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THE EQUILIBRIUM CONTENT OF CORPORATE FEDERALISM

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INTRODUCTION

This is a time of spirited debate about the state-federal allocation of corporate regulation. Arguments about the legitimacy of charter competition and Delaware's national role as a corporate lawmaker are as intense as ever. The Sarbanes-Oxley Act[1] simultaneously has triggered a loud discussion about the legitimacy of federal intervention into corporate internal affairs traditionally regulated by the states. We, however, see no cause for excitement

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1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C. (Supp. II 2002)).

on either front. Despite recent evidence of infirmities in the charter market, we think Delaware legitimately plays a national role. At the same time, we see no support for the view that recent federal expansion into internal affairs territory destabilizes or impairs corporate law's federal structure.

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

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

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

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

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

The good cop/bad cop routine follows from the federal structure. Delaware's sales of domiciles to firms operating nationwide can implicate externalities. Externalities do occur because Delaware's strategy structurally favors management on allocational questions. It follows that a state with Delaware's incentives would not be tolerated as a de facto national lawmaker absent the possibility of federal preemption to reverse or modify state law results. At the same time, when financial crises and compliance breakdowns coincide,[2] national lawmakers worry about the reactions of the median voter. There result national political demands concerning the conduct of corporate business. Delaware is disabled from responding to such demands, self-regulation and kid glove treatment being essential components of its evolutionarily stable strategy. Charter competition embeds enabling state corporate law

2. Price declines have been triggering governmental regulation of the securities markets for 300 years. *See* STUART BANNER, ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS 1690-1860 41 (1998).

and inhibits policing. By default, then, the job of confronting external shocks goes to actors at the national level. This leaves Delaware structurally vulnerable to shifting preferences and abrupt changes in response at the federal level.

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

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

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

Summing up, this Article brings five points to corporate federalism discussions. First, federal intervention into internal affairs is inevitable because Delaware follows an evolutionarily

stable strategy that constrains its ability to respond to shocks that create national political demands. Second, national interventions are structured so as to leave the rent-driven state equilibrium undisturbed. Third, the cooperative federal strategy has come to respond to political demands focused on shareholder value. Fourth, the state equilibrium's second-best quality has no bearing on corporate federalism. From all of this follows a fifth point—the threat of federal intervention has sunk into the deep constitutional structure, leaving Delaware safe in the present context.

Part I recounts the evolution of state corporate codes from the appearance of charter competition in New Jersey in 1888 through the takeover wars of the 1980s. This account shows that an enabling approach quickly became embedded in corporate law due to the appearance of a stable strategy for charter market success. The discussion goes on to describe the opposing evaluative models drawn on by the charter system's opponents and proponents—the trust paradigm of Adolf Berle and Gardiner Means[3] (and successors) and the market paradigm of Henry Manne and Michael Jensen[4] (and successors). Finally, Part I takes up the question of whether the charter market's second-best properties make any difference for federalism and the internal affairs norm, concluding that they do not matter.

Part II turns to national law, setting out a political economy of federal incursions on corporate internal affairs since 1934. This begins with two prominent initiatives that failed, federal chartering and federal protection of hostile takeovers, and shows how both the trust and market paradigms both fell short as political motivators. Discussion turns to incursions that succeeded, mostly prominently the Williams Act,[5] the Foreign Corrupt Practices Act,[6] and the Sarbanes-Oxley Act.[7] These histories show that where the state system is embedded, federal corporate lawmaking is politically contingent and responsive to events. Even so, federal regulators respond to events in predictable ways, hewing to the governance agenda, the shareholder value enhancement objective, and a

3. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed. 1991).

4. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976).

5. Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2000)).

6. Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified at 15 U.S.C. §§ 13(b)(2), 30A, 32, 78m(b)(2), 78dd-1-2, 78ff (2000)).

7. Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C. (Supp. II 2002)).

cooperative pattern of respect for the stable state equilibrium.

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

Part IV concludes.

I. POLITICAL ECONOMY AT THE STATE LEVEL

National regulators—Congress, the Securities Exchange Commission, the stock exchanges, and the federal courts—have generated a long list of disclosure[8] and governance mandates that expand on the state corporate law system, imposing additional duties on corporate managers and according shareholders additional rights. These national regulations tend to supplement the state system, rarely displacing it altogether.[9] The pattern of restraint does not follow from a constitutional mandate—Congress could draw on the same Commerce Clause[10] on which it draws in supplementing the state system to occupy the entire field of corporate law. The restraint instead follows from an informal norm of federalism, termed "internal affairs." This abstracts from the post-1934 regulatory pattern to hold that federal law appropriately addresses trading markets, adding disclosure, antifraud, and insider trading mandates. All other corporate subject matters concern "internal

8. The disclosure mandates significantly impact day-to-day conduct of business, despite their formal denomination as market regulation. Commentators point out that enforcement proceedings implicate complex fact questions about the business and management decisions, subjecting ordinary operations to regulatory review. Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 895-901 (2003). They in effect substitute for the minimalist state law duty of care. *Id.* at 903-09; *see also* Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 2 (1993).

9. For a discussion of the points of preemption, see Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue*, 62 LAW & CONTEMP. PROBS. 215 (1999).

10. U.S. CONST. art. I, § 8, cl. 3.

affairs" and presumptively are left to the states. At the national level we have markets and mandates, and at the state level, internal affairs, free contract, enabling governance strategies, and ex post fiduciary review.

The internal affairs norm is fragile, both descriptively and normatively. Even as it influences the national regulatory agenda at some level[11] and federal regulators habitually restrain their entries into state territory, the norm has not contained the federal agenda in a formal sense. With the proxy rules, for example, the federal securities law shifts from regulation of market transactions to regulation of shareholders meetings, going deep into internal governance territory. National market regulators also traverse the states' enabling internal regime as they seek to assure the quality of financial reports, imposing compliance systems and committee requirements. As the list of such interventions lengthens, a subject matter-based description less and less describes the content of corporate federalism.

Corporate law's complex, overlapping pattern results from more than a century of political and economic interaction among actors in large firms, in the securities markets, and in state and federal governments. As a descriptive matter, it follows that federalism's content can be accessed fully only if the static picture is recast in the historical, political, and economic framework that created it. Such a dynamic description will help us address corporate federalism's central issue—the weight to be accorded state control of internal affairs in national corporate regulation. Two questions state the issue more specifically. The first is descriptive: whether the internal affairs norm in fact operates as a presumption that constrains national-level lawmakers. The second is normative: whether, to the extent the internal affairs norm does constrain at the national level, it follows from a reflexive subsidiarity and lacks policy content or, in the alternative, possesses welfare-enhancing properties. To address these questions, this Article undertakes a comparative political economy of corporate lawmaking. This Part evaluates lawmaking in the states.

At the state level, charter competition determines corporate law regulatory strategies. The question concerning the appropriate strength of the federal internal affairs presumption accordingly tends to overlap the question concerning charter competition's welfare effects. The discussion that follows enters onto this contested territory with a descriptive agenda. The description leads us to depict the states as noncooperative players of a rent-driven game and Delaware as the follower of a successful, evolutionarily

11. *See infra* text accompanying notes 190-96.

stable strategy. Corporate law emerges in a stable equilibrium state. The description, in turn, implies a favorable normative evaluation.

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

Part I.B looks at theories that evaluate charter competition. First comes the trust paradigm of Berle and Means, and Cary, and its race to the bottom description. Next comes the market paradigm of the late twentieth century and its race to the top description. We show that each paradigm was directed as much against the competing paradigm as either was directed toward accurate description of the state system and its political economy. Contemporary descriptions correct the shortcoming, showing that the charter market is uncompetitive and riddled with economic distortions. We do not dispute the accuracy of these descriptions. But we do question whether they have any significant implications for the internal affairs norm. In our analysis, the presumption leaving internal affairs with the states emerges unscathed even as economic analysis places the charter market deeper and deeper in second-best territory.

A. *The Competitive Era*

1. *New Jersey and Delaware*

In 1888 the government of New Jersey needed new sources of revenue. James Brooks Dill, a New York lawyer, suggested to the state's politicians that significant sums could be raised if the state provided an attractive domicile for the nation's growing corporate population.[12] The politicians countered that West Virginia already had tried this, liberalizing its corporate code, but without significant

12. Christopher Grandy, *New Jersey Corporate Chartermongering, 1875-1929*, 49 J. ECON. HIST. 677, 680-81 (1989).

fiscal results.[13] Indeed, in 1888, West Virginia's Secretary of State was stationed at the Fifth Avenue Hotel in New York, the seal of the state in hand, ready to sell charters. He found takers, but not in overwhelming numbers.[14] Dill assured the politicians that it would be different with New Jersey.[15] The state would not only draft a more liberal code, it would market the code more successfully. Toward the latter end, Dill organized the Corporation Trust Company, which would both serve as the state's marketing arm and as a local agent for incorporating firms, providing them a physical office within the state.[16] Dill, who made sure to put New Jersey's Governor and Secretary of State on the Corporation Trust board of directors, got his corporate code.[17]

The regulatory strategy was enabling. By 1896, all significant ex ante constraints on corporate agents had been stripped from New Jersey's code. Governance processes took their place. Corporations were left free to change their business, alter their equity capital structures, and amend their charters.[18] More importantly, the code left them free to merge and combine in holding company structures[19] toward the end of facilitating anticompetitive arrangements. New Jersey thus opened the door for merger[20] even as other states were

13. Harold W. Stoke, *Economic Influences upon Corporation Laws of New Jersey*, 38 J. POL. ECON. 551, 571 (1930).

14. Lawrence Mitchell, Squeezing Truth From Power: The Growth of American Corporate Capitalism: 1899-1919 ch. 2, 15-16 (Aug. 2006) (unpublished book manuscript, on file with author).

15. Stoke, *supra* note 13, at 571.

16. *Id.*

17. Stoke, *supra* note 13, at 570-71, 573. The strategy relies on federal constitutional law, under which corporations are treated as "persons" entitled to the Constitution's protection. Under a nineteenth-century judicial doctrine termed "unconstitutional conditions" it was held to that a state could not exclude corporations incorporated elsewhere. *See* HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW 1836-1937 47-48 (1991). Under a common law conflict of laws rule that evolved during the twentieth century, the states respect the chartering states' governance of corporate internal affairs. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 (1971).

18. Stoke, *supra* note 13, at 572-73.

19. The removal of agent constraints facilitated mergers. The removal of legal capital constraints made stock watering legal, which made it possible for a large corporation to buy up competitors by offering stock consideration at bargain prices. In addition, the code permitted different classes of stock to have different economic and voting rights, facilitating deal-making by making it possible to pay with nonvoting or low-voting shares. RALPH NADER ET AL., CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS 45 (1976).

