseminate information in addition to (or instead of) the need to solve distributional issues. Committees may be powerful in a legislature not (only) because they monopolize agenda power but (also) because they monopolize information and expertise."<sup>105</sup> This modern political science view corresponds to an older view in the legal academy about administrative expertise.<sup>106</sup> Congress may tolerate Delaware because it specializes in corporate law issues, similar to how a federal agency specializes and becomes expert. Had Delaware not emerged as the de facto maker of American state corporate law, Congress might have created an expert administrative agency to make corporate law, one like the Fed or the SEC, or expanded the powers of one already in place. In this view of the current structure, Delaware still creates the corporate law that Congress wants, or at least tolerates, just like an administrative agency rules within the ambit of Congress's parameters. It's the accidental agency.

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The analogy to the Fed is good but imperfect. For instance, some American political players are more attached to federalism and state power as vital to American democracy than they are to the autonomy of federal agencies. Similarly, senators at times get their peers' deference on matters of local significance, but senators will not accord the same deference to policy matters in the agencies. As a result Delaware's senators may at times seek to deter federal action and other senators feel federalist comity compels deference. And congressional and presidential control over agencies are much tighter, as we have seen, and the interest group influences looser, than they are for Delaware.

And whereas the Fed's buffering is temporal; Delaware aims to narrow policy breadth. Thus even if everyone wants the Fed's policy when we're planning the long future, when that future time finally arrives, short-term interests would dominate if the buffer did not slow down the political juggernaut. For Delaware, the interests outside the core corporate law players—the public interest groups, public-policy-makers, and employees—have a public interest vision, but theirs fundamentally differs from that held by the corporate players. In the end, although the particulars and degree differ, the general institutional role is still the same for the Fed and for Delaware as buffers against immediate political pressure.

### C. And How Delaware Affects Congress

*1. In justifying strong regulation.* Congress, knowing that Delaware provides corporate flexibility, can more easily enact rigid rules, rules that it knows will be tempered in Delaware. If Delaware seems weak, Congress can be strong.

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<sup>105</sup> [KEITH KREHBIEL, INFORMATION AND LEGISLATIVE ORGANIZATION (1991);] KENNETH A. SHEPSON & BARRY R. WEINGAST, POSITIVE THEORIES OF CONGRESSIONAL INSTITUTIONS 5, 15-16 (1995).

<sup>106</sup> JAMES M. LANDIS, THE ADMINISTRATIVE PROCESS 1, 23-24 (1938); Richard B. Stewart, *Administrative Law in the Twenty-First Century*, 78 N.Y.U. L. REV. 437, 440-41 (2003).

2. *In facilitating anti-corporate posturing.* Similarly, if Delaware provides a contractarian corporate law and a good forum for arbitration, Congress can more easily attack corporations. Delaware can take care of the core efficiency issues, and Congress doesn't need to be overly wary that it is severely damaging the corporate contract when it makes populist laws, because Delaware can mitigate the costs.

Moreover, those in Congress who get support from Delaware's primary interest groups don't need to pass laws favoring them to get their clients' support. As Jonathan Macey points out in analogous circumstances, all that the clients need to know is that their patrons successfully blocked federal action; Delaware takes care of the rest<sup>107</sup>

3. *In giving Congress cover and deniability.* If something goes wrong, Congress need not take responsibility. It doesn't need even to point a finger. Everyone knows states make corporate law. If there's a scandal, or a failure, the states have failed, and the U.S. Congress can ride in to the rescue.<sup>108</sup>

4. *In avoiding a full federal corporate takeover.* Why don't noncorporate interests who would do better in Congress force the game to move there? When there's a scandal or other focusing event, they should realize that they'd do better over the long-run if they institutionalize a federal presence in making basic corporate law.

Three explanations are plausible. When the time comes, managers and investors see their ox about to be gored, and gored in a permanent way, so they would intensely react. Since the federalizing interests get enough of what they want via external constraints, and via a rule responding just to the particular issue on the agenda, they recede from federalizing Delaware.