20. *See* Brian R. Cheffins, *Investor Sentiment and Antitrust Law as Determinants of Corporate Ownership Structure: The Great Merger Wave of*

following the federal government and enacting antitrust laws modeled on the Sherman Act.[21]

New Jersey's code also held out a critical innovation respecting governance process: for the first time in any state code, initiation rights were vested in the board of directors subject to shareholder ratification.[22] This gave managers agenda control over fundamental changes, including, critically, reincorporation to another state. (Previously, an agency theory of board authority had prevailed and shareholder initiative had been the rule.)[23] There was also an innovative governance mandate: all shareholders' meetings had to be held in New Jersey, providing not only rents for the state but also assuring that voting would be by proxy, making challenges less likely.[24]

New Jersey's 1896 code became the template[25] for the evolution of the state-level corporate regime.[26] Subsequent departures from it have opened new stretches of enabling territory but have not changed the system fundamentally. The New Jersey code became the template because it succeeded competitively. Half of the nation's largest corporations were domiciled in New Jersey by 1899.[27] The state's deficit was wiped out. By 1905, its governor even boasted that none of the state's income was contributed by direct

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1897 to 1903, 21-25 (Social Science Research Network, Working Paper, 2002), *available at* http://ssrn.com/abstract=348480 (describing the mergers and showing that this period of acquisition activity amounted to a catalyst for diffuse equity ownership).

21. By 1914 all but New Jersey and six other states had done so. Stoke, *supra* note 13, at 575. *See also* HOVENKAMP, *supra* note 17, at 266-67.

22. JAMES B. DILL, THE STATUTORY AND CASE LAW APPLICABLE TO PRIVATE COMPANIES UNDER THE GENERAL CORPORATION ACT OF NEW JERSEY 42-43 (1898) (New Jersey General Corporation Act § 27).

23. *See* JOSEPH K. ANGELL & SAMUEL AMES, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE §§ 297-99 (10th ed. 1875); 1 VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS §§ 243-44 (2d ed. 1886). Delaware followed in its corporations code of 1899. *See* Section 135 of the Act of 1899, 21 Del. Laws 501 (1899); RUSSELL CARPENTER LARCOM, THE DELAWARE CORPORATION 11-13 (1937). These agenda control provisions diffused into the codes of other states during the subsequent decades. By 1960, twenty-five state codes conditioned charter amendment on board approval. *See* 2 MODEL BUS. CORP. ACT ANN. § 54 ¶ 6 (1960). By 1970, twenty-eight state codes did so. *See* 2 MODEL BUS. CORP. ACT ANN. 2D § 59 ¶ 6 (1971).

24. NADER ET AL., *supra* note 19, at 46.

25. *See* Richard M. Buxbaum, *Facilitative and Mandatory Rules in the Corporation Law(s) of the United States*, 50 AM. J. COMP. L. 249, 249 (2002) (noting that state codes have been facilitative since the New Jersey innovation).

26. New Jersey's code in 1929 resembled "very much the laws of 1896." Stoke, *supra* note 13, at 579.

27. *Id*. at 574.

payments from individuals.[28]

Other states entered the new charter market. In 1899, Delaware's Josiah A. Marvel marked up his state's corporate code to mimic New Jersey's.[29] (He also formed the Corporations Services Company and mailed advertisements.)[30] Marvel's code offered fewer restrictions on the issuance of stock and lower franchise fees. It also carried the contractarian model to its logical conclusion by providing that the charter could contain any provisions not contrary to law.[31] Delaware attracted a handful of large firms but did not threaten New Jersey's dominance.[32] Even so, corporate revenues quickly constituted an important source of Delaware's revenues, rising from 7% of total revenues in 1899 to 20.5% in 1900 and 30.6% in 1906.[33] West Virginia, Maryland, and Maine quickly followed with revisions of their own codes.[34] Other states soon fell into line. By 1912, the laws of most of the states had been revised in varying degrees to follow the enabling strategy.[35]

New Jersey backtracked on February 17, 1913, enacting a series of antitrust amendments called the "Seven Sisters."[36] These variously prohibited monopolization, price fixing, and other anticompetitive behavior, following an agenda set by Governor Woodrow Wilson, who was about to be inaugurated president.[37] The number of charters issued in New Jersey declined in succeeding years.[38] The state's lawmakers then had second thoughts, removing the salient prohibitions from the corporate code in 1915 and 1917.[39]

Chartering firms neither forgave nor forgot New Jersey's

28. NADER ET AL., *supra* note 19, at 48.

29. *Id.* at 51-52.

30. *See* Note, *Little Delaware Makes a Bid for the Organization of Trusts*, 39 AM. L. REV. 418, 419 (1899).

31. *See* E. Merrick Dodd, Jr., *Statutory Developments in Business Corporation Law, 1886-1936,* 50 HARV. L. REV. 27, 27 (1936).

32. NADER ET AL., *supra* note 19, at 503-05 tbl.5.

33. *Id*. at 535 tbl.2. The percentage figure was volatile, however. In 1908 the percentage of revenues from chartering fell to 15.7%. *Id.*

34. Stoke, *supra* note 13, at 575-76.

35. *See* NADER ET AL., *supra* note 19, at 50 (noting that forty-two states permitted organization for any lawful purpose; forty-three had lifted limits on capitalization; twenty-four permitted perpetual existence; eighteen permitted mergers; and forty permitted stock to be issued for noncash consideration, nine of which made the judgment of the board respecting the value of the consideration conclusive absent fraud). Even New York proved capable of innovation in the removal of agent constraints by becoming the first state to permit no-par stock in 1912. Dodd, Jr., *supra* note 31, at 44 n.68.

36. Stoke, *supra* note 13, at 578.

37. *Id.*

38. *Id.* at 574 n.74, 579.

39. *Id.* at 579.

defection to the antitrust side. Delaware saw a significant increase in large firm incorporations and reincorporations, numbers that would peak during the boom years of the 1920s.[40] By 1917, 36.4% of Delaware's revenues came from chartering.[41] (The percentage peaked at 42.5% in 1929.)[42] By 1922, Delaware had a clear lead, emerging as the state of incorporation of 55% of the firms listed on the New York Stock Exchange ("NYSE").[43]

State corporate law emerged fully formed by the boom years of the 1920s. Then, as now, the terms of affiliation of corporate agents were left to be arranged through contract. Then, as now, the law imposed no significant protections for creditors or other constituents. Then, as now, ex post fiduciary law provided the principal constraint. Then, as now, ultimate shareholder control had to be achieved through the exercise of governance mechanisms, the board of directors held agenda control, and the proxy voting system operated as a barrier to soundings of shareholder voice.[44] State law emerged in this mature form in a hotly competitive environment, with two states (New Jersey and Delaware) enjoying the lead in succession and others affirmatively vying for business. Competing state actors were highly incentivized, between the twin payoffs of a significant positive impact on state revenues and private rents for key state actors from stakes in service companies.

Two additional points should be noted about the early period. Charter competition was invented by a New York corporate lawyer and from the very beginning was fully compatible with the interests of New York's corporate bar.[45] Transactions involving New Jersey and Delaware corporations closed in New York, stage managed by New York lawyers, without any fee sharing with New Jersey or Delaware lawyers. From the beginning, lawyers in financial centers opined on due organization under New Jersey and Delaware law, ignoring the usual formal requisite of membership in the bar of the state law applied in the opinion.[46] Delaware's famously well-

40. NADER ET AL., *supra* note 19, at 503-05 tbl.5.

41. *Id.* at 535 tbl.2.

42. *Id*. at 536 tbl.2.

43. LARCOM, *supra* note 23, at 174.

44. For a summary of the operation of the state codes, see Dodd, Jr., *supra* note 31, at 51.

45. NADER ET AL., TAMING THE GIANT CORPORATION 50-52, 54 (1976).

46. *See* Association of the Bar of the City of New York, Committee on Real Property Law, Subcommittee on Mortgage Loan Opinions & the New York State Bar Association, Real Property Law Section, Attorney Opinion Letters Committee, *Mortgage Loan Opinion Report*, 54 BUS. L. 119, 140 (1998) (explaining that New York lawyers give Delaware law opinions); *see also* Committee on Corporations, *1989 Report of the Committee on Corporations of*

compensated bar[47] conducts a litigation practice.

Secondly, the states competed for charters and created enabling codes against a constant threat of federal intervention. Bills proposing federal incorporation of large firms, modeled on nineteenth-century corporate codes that restricted size, lines of business, and mergers, were a staple of congressional life from 1900 until 1914.[48] All were motivated by a perceived public interest in competitive production and against industry concentration.[49] But the clamour for corporate reform abated after 1914.[50] At both the state and federal levels a consensus formed that the Sherman Act's approach to antitrust, broadly directed to restraints of trade, worked better than corporate law's rules-based restrictions on lines of business and combinations, which had not provided a viable basis for distinguishing between good and bad mergers.[51]

2. State Corporate Codes after 1913

Legislative innovation at the state level never again reached the intensity experienced in the wake of New Jersey's competitive initiative. But three smaller waves of change did occur in subsequent decades. Here we describe the first two, which occurred in the 1920s and 1960s. The third wave, the state antitakeover statutes of the 1980s, will be taken up in Part I.B.3.[52]

The first round of innovation came in the wake of the boom stock market of the 1920s. Corporations and their promoters, utilizing the corporate codes' allowance of nonvoting preferred and common stock, took advantage of the market boom to float new equity issues that carried no sacrifice of control. But, in 1926, the NYSE intervened with a one share/one vote rule.[53] Delaware followed up with give backs, removing from its code some remaining constraints on stock issuance. First, in 1927, it removed one last mandate respecting affiliation terms—preemptive rights—which

the Business Law Section of the State Bar of California Regarding Legal Opinions in Business Transactions, 45 BUS. L. 2169, 2198 (1990); Scott FitzGibbon & Donald W. Glazer, *Legal Opinions on Incorporation, Good Standing, and Qualification to Do Business*, 41 BUS. L. 461, 473 (1986).

47. Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 695 (2002) (showing that Delaware lawyers are the most highly paid in any state).

48. Mitchell, *supra* note 14, at ch. 6, 1-4.

49. *Id. See also* John W. Brabner-Smith, *Federal Incorporation of Business*, 24 VA. L. REV. 159, 163-66 (1937).

50. Stoke, *supra* note 13, at 579.

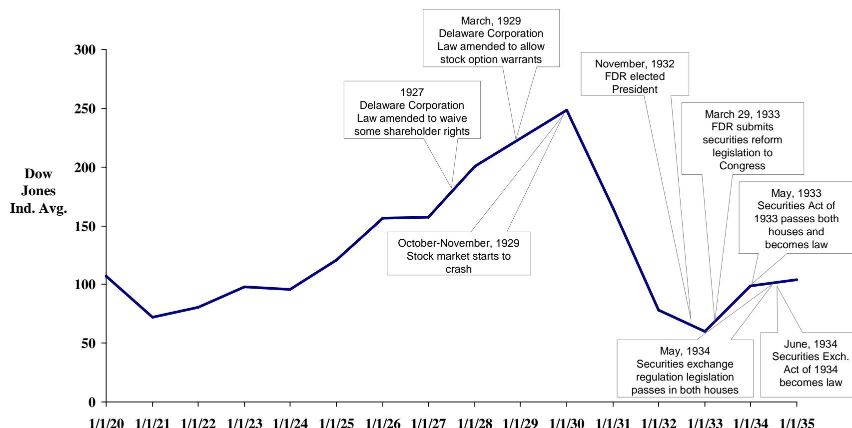
51. *See* HOVENKAMP, *supra* note 17, at 247-48, 266-67.

52. *See infra* notes 107-17 and accompanying text.

53. Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 687 (1987).

thereafter became optional.[54] Second, in March 1929, it amended its code to permit blank stock charter provisions,[55] permitting corporations to waive shareholder ratification respecting the terms of new stock issues and enhancing management's freedom of action respecting equity capital structure.[56] Third, and also in March 1929, Delaware sanctioned the issue of stock option warrants, facilitating the distribution of bargain purchase rights to insiders even in a world of one share/one vote.[57]

Figure I: Market Context 1920-41[58]



The stock market crash six months later caused the venue of corporate law innovation to move to the national level and stay there for three decades. At the same time, new incorporation activity in Delaware slowed substantially. Delaware would not equal the dollar amount of its 1929 chartering revenues until 1952.[59] Even then, 1952 in no sense equalled 1929 so far as concerned Delaware's public fisc. The portion of its revenues contributed by chartering would remain under ten percent of the total until after 1967. Worse, during the 1950s and early 1960s, reincorporation to Delaware continued only at the diminished pace set during the

54. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 43 (1982).

55. *Id*.

56. NADER ET AL., *supra* note 19, at 56-57. Delaware also added a loophole in its legal capital provisions in the late 1920s—the "nimble dividend." *Id.*

57. *Id.*

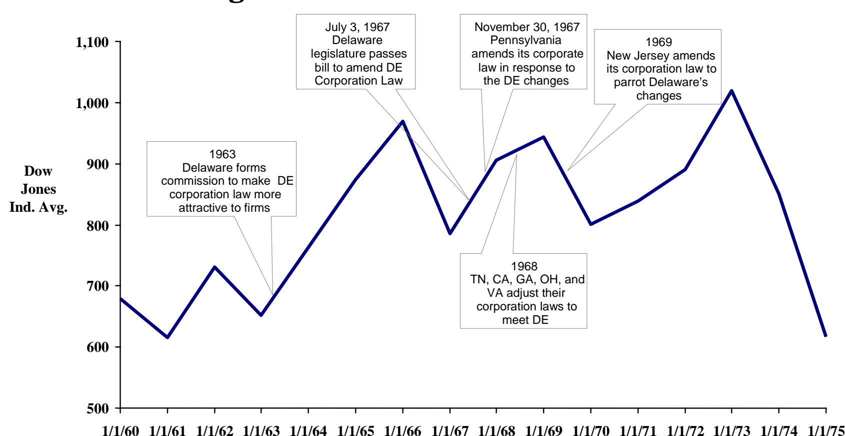
58. Yahoo! Finance, http://finance.yahoo.com (graph developed using the opening level of the Dow Jones Industrial Average on the first trading day of each month over the course of the cycle).

59. NADER ET AL., *supra* note 19, at 535-36 tbl.2.

Depression.[60]

By 1963, revenues from chartering had declined to seven percent of Delaware's total, and its lawmakers began to fear competition from New Jersey and Maryland.[61] The legislature organized a law revision commission to review the code.[62] Another round of innovation followed, with the amendments becoming effective in 1967.[63] These added an enabling section liberalizing indemnity of officers and directors found liable for breaches of fiduciary duties.[64] The amendments also significantly narrowed the class of shareholders accorded merger appraisal rights,[65] facilitating acquisitions by large firms.[66] Figure II shows that the equity market environment at the time resembled that prevailing during the first round of code innovations of the late 1920s: Delaware returned to an aggressive, competitive mode in the "go go" stock market of the 1960s, during which the Dow Jones Industrial Average reached the 900 level for the first time since 1929.[67]

Figure II: Market Context 1960-75 [68]



60. *Id.*
61. *Id.* at 60.
62. *Id*. at 60-61.
63. *Id.* at 64.
64. DEL. CODE ANN. tit. 8, § 145 (2001).
65. *Id.* § 262(b).
66. Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861, 863-72 (1969). For a realistic description of the influences that came to bear on the revision, see Ernest L. Folk III, *Some Reflections of a Corporation Law Draftsman*, 42 CONN. BAR J. 409, 411-19 (1968).
67. NADER ET AL., *supra* note 19, at 66; Yahoo! Finance, http://finance.yahoo.com (daily Dow Jones Industrial Average data from Oct. 1, 1928 through Dec. 31, 1969).
68. Yahoo! Finance, http://finance.yahoo.com (graph developed using the opening level of the Dow Jones Industrial Average on the first trading day of each month over the course of the cycle).

Delaware's initiative yielded palpable rewards. Incorporations and reincorporations of large firms increased markedly in 1966 and continued through 1971 at levels not seen since the 1920s.[69] Even though other states quickly copied the new provisions, Delaware's market share recovered to one-third of NYSE companies.[70] Since then, Delaware has steadily increased that market share. By 1977, 40% of publicly traded companies were organized in Delaware;[71] in 1981 the figure was 44%;[72] the 50% figure was reached again by 1991;[73] and by 1999 the figure was 57.8%.[74]

3. *Stability and Political Insulation*

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

The confirmation is that state legislative innovation tends to enhance management's freedom of action by expanding the enabling envelope.[75]

The prediction is that management-friendly innovation tends to occur against the background of a strong stock market. Concerns about legitimacy and federal intervention could have something to do with this, but marketing does also. Corporations tend to bring reincorporation proposals to their shareholders in the wake of abnormal run ups in their stock prices.[76] The competitive state strikes while the iron is hot, drawing attention to its product line so

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69. NADER ET AL., *supra* note 19, at 505 tbl.5.

70. Comment, *supra* note 66, at 891-92.

71. *See* Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259, 262 (1980).

72. Stephanie S. Rojo, Comment, *Delaware Versus Texas Corporate Law: How Does Texas Compare?*, 3 HOUS. BUS. & TAX L.J. 290, 291 (2003).

73. Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 190-91 n.6 (1991).

74. Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 391 tbl.2 (2003).

75. We do not claim that all states match Delaware in providing menus of enabling terms. For a survey of some residual mandates and an empirical showing of their contribution to outward migration, see Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?* (N.Y. Univ. Law and Econ. Research Paper Series, working paper No. 04-017, 2004) *available at* http://ssrn.com/abstract=557869. For a contrarian discussion questioning the appropriateness of mandates for corporate law regimes in emerging economies, see Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055, 1127, 1155 (2004).

76. *See* Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 67 (1989); Dodd & Leftwich, *supra* note 71, at 272-78.

as to focus management's attention on the benefits of reincorporation.

The structural point concerns the overall trajectory of state legislative innovation. The post-1913 rounds of innovation amount to minor adjustments to a stable legal regime. New Jersey set the states' enabling agenda in 1888 and the agenda remained stable for eight decades thereafter.[77] The economic shock of crash and depression at most brought quietude. The only political shock came when Woodrow Wilson took the presidency and the New Jersey legislature opened its code to the influence of the broader public's political concerns. The management customers in the charter market reacted emphatically. The message has never changed: public politics and corporate law do not mix; any significant departure from the norm means reincorporation to another state.

Political theorists evaluate political systems in terms of their accountability and representativeness. Accountability is high when voters can identify the actors responsible for making policy and oust those who perform badly. Representativeness is high when policies reflect the preferences of a large spectrum of voters.[78] The larger the political subdivision, the more likely it is that policies are broadly representative, as politicians are forced to seek the support of broad coalitions, representing multiple socioeconomic groups. In smaller districts, competing politicians may cater to narrower, geographical constituencies.[79]

Charter competition rearranges the conventional patterns. The possibility of reincorporation out of the state assures a high degree of accountability. But now accountability goes not to the voters of the state (whether a broad or narrow coalition), but to the firms' managers and shareholders, who react not as voting citizens but as economic interest holders. Paradoxically, we simultaneously see a high degree of representativeness, at least in the one state with a stake in chartering revenues. So far as the concerns the people of Delaware, any corporate law policy that suits the chartering customers also suits them. This complete concord between the voters of the chartering state and the chartered firms cordons off corporate law from conventional political influences and concomitant regulatory volatility. Such a stable political settlement could never be reached at the federal level, where broad political

77. Bayless Manning pronounced corporate law intellectually dead in 1962. *See* Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 245 n.37 (1962).

78. TORSTEN PERSSON & GUIDO TABELLINI, THE ECONOMIC EFFECTS OF CONSTITUTIONS 12, 17 (2003).

79. *Id*. at 17-18.

coalitions could contest it.

The stable settlement holds out a possibility of externalities, of course. Even as the dominant chartering state makes corporate law without regard to conventional politics within its borders, its firms carry its law across the wider national political and economic geography. As a national lawmaker, it potentially impacts the economic interests of actors nationwide, actors who may be badly represented or entirely unrepresented in its lawmaking process and to whom it is unaccountable. To the extent that corporate law has political implications at the more broadly representative national arena, such an arrangement is politically tolerable only given the possibility of preemption by the national government. Any disadvantaged group or broad public interest coalition gets a right to contest the state-level result by making a political appeal to the Congress. In view of the fact that a chartering state may impose its law outside its borders only due to a federal constitutional mandate,[80] federal political contestability makes structural sense.

B. Chartering Races

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

1. The Trust Paradigm and the Race to the Bottom

The race to the bottom charge dates back to charter competition's first appearance, when critics denounced it for facilitating anticompetitive activity.[81] Subsequent decades saw no abatement of criticism, even as the critics shifted their focus. The leading basis for denunciation became the trust paradigm articulated in 1932 by Berle and Means in *The Modern Corporation and Private Property*.[82]

The enabling state system, said Berle and Means, had facilitated the appearance and success of the large, mass-producing,

80. *See supra* note 17 and accompanying text.
81. *See* Liggett Co. v. Lee, 288 U.S. 517, 580 (1933) (Brandeis, J., dissenting).
82. BERLE & MEANS, *supra* note 3.

management-controlled corporation.[83] The law thereby had become implicated in the creation and perpetuation of an unsatisfactory separation of ownership and control. The big corporations of the twentieth century had split the classical entrepreneurial function between salaried executives, who sat atop hierarchical organizations, and anonymous equity participants, who held small stakes and prized market liquidity over participation. This presented problems of competence and responsibility absent in an ideal, classical, capitalist world inhabited by self-employed individual producers.[84] In the classical model, market competition effectively controlled the producers, constraining both the incompetent and the greedy and legitimating private economic power. But corporate mass production on a large capital base broke those parameters, with firms taking on significant attributes and powers, social as well as economic.[85] Industrial oligarchs exercised unified control over the wealth under their charge, and the law played a role in investing the power.[86] Therefore, said Berle and Means, corporate property should no longer be deemed private property.[87] That assertion in turn supported a presumption favoring new regulation of corporate internal affairs.