The second is that the serendipitous alignment of interests, policymakers, and scandal just hasn't been right for full nationalization of corporate law.<sup>109</sup> It's almost happened, but it just missed, because some key player just wasn't on board when the issue was ripe.

A third explanation is more interesting—albeit more complex. Focus on the split of interests at the federal level. Some interests and associated policymakers want maximum corporate productivity, others focus on fairness. The media we suppose turns on the scandal lights for a time on corporate America, but those bright lights turn away when another issue grabs the media's attention. The productivity-oriented policymakers fear that interests inimical to productivity would capture the federal machinery to often when the media loses interest in corporate lawmaking. They favor a specific rule to ameliorate the current problem, but do not want to institutionalize a federalization all corporate lawmaking, fearing that the inimical interests would then find it worthwhile to lobby to affect the new federal institution that could mandate corporate structures. Productivity-oriented policymakers (and their associated interests) prefer external constraints, not internal structures, that promote the fairness goals. (And some oppose the fairness goals entirely.) If a federal corporate rulemaking institution in place, the fairness-oriented interests would have reason to

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<sup>107</sup> Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265, 268 (1990).

<sup>108</sup> See MORRIS FIORINA, CONGRESS: KEYSTONE OF THE WASHINGTON ESTABLISHMENT 48 (1977).

<sup>109</sup> See generally Kingdon, *supra* note 85.

lobby the corporate lawmaking institution, in a way that they can't succeed at when corporate law is in Delaware.<sup>110</sup> So the productivity-oriented policymakers oppose managers (and maybe investors) on the specific issue, but join managers (and investors) in preferring not to federalize the future.<sup>111</sup>

If Delaware weren't available, these veto possibilities over institutionalizing federal corporate lawmaking wouldn't be available.

## V. CORPORATE THEORY MEETS POLITICAL THEORY

### A. The Contractarian Paradigm

1. *What is it?* A standard view is that corporate law should be contractarian, reflecting the terms shareholders and managers would have adopted had they built the corporation up from basic contract law. Those terms should be default rules, malleable for shareholders and managers that want differing relationships. Mandatory terms should be few. Analysts argue that Delaware corporate law comes close to reflecting the contractarian agenda.<sup>112</sup>

2. *How the public choice structure makes the contractarian paradigm possible.* Delaware's lawmaking structure makes contractarian results more likely than would congressionally-made law. Essentially, Delaware's corporate lawyers propose new corporate law to Delaware lawmakers. The form is a meta-contract: investors, managers and their lawyers are represented on the bar association's corporate committees; Delaware's corporate law is itself a quasi-contract between managers and shareholders, written by the two and enforced by the legislature. And the laws as passed also typically defer to further firm-by-firm shareholder-manager contractual fine-tuning.

The two parties to this corporate meta-contract prefer flexibility for themselves, while third parties might prefer more mandatory terms attuned to their own interests. The third parties—and their mandatory terms—would be more viable in a federal forum than in a Delaware forum. Or to heighten the relative power of other groups,

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<sup>110</sup> Cf. RALPH NADER, MARK GREEN & JOEL SELIGMAN, CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS (1976).

<sup>111</sup> Figure 8 illustrates. While populists prefer to move to institutionalize a federal agenda, policymakers at the top of the parabola, investors, and managers all prefer to keep the game in Delaware. Only if Delaware is sharply antagonistic to investor interests would the investors want a strong federal agenda. This multiplicity of interests at the federal level—some disfavoring investor interests—can also explain why shareholders don't run to Congress on every little issue, but stay with Delaware or limit themselves to a shareholder-oriented agency like the SEC.