Berle and Means recommended no pervasive system of national oversight, however. Instead, they focused on the problem of management self-dealing in the context of the enabling system. Corporate insiders were writing their own contracts, with immunity clauses and waivers of shareholder rights allowing much diversion of corporate profit to managers' pockets.[88] The law, they said, would do a better job if it were rewritten to follow basic principles of trust law.[89] More particularly, there should be a pervasive equitable limitation on powers granted to corporate management (or any other group within the corporation) by the enabling system: power should be exercisable only for the ratable benefit of all the shareholders.[90] Enforcement of the equitable limitation safely could be remitted to the state judiciary. In Berle and Means' view, charter competition impacted only statutes, leaving the common law of fiduciary duties as the one area of corporate law remaining robust: "[f]lexible and

83. *Id.* at 7.
84. *Id.* at 3, 5, 7, 9.
85. *Id.* at 3.
86. *Id.* at 4, 131.
87. *Id.* at 219.
88. *Id.* at 128, 220, 312.
89. *Id.* at 220.
90. *Id.* at 220. Berle and Means had in mind an overarching standard that would constrain the enabling system ex post: no language in a corporate charter could deny or defeat the fundamental equitable control of the court. *Id*. at 242.

realistic" judges, "if untrammeled by statute," could be expected to find solutions to problems that demanded a remedy.[91]

Events did not unfold in accordance with the book's description, however. Delaware's judges did indeed prove "[f]lexible and realistic," but their flexibility followed their realism and so benefited management interests. By the 1960s, observers attempting to explain why no other state had wrested a significant market share away from Delaware were mentioning Delaware's courts as well as its code. The accumulated stock of precedent was mentioned, along with competence and fairness. But Sam Arsht, a dean of the Delaware bar, added a telling point—corporations considered Delaware the most favorable forum available.[92]

The results frustrated proponents of the trust paradigm, whose views were embodied in William L. Cary's famous indictment of Delaware, published in 1974.[93] Cary reviewed leading Delaware opinions, along with the statutory developments reviewed above, and concluded that Delaware had "no public policy left . . . except the objective of raising revenue."[94] To Cary, the "public policy" at stake was the integrity of corporate managers. Rents had led a single state to "grant management unilateral control untrammeled by other interests,"[95] thereby sacrificing the national public interest. Charter competition was a "race to the bottom." The stable settlement between Delaware and the chartering firms meant that corporate law addressed only the interests of a narrow class of management consumers, causing it to be more and more removed from the public interest.

Cary recommended a preemptive federal regime of fiduciary standards, a traversal of internal affairs that might have enervated the charter market. Unlike the federal mandates we see in practice,[96] fiduciary standards would have removed fiduciary lawmaking to the federal courts, destroying Delaware's body of case precedents and removing its judiciary from the front line of corporate lawmaking. Given the gradual convergence of corporate

91. *Id.* at 197, 295.

92. Comment, *supra* note 66, at 893-94.

93. William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974).

94. *Id*. at 684; *see also* Marvin A. Chirelstein, *Towards a Federal Fiduciary Standards Act*, 30 CLEV. ST. L. REV. 203 (1981).

95. Cary, *supra* note 93, at 697, 698.

96. If the federal mandates described above at any time adversely affected Delaware, they did so in the period between 1929 and 1967, when Delaware lost market share and suffered reduced revenue support from chartering. Since the mandates stayed in place after Delaware's 1967 recovery, it seems sounder to refrain from inferring a negative impact during any period.

codes, Delaware's customers thereupon might have reappraised the costs and benefits of domicile in the state.[97]

2. The Market Paradigm and the Race to the Top

The market paradigm rebuts both the trust paradigm's description of separated ownership and control and its call for regulation. This perspective, which originated in economics during the 1960s and 1970s, recasts the firm as an incident of contracting among rational economic actors.[98] The firm becomes a series of contracts joining inputs to outputs, with equity capital as one of the inputs and corporate law as a part of the input's governing contract.[99] The imperfections identified under the trust paradigm reemerge under the denomination "agency costs," costs that firms must minimize due to the free market's competitive force. Managers are no longer seen as empowered actors, and responsibility is no longer seen as a problem. When managers fail, they get removed—either a hostile offeror takes over the company and throws them out,[100] the firm with a high agency cost base fails to survive in the product market, or poor managers fail to survive in the management labor market. Their incentives accordingly are focused on long-run productive success for the firm.[101] Given these market deterrents, corporate property again becomes private, the regulatory agenda goes blank, and a powerful presumption lies against national intervention.[102]

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97. While Berle and Means limited the trust paradigm's class of beneficiaries to the corporation's shareholders, many of the paradigm's subsequent proponents expanded the zone of beneficiary to include other corporate constituents and the public interest. The "public" characterization in THE MODERN CORPORATION AND PRIVATE PROPERTY invited the extension. So did the book's emphasis on managerial power: to mid-twentieth century antimanagerialists, power implied responsibility and, given the separation of ownership and control, responsibility needed to be imposed in law—federal law. *See* NADER, ET AL., *supra* note 45, at 1, 7; *see also* Robert A. Dahl, *Governing the Giant Corporation, in* CORPORATE POWER IN AMERICA 10, 12 (Ralph Nader & Mark J. Green eds., 1973).

98. William W. Bratton, *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 420 (1989).

99. *See* Jensen & Meckling, *supra* note 4, at 305, 310. For a review of the literature, see Bratton, *supra* note 98, at 420.

100. This point originated in Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 120 n.34 (1965). For a discussion of Manne's contribution, see William J. Carney, *The Legacy of "The Market for Corporate Control" and the Origins of the Theory of the Firm*, 50 CASE W. RES. L. REV. 215 (1999).

101. Bratton, *supra* note 98, at 417-18.

102. William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 NW. U. L. REV. 180, 186-90 (1992).

The market paradigm also counters Cary's denunciation of Delaware. It draws on public choice theory to debunk the public interest ideal of regulatory motivation and assert that regulators should be expected to behave no differently than actors in private economic relations.[103] There is, accordingly, nothing suspicious about the sale of charters. This point, coupled with the market deterrent story of well-aligned agent incentives, reverses the race to the bottom into a race to the top.[104] In the race to the top description, state corporate codes and judicial venues are viewed as products consumed by corporations. Competition for the legal business of firms forces the states to adapt the law to the dynamic conditions in which the firms operate. State lawmaking emerges as a trial-and-error process suited to the accurate identification of optimal corporate arrangements.[105]

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

Each paradigm, trust and market, has a strong ideological affinity. The trust perspective suits progressives disposed to impose regulations that disempower managers and protect actors in vulnerable economic positions. As such, it lost its leading role in public policy discussion after 1980, along with the general collapse of confidence in regulatory solutions to economic problems. The trust paradigm still echoes in a significant body of academic commentary.[106] But it neither informs corporate law agendas in the wider polity nor figures importantly in contemporary criticisms of the charter competition system.

The market paradigm presents an ideological mirror image. It suits deregulatory policy agendas and devolutionary federalists. The deregulatory 1980s should have carried it to unquestioned ascendancy in corporate law discussions. But it instead ran into an unanticipated public choice problem when the mature, state-level enabling system underwent a third and final round of statutory innovation.[107]

103. Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. 167, 168-69 (1990).

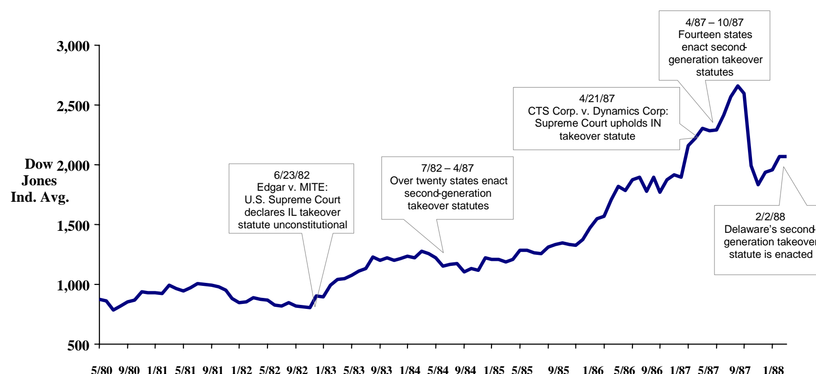
104. *See* Ralph W. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254-62 (1977).

105. ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 6 (1993).

106. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (challenging the shareholder primacy norm).

107. See *infra* notes 109-13.

Figure III: Market Context 1982-88[108]



During the 1980s, a majority of the states added antitakeover provisions to their codes. The statutes entered territory where free contract formerly had prevailed, making takeovers more expensive and variously containing shareholder rights of alienation and decisionmaking.[109] The statutes began to appear in the 1960s and 1970s, but changed in form after 1982, when the Supreme Court, in *Edgar v. MITE Corp.*,[110] invoked the Commerce Clause to invalidate state statutes that subjected hostile tender offers to substantive review by state securities administrators. The new statutes, which operated in traditional internal affairs territory, passed constitutional inspection in 1987, when the Supreme Court decided *CTS Corp. v. Dynamics Corp. of America*.[111] Twenty states enacted such statutes in the years between the two rulings, with fourteen more acting in the six months after *CTS*.[112] Delaware, lagging, followed in 1988.[113]

The antitakeover round followed the earlier pattern of state law innovation in two significant respects. The statutes once again were enacted against the backdrop of a booming stock market, as shown

108. Yahoo! Finance, http://finance.yahoo.com (generated using the closing price of the Dow Jones Industrial Average on each day of the historical period); *see also* Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 461-63 (1988).

109. More specifically, the statutes tended either to condition the voting right of bidders on the approval of the shareholders as a whole, to impose freeze periods on combinations between bidders and targets, or to require that an equal price be paid in the second stage of a two-tier acquisition. For a summary, see ROMANO, *supra* note 105, at 53-57, 74-75.

110. 457 U.S. 624, 640-46 (1982).

111. 481 U.S. 69 (1987).

112. Romano, *supra* note 108, at 461.

113. *Id.* at 464, 464 n.16.

above in Figure III. They also catered to management's interest in freedom of action.

But the antitakeover statutes also broke the pattern in significant respects. Innovations in the bull markets of the 1920s and 1960s facilitated deal making; here the states chilled transactions.[114] Formerly, state law innovation almost always moved in an enabling direction. Here, even as the governance device of shareholder ratification figured prominently, so did mandates. Formerly, the first mover had been Delaware, the charter market leader. Here, states that did not pursue charters made the first move. Where Delaware innovated with an eye to business preferences nationwide, the states enacting antitakeover statutes moved at the behest of nervous managers with local influence.[115] The politics were unrepresentative. Threatened managers and local lawyers, acting independently of local business, labor, and community leaders, used their influence to procure legislation.[116] The responsive legislators in effect externalized the costs of takeover defense on out-of-state shareholders. Rising stock prices also figured into the picture: takeover activity, friendly as well as hostile, rises and falls with the stock market.

The Delaware process differed, reflecting the more diverse constituency swept in by its law's national reach. Managers seeking protection (and their lawyers) lobbied in favor of takeover defense, some even threatening to pull out of the state. They were countered by institutional investors, shareholders organizations, and SEC commissioners.[117] A weak statute emerged.