<sup>112</sup> EASTERBROOK & FISCHER, *supra* note 80, at 4.



corporate law might diminish the power of the two Delaware players.<sup>113</sup> Day-to-day American corporate law, however, doesn't heighten those other groups' power.<sup>114</sup>

3. *Limits to the contractarian paradigm.* Delaware facilitates that contract between investors and managers because the other players are absent or weak. Others cannot by themselves move the franchise tax to another state. When other parties want to affect the political calculus, they typically find the federal authorities a friendlier venue.

Early New Jersey corporate law again exemplifies. When New Jersey became the Mother of Trusts, it acted consistently with the contractarian model. It allowed corporations to combine, merge, and form holding companies. When the contract attracted public attention, federal authorities tossed aside the contractarian result. The Sherman Act is the legislative exemplar; the Supreme Court's 1911 *Standard Oil* decision its early judicial culmination.<sup>115</sup>

Similarly, when populist and progressive forces wanted to cut the power of financial institutions, they turned to federal authorities to keep financial institutions small and weak.<sup>116</sup> Once Congress cut financial power—symbolized by J.P. Morgan's interests—rhetorically with the Pujo investigation in 1913 and more vigorously with the fragmentation of banking and, in the 1930s, with the Glass-Steagall Act, policymakers then deferred to state-law corporate contracts. Populists and progressives altered corporate structure, but primarily at the federal level, not via New Jersey's and Delaware's corporate law. If a state's corporate law became too mandatory, in a way that investors and managers abhorred, they could move the firm to another state. But if more corporate law were federal, the interest groups who would want more mandatory law would have more reason to lobby for it, since if they succeeded the target firms couldn't slip away to another state.<sup>117</sup>

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<sup>113</sup> For example, Delaware law—if sensitive to outsiders' goals—might bar shareholders from serving on the board, or require as a matter of corporate law that the firm must notify all employees prior to any major downsizing, or mandate that the board present mergers to both company shareholders and employees, with the employees for their prior consultation or approval. French and German results differ, as German codetermination shows.

<sup>114</sup> Or, to flip the analysis: Delaware exports its narrow notion of the corporation to the other 49 states, whose voters would from time-to-time become third-parties to Delaware corporate contracts. Sometimes Delaware incorporates a soft form of that outside opinion into its law, sometimes federal authorities insist on that result. Cf. Susan Rose-Ackerman, *Does Federalism Matter? Political Choice in a Federal Republic*, 89 J. POL. ECON. 152, 153 (1981) (“interstate spill-ins and spill-outs can alter the substance of national legislation”).

<sup>115</sup> 22 U.S. 1 (1911).

<sup>116</sup> MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* 28-32 (1994). Insurance company laws, which came from the states, are the exception.

<sup>117</sup> In modern times, when Nader-types sought to reform the corporation, they looked to federal institutions, not state corporate law, to re-set the corporate contract. RALPH NADER, MARK GREEN & JOEL SELIGMAN, *TAMING THE GIANT CORPORATION* (1976). They sought directors who would have separate portfolios of responsibility, representing nine categories: employees, consumer, the environment, shareholders, legal compliance, finance, marketing, management, and research. *Id.* at 125, 180 et seq. (About half their proposals were mainstream; half would have greatly pushed the envelope outward.)

## B. The Internal Affairs Norm

1. *What is it?* The relationships among shareholders, and between shareholders and managers, are seen as internal to an entity sitting within a single state, and therefore are properly matters for state regulation. External buying and selling of securities across state lines is for the SEC and the securities laws to regulate. The line between internal and external is surely not bright, but the distinction has been important in defining the national and state spheres of corporate lawmaking.<sup>118</sup> The formal doctrine originates outside the federal-state divide in state-to-state with choice of law rules in which states defer to the incorporating state's rules for the firm's internal affairs;<sup>119</sup> but the internal/external line has also come to roughly mark the traditional boundary between the state and federal domains. And some courts say that the SEC cannot move into state internal affairs without clear congressional authorization, but can go beyond the precise terms of the statute to define ambiguous grants to regulate securities trading.<sup>120</sup> The internal/external distinction is part of the debate over who should make American corporate law.<sup>121</sup>