The equilibrium pattern broke because, with the hostile offers of the 1980s, the enabling framework, for the first time in its history, held out an effective means of management removal unimpeded by the shareholder collective action problem. When the states adjusted by erecting new barriers, the shareholders, again for the first time in corporate law history, went into irreconcilable opposition. Previously, the states' successive moves to extend managers more slack had failed to rouse shareholder opposition. There were a number of reasons for the shareholders' cooperative attitude. First, as the trust proponents noted, the shareholders suffered collective action problems. Second, under the Wall Street Rule, shareholders were content to resort to exit by market sale when excessive slack led to poor results. Third, since 1934, the SEC had stood in to

114. *Id.* at 462.
115. *Id.* at 461.
116. *Id.* at 462.
117. *Id.* at 463-64.

protect shareholder interests at the national level.[118] Sleazy market practices facilitated by enabling innovations in the 1920s had been dealt with by federal disclosure and market regulation mandates. In the 1980s, however, federal regulators did not come to the shareholders' rescue. Institutional shareholding, meanwhile, ameliorated the collective action problem. Now organized, the shareholders found their voice, a dissenting voice.

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

The failure of the market analogy was inevitable, given the crystallization of opposing views between shareholders and managers on the power implications of the shareholders' right of free transfer. The law as product analogy works as a policy justification only to the extent that the supplying jurisdiction purveys an unbundled regulatory product to a consumer with a unitary set of preferences, without externalizing costs on anyone else. The charter market does meet the former qualification—Delaware's customers take only its corporate law free of all other regulations. The latter qualification has always been problematic, for it depends on the heroic assumption that shareholder and manager interests always are perfectly aligned, rendering irrelevant the mandated agenda control managers enjoy under the state system. Where, as with takeovers, interests do not stand aligned, the state system displays a structural defect. Because the market forces a state that actually competes to focus on the variables that influence incorporation decisions,[119] there follows a concern for

118. The promulgation of the proxy rules in the 1950s provides an example of this. *See* SELIGMAN, *supra* note 54, at 270.

119. Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1452, 1454 (1992).

management preferences rather than shareholder value itself. Accordingly, nothing at the state level prevents suboptimal accommodation of management preferences respecting ex post affiliation terms and fiduciary standards.[120]

Since the defect is intrinsic to the system, regulatory correction must occur at the national level. Should the issue be joined there, and should the diagnosis of suboptimal results prevail there, the internal affairs presumption, standing alone, would present no barrier to intervention. The economics of federalism posit intervention to police interstate externalities as a principal justification for the very existence of the national government.[121] Moreover, such intervention could be designed so as to cause minimal disruption at the state level. It could even prove beneficial. We have suggested elsewhere that the federal government could partially preempt the states' provision of management agenda control and mandate a right of shareholder initiative to effect reincorporation.[122] We projected that such an adjustment could jumpstart the charter market and import a state-level incentive to create a regime more single-mindedly directed to shareholder value maximization.[123] Lucian Bebchuk and Allen Ferrell apply this strategy in a different direction, suggesting that the federal government create a parallel takeover regime and accord the shareholders a privilege to opt into it.[124] There is, then, no shortage of regulatory strategies fitted to the task of correcting the charter market's defects. Yet the federal government has not intervened, even as the era of shareholder capitalism dawned in the wake of the takeover wars of the 1980s.

4. How Robust is the Charter Market?

A growing body of commentary criticizes Delaware and the charter market from a different perspective, that of microeconomic theory. The market, it is charged, little resembles an efficient product market—a market that maximizes welfare by producing in

120. *Id.* at 1462-63, 1468, 1488.

121. *See* Frank H. Easterbrook, *Federalism and European Business Law*, 14 INT'L REV. L. & ECON. 125, 127 (1994).

122. William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1936-47 (1995).

123. *Id.*

124. Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111 (2001). *See* Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961, 975-77, 991 (2001) (suggesting that the proposal might have minor perverse effects).

the competitive equilibrium quantity.[125] It is instead a bundle of suboptimal distortions.[126] Delaware charges much more for its product than its marginal cost of production and its franchise tax rates implicate price discrimination.[127] Other states have no incentives to compete with Delaware, leaving their regimes open to suboptimal influence activities by managers and lawyers.[128] Even if actors in another state had incentives to attempt to enter the market to take market share from Delaware, structural barriers would make competitive success highly unlikely.[129] Delaware, for example, takes the benefit of network and learning externalities incident to the sale of an integrated legal system.[130] Its system also is surprisingly friendly to litigating plaintiffs, toward the manifest end of generating rents for its bar.[131]

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

125. HOWELL E. JACKSON ET AL., ANALYTICAL METHODS FOR LAWYERS 325 (2003).

126. Oren Bar-Gill et al., *The Market for Corporate Law*, (Harvard John M. Olin Ctr. for Law, Econ. and Bus., Discussion Paper No. 377, 2002) develops a formal product market model that incorporates many of the main points of this line of thinking.

127. *See* Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1211, 1215-19 (2001); *see also* Michal Barzuza, *Price Considerations in the Market for Corporate Law*, 26 CARDOZO L. REV. 127, 132 (2004) (describing Delaware's pricing as reflecting a trade off between benefits to managers and injury to shareholder value due to suboptimal law, with Delaware charging less than it might otherwise).

128. Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 735-40 (2002).

129. *See* Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1820 (2002); Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 557 (2002).

130. *See* Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347 (1996); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1910 (1998); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 845-46 (1995).

131. *See* Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 471-72 (1987). S*ee also* Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1580 (2002) (noting that the personal interests of chartering lawyers in addition to the substance of the legal regime determines the choice of domicile); Kahan & Kamar, *supra* note 128, at 695 (showing that Delaware lawyers have average incomes higher than those of any other state).

law only provides a self-standing justification on the assumption a parallel market for corporate control imports incentive compatibility. Once the states chilled the takeover threat, federal intervention could be justified whether or not Delaware faced active competition. Second, the structure of state law showed remarkable stability between 1896 and the takeover wars of the 1980s, and that structure was determined in a manifestly competitive environment. Potential entrants prompted Delaware to legislative action as late as 1967.[132] Third, Delaware always remains subject to potential competition from other states. If, like New Jersey in 1913,[133] it defected from the political settlement and took a public-interest view of regulation, the firms would find somewhere else to go. The same thing would happen if the quality of its lawmaking took a costly adverse turn. Similarly, were Delaware to raise its rents to the point where firms found it too costly, its business would drop off, causing it to reconsider both its franchise tax scheme and litigation rules. Fourth, no one forces firms to go to Delaware and pay the rents. And if there is a group of consumers in the world well suited to contractual self-protection, it is Delaware's customers. Indeed, more than forty percent of publicly traded firms choose to stay out.[134] So, even though a pinpointed federal intervention could in theory jumpstart the charter market, such intervention is a remote possibility as a political proposition. Excess rents to Delaware and other imperfections highlighted by analogy to the economics of industrial organization seem an improbable basis for invoking national entry into internal affairs.

Fifth, and most important, the economics of federalism looks beyond competition to support a presumption favoring state- and local-level regulation. So long as production costs are equal, decentralized regulation is favored because it is more responsive—it narrows the variance in the distribution of preferences, reduces the likelihood of bundled preferences, and ameliorates problems of asymmetric information.[135] On the majority of matters as to which management and shareholder interests stand in alignment, the century-old political settlement between firms and the competitive chartering state, with its extraordinarily high degree of accountability, fits this description. At the same time, the market paradigm succeeds in an important respect, despite its

132. NADER ET AL., *supra* note 19, at 64.

133. *Id.* at 50-51.

134. BEBCHUK & COHEN, *supra* note 74, at 389.

135. William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201, 215 (1997).

shortcomings. Cary's public interest objection to the sale of corporate law no longer carries weight. Charter competition is no longer seen as inherently corrupt. It is viewed functionally in the wider legal and economic framework of shareholder capitalism.

The picture of an uncompetitive charter market holds out devastating implications not for the internal affairs presumption but for the economic theory of regulatory competition. This economics dates back a half century. It got off to a bright start. For a while it was thought that devolution within federations could be relied on to trigger races to the top respecting diverse subject matters. Competition for domiciliaries and factors of production was posited as the cure for public choice problems. Under the theory, citizens signal their preferences respecting legal goods and services when they migrate from regime to regime. Their ability to exit disempowers government actors, whose welfare diminishes as citizens depart, taking along votes and revenues.[136] Competition for domiciliaries and factors of production, having disabled the interest groups, then causes government policies to be matched with diverse citizen preferences.[137] A preference for state over national lawmaking also is implied, since the revenue enhancement constraint on the national government is less intense.[138] Because national-level competitive constraints also are less intense, the national lawmaking process will be slower, less responsive to productive concerns, and more susceptible to the influence of organized interest groups.[139]

The theory ran into two problems. First, multiple frictions at the state level impair competition. These include product bundling, mobility costs, spillovers, information asymmetries, and the absence of entrepreneurial incentives on the part of government actors.[140] Second, even assuming competitive incentives at the state level, the economics proved incapable of predicting stable, long-term equilibriums in competitive lawmaking situations.[141] Charter competition, along with other cases where a conflict of laws regime allows actors to chose a nominal jurisdictional situs for a legal relationship, are the exceptional cases where the theory has descriptive power. This is because nominally sited legal relationships can be sold separately as unbundled legal products.[142]

136. *See* Ronald J. Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 MCGILL L.J. 130, 142-43 (1991).

137. ROMANO, *supra* note 105, at 4-5.

138. *Id*. at 4-5, 48.

139. *Id*. at 5.

140. Bratton & McCahery, *supra* note 135, at 260.

141. *Id.* at 261.

142. *Id.* at 267.

Given something to sell, entrepreneurial lawmakers can appear. Of course, as we have seen with New Jersey and Delaware, a concomitant private sector sideline, in the form of service company profits, may be necessary to jump start the operation. But the service companies, along with other rent-seeking intermediaries, also serve a market function because they correct information asymmetries. With corporate law, a stable lawmaking equilibrium resulted. But, as we also have seen, externalities have remained a problem.

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

Competition, then, does not provide a stand-alone justification for a strong internal affairs presumption. But we do not think this makes for a federalism problem for Delaware. To our knowledge, no first-best lawmaking equilibrium has ever been identified, so it is not clear to us why the charter market needs to be judged by that measure in the first place.

C. Summary: The Stable Equilibrium

The state system can be described as a stable equilibrium. Drawing on concepts from evolutionary game theory, we see that prior to 1920 New Jersey adopted a noncooperative strategy, turning corporate law making into a strategic game directed to the acquisition of rents from managers looking for responsive, enabling legal frameworks, despite negative consequences for other states. There followed a period of learning (or adaptive behavior) during which other states adjusted their strategies, following New Jersey.[143] New Jersey then abandoned its strategy for exogenous political reasons. Delaware, playing New Jersey's original strategy, captured its rents. Delaware has been playing noncooperatively vis-à-vis the other states ever since. Within the game, an enabling corporate

143. *See* LARRY SAMUELSON, EVOLUTIONARY GAMES AND EQUILIBRIUM SELECTION 22-24 (1997).

code that also vests agenda control over governance matters in management amounts to an evolutionary stable strategy—any state without one risks the loss of its significant charters;[144] any state innovation that fails to follow the strategy will not succeed. Meanwhile, Delaware's agents resemble rational maximizers, seeking to protect the state's rents. They update and learn on an ongoing basis, adjusting their strategies respecting the terms of corporate law as they face new situations.[145] The history shows that so long as the states are left alone to play the game, corporate law nearly approaches a stationary state.[146]

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

144. *Id.* at 17.

145. *Id*. at 23. Conventional game theory with its stringent rationality requirements teaches us little about how norms can be self-enforcing. *See* Paul G. Mahoney & Chris William Sanchirico, *Norms, Repeated Games, and the Role of Law*, 91 CAL. L. REV. 1281, 1300-01 (2003) (showing counterfactuals are destabling for equilibrium strategies, such as the def-for-dev, and always defect). Dissatisfied with the stringent rationality requirements of standard Nash equilibrium approach to strategic environments, the evolutionary game theory literature makes less stringent assumptions regarding the knowledge and understanding of the players. But a key assumption is made about learning processes of players—that a player's behavior will adapt to the new circumstances posed by the game. SAMUELSON, *supra* note 143, at 91. The learning dynamic allows players to distinguish between noise (cheap talk) and out-of-equilibrium strategies (real threats), which could cause the system to move toward another equilibrium. The learning process is crucial for the charter market game because Delaware's agents have needed to accumulate, through many rounds of play, sufficient experience to learn the optimal behavior required to keep the system in equilibrium.

146. SAMUELSON, *supra* note 143, at 26; *see also* David P. Baron, *The Economics and Politics of Regulation: Perspectives, Agenda, and Approaches, in* MODERN POLITICAL ECONOMY 27-32 (Jeffrey S. Banks & Eric A. Hanushek eds., 1995) (describing the mechanisms that produce long-run institutional stability). *Cf.* JEAN-JACQUES LAFFONT, INCENTIVES AND POLITICAL ECONOMY 189-206 (2000) (showing formally that a continuum equilibrium emerges when a principal can write side-contracts with agents that elicit information about collusive interest group activities); Jean Tirole, *Collusion and the Theory of Organizations, in* 2 ADVANCES IN ECONOMIC THEORY, SIXTH WORLD CONGRESS, at 151-206 (1992) (showing similar results when enforcement is by reputation rather than collusive side contract).

differ on the probable state level effects of federal intervention. Some argue that the states' failure to contain externalities and regulate toward the end of shareholder value maximization rebuts the internal affairs presumption and justifies corrective intervention.[147] As we have seen, they also argue that this can be done in a way that forces the states to change their strategies, accommodating the shareholder interest and changing their strategy without cutting off the rent incentive. Others take the position that the stable equilibrium holds out such benefits that any shortcomings must be forgiven. They point out that the political agenda at the federal level is highly contestable. Management remains a more concentrated group than the shareholders and thus more able to wield influence. It could co-opt a federal reform process, for example procuring legislation making takeovers more expensive still.[148] That risk, together with the possibility of perverse effects stemming from the federal habit of governance by mandate,[149] implies a preference for the states' enabling equilibrium, with its high degree of accountability within the corporate community.[150]

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

II. POLITICAL ECONOMY AT THE NATIONAL LEVEL

The federal government took the lead in regulating the securities markets when it added disclosure, antifraud, and insider trading mandates in 1933 and 1934.[151] Under the internal affairs norm, as thereafter articulated, markets and disclosure were federal subject matters, while other corporate subject matters were

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147. *See infra* notes 150-52 and accompanying text.

148. Choi & Guzman, *supra* note 124, at 975-76.

149. William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 757 (1998) (arguing that interest group rent seeking will result from shifting the lawmaking venue to the federal level); *Id*. at 977.

150. ROMANO, *supra* note 105, at 4-5, 48-50, 75-76.

151. The federal disclosure regime less displaced the states than it did the NYSE listing requirements, which had required annual financial reports in 1907, semiannual financials in 1917, quarterly financials in 1923, and independent audits in 1932. *See* GILBERT W. COOKE, THE STOCK MARKETS 340 (rev. ed. 1969); Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 970, 970 n.40, 977 (2003).

presumptively left to the states and the stable equilibrium. Despite the norm, the federal government and the stock exchanges since that time have progressively, albeit episodically, entered into internal affairs. These interventions are historically contingent, occurring when political demands are registered nationally.[152]

Despite the contingent and episodic nature of these federal entries, federalism has evolved toward an equilibrium balance. Where the exchange of a product for rents describes the state equilibrium, the federal equilibrium is political. Where the state equilibrium is self-enforcing, federal actors have a range of strategies at their disposal and a zone of discretion. They could play uncooperatively, intervening so as to terminate the rents and the state equilibrium. They also could be wholly cooperative, leaving internal affairs to the states. Strategies actually chosen depend on political norms and pressures, which in turn depend heavily on the environment in which the game is played. We accordingly should not expect the federal-state game to replicate the stability we see in the states because the federal game is political and driven by exogenous events. Even so, four patterns can be discerned in the history of federal incursions on internal affairs. Together they suggest the evolution of a stable, cooperative strategy at the federal level.

The first pattern concerns subject matter. Interventions tend to address topics, legal compliance most prominently, as to which unilateral action by Delaware would be inadequate to fully satisfy national political demands. This follows in part from the federal structure: national demands create a need for parallel action across all fifty states. It also follows from the properties of the state equilibrium. In the charter market, the evolutionarily stable strategy is fidelity to the management interest. If Delaware shifted to a strategy of imposing hardwired accountability and enforcement, it would be viewed as a defection against management and would disrupt the equilibrium, reducing Delaware's rents. The same thing would happen if Delaware mandated governance processes. It follows that not only does federal intervention accomplish results unavailable in the states, the stable equilibrium disables the states from preemptively anticipating federal strategies. The states'

152. The state-federal comparison here bears a resemblance to the comparison of state law in this country and Japanese corporate law in Mark D. West, *The Puzzling Divergence of Corporate Law: Evidence and Explanations from Japan and the United States*, 150 U. PA. L. REV. 527, 588-91 (2001). Federal corporate law in this country responds to exogenous shocks where state law shows more stability, just as West shows that Japan's unitary system is more shock sensitive than the United State's state corporate law, considered alone.

evolutionarily stable strategy embeds the legal regime. At the same time, because the federal government never makes full use of its constitutional preemptive authority, the federal-state equilibrium has a cooperative aspect.

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

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

The fourth pattern manifests the operative federalism. Even as the federal government and the stock exchanges cross the internal affairs line and mandate governance strategies, they have never disrupted the state equilibrium. National intervention has impacted neither the basic terms of the state settlement nor Delaware's rent flows, once again implying a cooperative strategy. Contrariwise, even as federal moves have prompted Delaware to adjust its strategies on occasion, Delaware never goes so far as to imitate federal strategies.

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

A. The Trust and Market Paradigms at the Federal Level

Federal incorporation proposals antedate the federal

government itself—James Madison mooted the idea at the Constitutional Convention.[153] Federal incorporation went on to reach the top of the national policy agenda as a first reaction to the appearance of charter competition. But its proponents in successive administrations never managed to put together the broad-based coalition needed to secure passage in Congress.[154] After 1920, federal chartering never regained comparable political salience, even as the trust paradigm's adherents brought it back to the national agenda on two later occasions. This section takes the benefit of hindsight to explain those later failures, drawing a parallel to the failure of the market paradigm's proponents to invoke federal preemptive power to protect the hostile takeover.

1. The New Deal

Federal incorporation had a place on the agendas of a number of prominent New Dealers, President Franklin D. Roosevelt and SEC Chairman William O. Douglas not least among them.[155] They were joined by Senators Joseph O'Mahoney and William Borah, who promoted the idea in Congress during the second Roosevelt administration. O'Mahoney and Borah wanted to make federal incorporation the vehicle for an omnibus progressive assault on management discretion. O'Mahoney's proposed bill[156] revived old antitrust agenda items, adding to them Berle and Means' rule of trusteeship and other current items from the governance agenda. O'Mahoney also included the labor agenda, mandating compliance with the National Labor Relations Act as an internal corporate duty.[157]

Unfortunately for O'Mahoney, prominent actors in the administration were opposed. Even Douglas had other matters at the top of his agenda and in any event opposed the inclusion of antitrust and labor compliance.[158] The best that O'Mahoney could get from Congress was the formation of a study committee, the Temporary National Economic Committee.[159] This brought together six members of Congress and six agency representatives under O'Mahoney's chair.[160] The committee held hearings but never got behind O'Mahoney's omnibus approach. Its final report in 1941 had

153. *See* JAMES MADISON, NOTES OF DEBATES IN THE FEDERAL CONVENTION OF 1787 638-39 (W. Norton & Co. ed., 1966).

154. Brabner-Smith, *supra* note 49, at 162-63.

155. SELIGMAN, *supra* note 54, at 205.

156. S. 10, 75th Cong. (1937).

157. Brabner-Smith, *supra* note 49, at 165.

158. SELIGMAN, *supra* note 54, at 207-08.

159. *Id*. at 209.

160. *Id.*

no impact.[161]

The bundling of the labor agenda has been accorded a causal role in the failure of the O'Mahoney initiative.[162] To second the point, reference can be made to the labor movement's congressional agenda since World War II, which has never targeted empowerment in corporate internal affairs. Under an enduring American political settlement, labor works within the model of contractual engagement, where, since the enactment of the Taft-Hartley Act in 1947,[163] it has been fighting a rearguard political action.[164] Organized labor works to improve its rights to organize shopfloors, empower the National Labor Relations Board (NLRB) (or nominate a stronger enforcement agent), and secure the power of the secondary boycott.[165] State law also shows up on the agenda, but labor wants right-to-work laws preempted rather than state corporate codes.[166] Today, even as union pension funds use their shareholdings for antimanagerial initiatives, they tend to stick to items on the institutional investors' governance agenda, avoiding labor movement issues in order to retain plausibility.[167]

161. *Id*. at 209-10.

162. *Id.* at 210.

163. The Labor Management Relations Act, 1947, 29 U.S.C. §§ 141-87 (2000).

164. *See* Michael H. LeRoy & John H. Johnson IV, *Death by Lethal Injunction: National Emergency Strikes Under the Taft-Hartley Act and the Moribund Right to Strike*, 43 ARIZ. L. REV. 63, 126-30 (2001) (claiming that "Taft-Hartley contextualizes strikes as a harm to the public" and that "Taft-Hartley injunctions played an important role in the long-term decline of industrial unions"); Nelson Lichtenstein, *Taft-Hartley: A Slave-Labor Law?*, 47 CATH. U. L. REV. 763, 765 (1998) (arguing that "the Taft-Hartley law stands like a fulcrum upon which the entire New Deal order teetered" and that, since 1947, the labor movement in the United States has been "forced into an increasingly defensive posture").