2. *The internal affairs norm as crude interest group public choice.* Behind the internal affairs standard is the *realpolitik* that deferring to states on internal affairs is equivalent to deferring to manager-shareholder interests. While the doctrine surely has a life apart from the interests that benefit from its use, for some players the ideology may only thinly mask self-interest. As Gordon Tullock remarked, most citizens “realize that the government can be expected to do things in their personal interest only if it at least superficially fits the public image.”<sup>122</sup> Many are surely sincere in their ideology, which matches their self-interest.

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<sup>118</sup> See *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987). For its choice of law origins, see Note, *The Internal Affairs Doctrine: Theoretical Justifications and Tentative Explanations for its Continued Primacy*, 115 HARV. L. REV. 1480 (2002). *CTS* nearly merged comity with doctrine, i.e., by seeing internal affairs as constitutionally in the states' domain. *CTS* at 91. The concept—federal authorities regulate external trading of stock, while state authorities regulate internal relationships among shareholders, directors, and managers—preexisted Chief Justice Rehnquist's use of internal affairs vocabulary to describe it.

<sup>119</sup> John Coates IV, *The Legal Origins of the (Unimportant) U.S. “Market” for Corporate Charters* (Harvard Law School working paper, Oct. 18, 2004); Daniel J.H. Greenwood, *Democracy and Delaware: The Mysterious Race to the Top/Bottom* (SSRN working paper) (questioning whether the constitutional and choice of law doctrinal bases for states' deferring to the incorporating state are strong).

<sup>120</sup> *Business Roundtable v. SEC*, 905 F.2d 406, [410-17] (D.C. Cir. 1990). State advocates are quick to mark off this limit to SEC authority. E. Norman Veasey, *The Judiciary's Contribution to the Reform of Corporate Governance*, 4 J. CORP. L. STUD. 225, 230 (1994) (Veasey was then Delaware's Chief Justice).

<sup>121</sup> See, e.g., TASK FORCE ON SHAREHOLDERS PROPOSALS OF THE COMM. ON FEDERAL REGULATION OF SECURITIES, SECTION OF BUS. LAW OF THE AMERICAN BAR ASS'N, REPORT ON PROPOSED CHANGES IN PROXY RULES AND REGULATIONS REGARDING PROCEDURES FOR THE ELECTION OF CORPORATE DIRECTORS 19, 23, 25 (2004). The task force, chaired by two respected lawyers who often represent managers, said that the SEC shareholder access proposals, see *supra* p., “raise[d] significant ... federalism concerns ...” And “federal regulation of ... proxies may impinge on state substantive law and raise federalism issues... . Exactly where that line exists has not been clearly delineated ...”

<sup>122</sup> Gordon Tullock, *Future Directions for Rent-Seeking Research*, in *THE POLITICAL ECONOMY OF RENT-SEEKING* 465, 473 (Charles K. Rowley, Robert D. Tollison & Gordon Tullock eds., 1988).

The ideology—the internal affairs norm—is stated, sometimes grudgingly, by SEC commissioners, by Congress, by the courts,<sup>123</sup> and, more relevantly and with more respect, by corporate players. Bruce Atwater, a big-company CEO and major corporate spokesman in the 1980s, opposed federal preemption of state takeover law and when doing so invoked the tradition that states define and create the corporation.<sup>124</sup> The norm's effect is to restrain the federal authorities. When it's successfully invoked, it impedes federal action. It weakens players who are stronger on the federal level, and boosts those stronger at the state level. It strengthens the contractarian paradigm, because the two primary contracting players are strongest at the state level.