165. MARK A. SMITH, AMERICAN BUSINESS AND POLITICAL POWER 1-2, 77-78 (2000).

166. *Id.* at 77. According to Professor Romano, when managers went to state legislatures to procure antitakeover statutes in the 1980s, organized labor sat out the political event, preferring to husband its political capital for its own agenda items. Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 134-37 (1987) (discussing events in Connecticut and asserting that evidence on other states is consistent).

167. *See* Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1042-74 (1998).

2. *The Watergate Era*

When federal chartering returned to the political stage in the 1970s, labor figured in only incidentally.[168] The antitrust agenda of the day also was separately pursued, resulting in the Hart-Scott-Rodino Antitrust Improvements Act of 1976.[169] Federal chartering proponents, who this time came from outside of government, pursued a more general notion of the "public interest." Social reformers like Ralph Nader linked the conduct of corporate business to a range of social problems.[170] It was thought that the benign, pluralist vision of government had failed. Legislative results were not protecting the public interest because business had overwhelming political influence. Indeed, under a theory in circulation at the time, business did not even need to lobby aggressively to get results: politicians automatically backed anything that encouraged investment because they were terrified of the political consequences of disinvestment during economic downturns.[171] The proponents sought to surmount the problems and enforce the public interest through legal control over internal affairs. This public interest agenda came in from the fringe when news of improper political contributions and foreign payments made management's conduct of business a national political issue in the post-Watergate environment.[172]

But only a handful of legislative proposals materialized. Three bills mandating federal chartering were introduced between 1972 and 1980.[173] Of these, the focal point initiative was Senator Howard

168. Two items from the contemporaneous labor agenda show up on one piece of proposed legislation. Representative Rosenthal's Corporate Democracy Act of 1980, H.R. 7010, 96th Cong. §§ 301, 401(c) (1980) contained a plant-closing-notification provision and would have amended the National Labor Relations Act ("NLRA") to add a good-faith termination provision.

169. Pub. L. No. 94-435, 90 Stat. 1383 (1976) (codified as amended in scattered sections of 15 and 28 U.S.C. (2000)).

170. See NADER ET AL., *supra* note 45, 16; Donald E. Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L. REV. 545, 548-49 (1984).

171. *See* CHARLES E. LINDBLOM, POLITICS AND MARKETS: THE WORLD'S POLITICAL-ECONOMIC SYSTEMS 170-88 (1977). Alternatively, it was argued that the regulatory state had become dysfunctional even as corporate externalities remained a critical problem. *See* Elliot J. Weiss, *Social Regulation of Business Activity: Reforming the Corporate Governance System to Resolve an Institutional Impasse*, 28 UCLA L. REV. 343, 347-55, 422-26 (1981) (suggesting imposition of a norm of "altruistic capitalism").

172. Schwartz, *supra* note 170, at 548-49.

173. Corporate Citizenship and Competition Act of 1975, H.R. 7481, 94th Cong. (1975) (reintroduced as H.R. 9076 July 29, 1975); Corporate Democracy Act of 1980, H.R. 7010, 96th Cong. (1980); Protection of Shareholders' Rights

Metzenbaum's Protection of Shareholders' Rights Act of 1980,[174] a bill that drew on the Berle and Means trust paradigm, omitting the broader public agenda and focusing on the shareholder interest and the governance agendas. Following Cary, it imposed federal fiduciary standards,[175] adding a series of process mandates including an independent director board majority,[176] audit and nominating committees entirely made up of independent directors,[177] a shareholder nomination mechanism,[178] and cumulative voting.[179] But time was running out for antimanagerial politics in 1980. When the Reagan administration came in the following year, the federal agenda shifted to the market paradigm. Federal chartering has not been heard of since on Capitol Hill.

The trust paradigm did better in the federal courts of the era than it did in Congress. Federal courts of appeal expanded the implied right of action under Rule 10b-5 to cover equitable fraud and breaches of fiduciary duty.[180] Had the expansion been sustained, the states' fiduciary regime might have been rendered superfluous as plaintiffs opted for a more hospitable federal venue. But, in 1977, a Supreme Court majority rejected the expansive reading of 10b-5,[181] emphatically employing the internal affairs presumption in its interpretation of the securities laws.[182]

3. *The Takeover Era*

The political tables turned in 1980. Now adherents of the market paradigm dominated the SEC.[183] Although friends of the

Act of 1980, S. 2567, 96th Cong. (1980).

174. Protection of Shareholders' Rights Act of 1980, S. 2567 96th Cong. (1980).

175. *Id*. § 4.

176. *Id*. § 5.

177. *Id*. §§ 6, 7.

178. *Id*. § 8.

179. *Id*. § 9.

180. *See* Shell v. Hensley, 430 F.2d. 819 (5th Cir. 1980) (holding that no express allegation of deceit is required to assert a Rule 10b-5 claim); Green v. Santa Fe Indus., 533 F.2d 1283 (2d Cir. 1976), *rev'd sub nom.* Santa Fe Indus. v. Green, 430 U.S. 464 (1977) (holding that Rule 10b and 10b-5 should not be extended to create uniform federal fiduciary standards); Ruckle v. Roto Am. Corp., 339 F.2d 24 (2d Cir. 1964) (holding that a corporation can sue under Rule 10b-5 when it is defrauded into issuing shares). *But see* Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969) (refusing to find a violation in a sale of treasury stock to a related party at a deflated price).

181. *Santa Fe Indus*., 430 U.S. at 479-80.

182. Cort v. Ash, 422 U.S. 66, 84 (1975) (asserting that state law governs internal affairs).

183. Romano, *supra* note 108, at 489.

internal affairs presumption, they soon ran into their own problems with the states. The states, still following the evolutionary stable strategy, were moving to chill hostile takeovers. The market paradigm supported preemptive intervention. Although generally committed to regulatory devolution, the paradigm also counseled central regulatory intervention to the extent necessary to protect a market by keeping transactional lanes open and policing externalities.[184] The paradigm's adherents won a single great victory when the same Supreme Court that had protected the states from the federal antifraud regime invalidated first generation antitakeover statutes as a burden on interstate commerce.[185] Unfortunately, the states took advantage of the Court's interpretive preference for state control of internal affairs and redrafted their statutes, winning the second round in the Supreme Court.[186] It accordingly was up to Congress to protect the market for corporate control. Unfortunately, the takeover wars of the period left Congress inundated with antitakeover constituent pressure. Most proposed bills were antitakeover.[187] The interest group alignment in Washington tracked that in the states, with the management voice sounding louder than the shareholder voice and the shareholders showing no cognizable public support for preemptive intervention against the states.[188] Administration opposition sufficed to block the antitakeover initiatives,[189] leaving the federal government in gridlock. The outcome accordingly was decided at the state level.

4. Summary

Now comes the question as to what these accounts teach us about the content of corporate federalism. More specifically, to what extent should we infer that the internal affairs norm played a causal role in these federal level outcomes? Drawing causal inferences from a historical pattern of inaction is a risky business, so we take a

184. Bratton & McCahery, *supra* note 135, at 211-12.

185. Edgar v. MITE Corp., 457 U.S. 624, 640-46 (1982); *see also* A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 905-20 (2003) (discussing Justice Powell's participation in both decisions and his managerialist opposition to hostile takeovers).

186. CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 78 (1987).

187. Romano, *supra* note 108, at 458-60.

188. *Id.* at 488-90.

189. *Id.*; *see also* Donald C. Langevoort, *The SEC's Statutory Authority to Promote Shareholder Access to the Corporate Ballot, in* SHAREHOLDER ACCESS TO THE CORPORATE BALLOT 9-10 (Lucian Bebchuk, ed.) (on file with author) (forthcoming) (describing a political change in the late 1980s, pursuant to which antitakeover views became more salient at the federal level).

flexible approach in addressing the question. Three contrasting inferences may be drawn.

a. *No Federalism.* Nothing in these cases compels the inference that federalism concerns played an operative role. The events plausibly can be read narrowly, as a series of federal-level political failures acted out against an inherited state-level default condition. Such a default persists so long as the actors at the higher level of government fail to agree, and can persist even though the terms of state regulation no longer embody a preferred outcome due to changed conditions.[190] No inference of respect for the states need be drawn. O'Mahoney acted at the moment in history when intervention against the states and corporate management had a comparatively high level of political plausibility. But he asked for too much in challenging the political settlement that excludes labor from internal affairs, a settlement long embedded at both the national and state levels. Metzenbaum asked for less, but taking advantage of hindsight, we can see that in 1980 the trust paradigm did not command a political base adequate to push business law reform past the management interest and into law. (The Reagan SEC and the market paradigm encountered the same problem a few years later.) Indeed, by 1980 the trust paradigm probably lacked the political gravitas to reach the top of the congressional agenda, much less to defeat the opposing interest group.

Both the trust and the market paradigms emerge in this description as political failures. Whatever their substantive merits, they were the projects of narrow networks of academic and policy elites. Neither resounded strongly enough, either with the median voter, or alternatively, the partisan agenda setters, to stay (or even arrive) at the top of the agenda, much less to override interest group opposition.[191] No general observation about the political influence of narrow, elite networks is intended. Academic paradigms help shape political agendas, perhaps even contributing a focal-point solution in a case where a problem has multiple competing solutions.[192] But the likelihood of such influence decreases as the distributional consequences of the competing outcomes increase.[193] Here, given the

190. *See* Fritz W. Scharpf, *The Joint-Decision Trap: Lessons from German Federalism and European Integration*, 66 PUB. ADMIN. 239 (1988).

191. The discussion draws on Kevin M. Murphy & Andrei Shleifer, *Persuasion in Politics*, 94 AM. ECON. REV. 435, 435-37 (2004) (Papers & Proceedings).

192. *See* Geoffrey Garrett & Barry R. Weingast, *Ideas, Interests, and Institutions: Constructing the European Community's Internal Market*, *in* IDEAS AND FOREIGN POLICY: BELIEFS, INSTITUTIONS, AND POLITICAL CHANGE 173, 176 (Judith Goldstein & Robert O. Keohane eds., 1993).

193. *Id.* at 205.

high stakes, it is unsurprising that the politics failed to work out for the proponents.

Significantly, both paradigms did better in the courts. There, given interpretive slack, network members in positions of authority can find room to maneuver. At the same time, the judicial rulings show us the only points in the sequence of events implying that respect for the states operates as an independent and causative value. There may have been members of the *CTS* Court who preferred the market for corporate control and economic federalism as a policy proposition but who also felt bound by a conflicting juridical tradition of reserve, here bound up in the internal affairs notion.[194]

b. *Parallel Politics*. Alternatively, we can read these events as a product of parallel normative views at the state and federal levels. On this view, no federal intervention occurred because actors controlling federal outcomes saw nothing amiss in state corporate law. This view can be restated in public choice form: whether or not most federal actors approved of state results, the federal interest group gestalt paralleled that of the states,[195] with the management interest proving sufficiently dominant to protect the state regime. An astute federal actor would anticipate an all out interest group assault on any legislation that threatened the state equilibrium. Management and related interest groups like the corporate bar and the financial intermediaries have a significant investment in Delaware law. Quite apart from any policy preferences, such investors can be expected to fight (or pay) to protect the yield from their sunk costs,[196] and federal politicians can be expected to settle in their favor, perhaps exacting tribute.

c. *Federalism*. Finally, it remains possible that independent federalism considerations operated to deter federal intervention. The operative federalism notions could have been either juridical or

194. It should be noted that Justice Powell opposed takeovers and wanted the states to be left free to contain them. *See* Pritchard, *supra* note 185, at 905-20.