## VI. IS DELAWARE CAUSE OR EFFECT?

### A. Means and Ends

1. *The median voter and the institutional structure.* Two views key modern political science are at work here. In one, a democratic polity does what the median voter wants.<sup>125</sup> In another, agenda setting is key because coalitions are many, politics is arrayed in too many dimensions for there to be a median voter, and, as Kenneth Shepsle and Barry Weingast showed, institutional structure shapes the agenda, which can determine the outcome.<sup>126</sup> I next integrate both views into the public choice foundation to American corporate lawmaking.

2. *Does the American voter want conservative corporate law?* Are broad political concerns kept out of American corporate law because of the institutional structure that has Delaware setting the agenda, with the federal authorities thereafter deciding whether to displace the Delaware decision? Or are such broad political concerns kept out because the American polity doesn't give them much weight and thus tolerates Delaware's excluding them? Would substantive results be the same, even if all corporate law were made at the national level?

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<sup>123</sup> *CTS*, at 91 (“It thus is an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares.”). Internal affairs aficionados refer to Delaware and its siblings as “States,” and not “states.”

<sup>124</sup> See *Witnesses at Takeover Bill Hearing Split on Preemption of State Regulation*, 19 SEC. REG. & L. REP. 851, 851 (June 12, 1987). Atwater didn't formally invoke the internal affairs vocabulary, but used the concept of states as the best maker of corporate law.

<sup>125</sup> DUNCAN BLACK, *THE THEORY OF COMMITTEES AND ELECTIONS* (1958); cf. ANTHONY DOWNS, *AN ECONOMIC THEORY OF DEMOCRACY* 115-18 (1957).

<sup>126</sup> Kenneth A. Shepsle & Barry R. Weingast, *Structure-Induced Equilibrium and Legislative Choice*, 37 PUB. CHOICE 503, 504 (1981) (“real-world legislative practices ... constrain ... the instability of [pure majority] rule by restricting the domain and the content of legislative exchange”). Which view arises depends on what kind of decisionmaking is investigated. When the issue is uni-dimensional, the median voter theorem is central; when the issues are multi-dimensional, institutional structure is central. Cf. Richard D. McKelvey, *Intransitivities in Multidimensional Voting Models and Some Implications for Agenda Control*, 12 ECON. THEORY 472 (1976) (one can “design voting procedures which, starting from any given point, will end up [anywhere] in the space of alternatives”); Charles R. Plott, *A notion of equilibrium and its possibility under majority rule*, 57 AM. ECON. REV. 787 (1967).

The view that federalism does not matter here can come in two varieties. In the first, the American polity keeps the categories separate, then limits the corporation's range of action via external constraints, not internal governance. In the second, interest group interplay would lead to the same result wherever corporate law is made: shareholders might find that managerial agency costs are not so high in the United States to make it worth allying with another group to reduce them further because the payoff to the third group would exceed the likely agency cost savings. Similarly, if managers sought more autonomy by allying with employees, shareholders might just give the managers that autonomy themselves, for fear that an alliance between managers and employees would take more out of shareholders' pockets. This dynamic could play out in Congress as easily as in Delaware. Does Delaware then cause narrow corporate law, or is it its effect?

We cannot know for sure, because we cannot run the real-world experiment of turning corporate law off in Delaware and requiring that Congress make all corporate law for two or three decades to see if the tilt changes. But we can reconcile cause and effect. The American polity is ready to defer to the corporate players on most corporate law issues, but needs an institutional mechanism. Delaware is the mechanism. Were it unavailable, that deference would be weaker, and corporate players would want another institutional buffer.

### B. Restraining the Corporation: External Bumpers vs. Internal Brakes

I have argued that Delaware's franchise tax defines its interest groups—as shareholders and managers. And I have argued that Congress is not so limited: Groups like environmentalists, employees, labor unions, economic policymakers, average voters, and so on would have a say in Congress.

Congress has given those groups an Environmental Protection Agency, an Occupational Safety and Health Administration, a National Labor Relations Board, a Council of Economic Advisors, and other agencies to constrain the corporation. So, one might argue, the law does confine corporations and their managers, but the confining rules just come in a form other than laws regulating internal corporate governance,, such as boardroom representation of third party interests.

But even when true—as it largely is—law thereby acts not through brakes inside the firm but through external constraints on the firm. Corporate internal relations are (quasi-)contractual, uncomplicated by outside alliances and outside rulemaking. The internal workings of the corporation do not fully reflect the workings of the polity. They could, and in some nations they do, but here they don't.

## CONCLUSION

The standard story is that states make corporate law, with state competition critically determining its content. This may be so, but perhaps the relationship between the states and Washington is just as determinative, because federal authorities can displace the states, and often do so on big issues. Corporate law issues can always go federal or attract federal attention. The SEC is always on stand-by, and Congress takes

up issues that deeply affect the economy or the opinion polls. These possibilities confine the range of state lawmaking and, on occasion, condition it.

I have here sketched a public choice, institutional analysis of the federal-Delaware relationship. The structure privileges state-level deals between managers and investors in Delaware. Although managers historically have had the upper hand in Delaware, they don't fully dominate there. Delaware doesn't let them dominate fully, not just because of, or perhaps even in spite of, state competition. It doesn't let them dominate—or they themselves choose to be moderate—because if it did, the game could move to Washington, where new players could induce new results. Hence, local interest groups compromise and local decisionmakers are evenhanded, even if local politics doesn't demand compromise or evenhandedness.

Sometimes, despite local compromise, the issue is so big—generating headlines in the media and fears for the economy—that it attracts federal attention. Different coalitions can, and do, emerge at the federal level. Sometimes the managers or the investors find new coalition partners at the federal level and thereby break the Delaware deal. Delaware limits the range of the first decisionmaking stage by keeping out corporate outsiders and public policymakers. Sometimes managers and investors can make their deal there and then unite at the federal level to fight off other forces. Sometimes—probably more often than not—their interests are sufficiently similar that they both want the states and not the federal authorities to make corporate law. But sometimes Delaware loses control of the agenda. It loses control when the public is sufficiently motivated that Congress acts because the economy is weak or because scandals dominate the media. Congress ousted Delaware most recently with Sarbanes-Oxley after the Enron and WorldCom scandals hit the headlines.

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Look what we have done here. We've reversed the conventional analytic form for Delaware, in which the making of public law governing the corporation is analogized to a market, one of competing states. We've turned that inside-out, into a public law perspective of interest groups and political institutions. Instead of seeing Delaware as solely the upshot of a market of competing states, we see it as also like a federal agency—captured by its interest groups—that can only move as far as Congress allows.

By thus viewing Delaware, we have uncovered rich public choice explanations for the core nature of Delaware and American corporate law. While these public choice explanations don't let us precisely explain statute after statute or exact judicial holdings, they mark off the broad boundaries of corporate lawmaking. We have explained Delaware's moderation, Delaware's dominance, and the conservative, boardroom-centered nature of American corporate law via federal-state interaction, without relying solely on the state-to-state race for franchise tax revenues. We've reinterpreted the state corporate franchise tax as excluding many players from making corporate law. We've shown how Delaware's structural differences with Congress arise not merely from the presence or absence of competitors, but also the differing interest groups and ideologies that affect each. We've seen how the internal affairs doctrine reflects deference to some interest groups and not others. And we've seen how the Delaware-federal sequence is an agenda-setting structure.

Delaware is just a state, embedded in a federal system that has more going on than just interstate competition for charters. It has only two senators and only one representative. Delaware law can be replaced and its acts can risk reversal and ouster at the federal level, by Congress, by courts, and by the SEC. Each of these institutions responds, however clumsily, to its own voters and inputs, and those inputs are not identical to those that are powerful in Delaware. Delaware can usually create the initial rule, to which the federal players react, but it can't uniformly control the final results in making American corporate law.