195. *See* Romano, *supra* note 108, at 475-76 (suggesting that federal- and state-level takeover politics paralleled one another).

196. *See* 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, 274-75, 278 (1990). Macey predicts that so long as existing state rents are greater than the rents created by federal regulation, the beneficiaries will pay Congress in return for retention of state control. *Id.* at 276; *see also* Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101, 117 (1987) (showing that where private parties have created quasi rents through capital investment, politicians can extract payments in exchange for promising not to regulate).

economic. We prefer an economic reading. The next sections of this Part look at a number of high profile cases where Congress did cross the internal affairs line, suggesting that any barrier posed by constitutional traditions yields easily. As to economic notions of federalism, a different inference arises. None of these incursions on internal affairs have disrupted the state equilibrium, permitting an inference of respect for state control over internal affairs, viewed from an economic perspective.

B. Federal Incursions on Internal Affairs Under the Governance Agenda

In 1934, William O. Douglas, then still a Yale law professor, published an article in the *Harvard Law Review* in which he described the shortcomings of the about-to-be enacted federal securities statute.[197] He noted scandals that had come to light in the aftermath of the great crash, variously involving secret loans, undisclosed profit sharing plans, self-dealing contracts, and insider trading.[198] Disclosure would not be enough, he said, more in the way of regulation was needed to prevent the repeat of such sorry spectacles in the next cyclical market rise.[199] The problem, said Douglas, lay in the separation of ownership and control.[200] Taking care to endorse the trust paradigm,[201] he nevertheless articulated a second agenda. Control of the board of directors needed to be taken out of management's hands and placed in those of an independent director majority. He proposed a monitoring model—a board made up of independent shareholder representatives who supervised from a position of power.[202] Douglas also wanted more disclosure of conflict of interest transactions and maybe even a per se prohibition of loans to officers.[203] Finally, Douglas noted that the present legal structure did little to move corporate governance in the direction indicated. He was flexible about means to the end of improvement. Any of federal incorporation, self-help by the shareholders (given a federally instituted organizational base on which to solve collective action problems), or improvement of state law might move things in

197. William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1306-07 (1934) [hereinafter Douglas, *Directors*]; *see also* William O. Douglas, *Protecting the Investor*, 23 YALE REV. 521, 529 (1934).

198. Douglas, *Directors*, *supra* note 197, at 1306.

199. *Id.*

200. *Id*. at 1306-07.

201. *Id*. at 1323.

202. *Id*. at 1314-16. In a later address he would add that boards should be smaller, salaries should be adequate, and outsider directors should acquire a thorough knowledge of the firm. SELIGMAN, *supra* note 54, at 207.

203. Douglas, *Directors*, *supra* note 197, at 1323-25.

the right direction.[204]

Douglas' article set out the basic terms of the governance agenda that has guided corporate law reform ever since.[205] Where both the trust and the market paradigms have failed, this academic paradigm has influenced both actors in the corporate sector and federal legislators. Significantly, the agenda is narrow, viewed in the broad scale of things, addressing only the management-shareholder relationship and eschewing other constituents and unrelated notions of the public interest. It has two branches. The first branch goes to the board of directors' make-up and institutional role. Here, two categories of questions come up. The first goes to the identification of best corporate governance practices. The second concerns whether a best practice, once identified, should be mandated, overriding the enabling state system. The agenda's second branch concerns compliance with law. This branch in part tracks state corporate law, looking to enforcement of fiduciary duties. But the compliance agenda has an independent federal side tied to the federal antifraud enforcement regime. This will be the point of entry against state control of internal affairs.

The rest of this Part II.B recounts the appearance of the two statutes that do most to carry the governance agenda across the internal affairs barrier, the Foreign Corrupt Practices Act of 1977 ("FCPA")[206] and the Sarbanes-Oxley Act of 2002 ("SOX").[207] We will see that the Congress traverses internal affairs on a fire patrol basis.[208] In both cases, a bipartisan Congress acted in response to an external shock. In both cases, the state equilibrium precluded significant corrective action. In both cases, corporate compliance failures triggered broad-based political demands. And in both cases, the federal compliance regime reached more deeply into internal affairs.

1. The Watergate Era

During the Watergate investigations of 1973-74, the special prosecutor discovered corporate political slush funds that evaded

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204. *Id*. at 1329-30.

205. For a later, more thorough-going exposition of points on the agenda, see MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 137-211, 316-20 (1976).

206. Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified in 15 U.S.C. §§ 13(b)(2), 30A, 32, 15 U.S.C. §§ 78m(b)(2), 78dd-1-2, 78ff (2000)).

207. Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C. (Supp. II 2002)).

208. *See* Mathew D. McCubbins & Thomas Schwartz, *Congressional Oversight Overlooked: Police Patrols Versus Fire Alarms*, 28 AM. J. POL. SCI. 165, 166 (1984).

normal accounting controls.[209] Payments included illegal domestic political contributions and bribes to officials abroad—termed "questionable foreign payments"—made in connection with the sale of American goods and services.[210] In March 1974, the SEC announced a voluntary disclosure program, asking companies to admit to any questionable payments to foreign officials.[211] There resulted admissions by over 450 companies implicating over $400 million in payments.[212] The public, already disgusted with corruption in government and agitated by the media, demanded a clean up of corruption in corporate America.[213] Corporate governance became bound up with the politics of corruption in high places.[214]

The SEC responded in 1977, taking up governance agenda items looking toward majority independent boards and committees. It held public hearings. But, unfortunately, the SEC had no statutory authorization to mandate committee structure. Aside from section 14 of the 1934 Act,[215] which authorizes the SEC proxy rules, the agency could only mandate disclosure. So the SEC worked the agenda into new disclosure rules concerning board and committee membership and structure. It wanted each director tagged as independent or affiliated. Management, however, made its voice heard and the SEC had to settle for less direct means of getting pertinent facts into the public filings.[216] Movement toward board and committee process mandates shifted over to the American Law Institute ("ALI"), which was taking up a corporate governance project. But management was so averse to mandates that it raised its voice at the ALI as well, stifling even a mandatory statement encapsulated in a nonbinding principle.[217] Efficiency worries had

209. *See* GEORGE C. GREANIAS & DUANE WINDSOR, THE FOREIGN CORRUPT PRACTICES ACT: ANATOMY OF A STATUTE 17 (1982).

210. *See* Roberta S. Karmel, *Realizing the Dream of William O. Douglas – The Securities and Exchange Commission Takes Charge of Corporate Governance* 10 (Social Science Research Network, Research Paper No. 7, 2004).

211. Daniel Pines, *Amending the Foreign Corrupt Practices Act to Include a Private Right of Action*, 82 CAL. L. REV. 185, 187-88 (1994).

212. *Id.* The lead item was the revelation of twenty-two million dollars of bribes abroad by Lockheed Aircraft. DONALD R. CRUVER, COMPLYING WITH THE FOREIGN CORRUPT PRACTICES ACT: A GUIDE FOR U.S. FIRMS DOING BUSINESS IN THE INTERNATIONAL MARKETPLACE 5 (2d ed. 1999).

213. *Id.*

214. Schwartz, *supra* note 170, at 549.

215. 15 U.S.C. § 78n (2000).

216. Karmel, *supra* note 210, at 12-13.

217. Mandatory independent board structure was proposed in the first draft of the American Law Institute's *Corporate Governance Project*, but was cut back to precatory status in later versions. *Compare* PRINCIPLES OF CORPORATE

come to the fore in the stagflating economy. The governance agenda was remitted to the less threatening venue of self-regulation, where it prospered.

But a handful of mandates were forthcoming. The SEC pressured the NYSE to amend its rules to require an audit committee comprised solely of independent directors.[218] Putting the proxy rules to one side, this amounted to the first national-level mandatory push into internal affairs pursuant to the governance agenda.

Additional mandates came with the FCPA, which prohibited bribery of foreign officials, making the "questionable" payments illegal. More importantly for present purposes, it amended the 1934 Act to go deeply into internal affairs, imposing record-keeping and internal-control requirements on reporting firms.[219] The FCPA also gave the SEC oversight over the formulation of accounting principles.[220] It was said to amount to the most extensive application of federal law to the regulation of corporations since 1934.[221]

The FCPA's mandates would have been inconceivable in the state law framework. The stable equilibrium, with its enabling approach, excluded them. Compliance systems were not even on the states' formal enabling menu. In theory compliance with the law fell within the regime of fiduciary review; in practice there was no enforcement commitment.[222]

The FCPA grew out of a presidential investigation and spate of committee hearings conducted in 1976, an election year.[223] There was significant political disagreement. The Ford Administration backed a disclosure-based statute; Democratic senators and their

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GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 3.03 (T.D. No. 1 1982) (recommending mandatory majority of independent directors), *with* THE AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3A.01 (1994) (suggesting having a majority of independent directors). S*ee also* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 170-85 (1976) (recommending mandate). For a discussion of the politics of the ALI proceedings, see Jonathan R. Macey, *The Transformation of the American Law Institute*, 61 GEO. WASH. L. REV. 1212 (1993).

218. Karmel, *supra* note 210, at 17.

219. *See* Walter Perkel, *Foreign Corrupt Practices Act*, 40 AM. CRIM. L. REV. 683, 683 (2003).

220. *Id*.

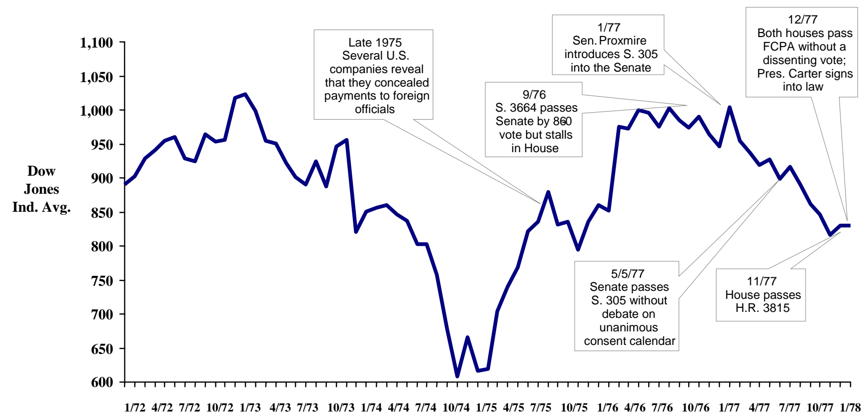
221. *See* GREANIAS & WINDSOR, *supra* note 209, at 1.

222. The classic citation is *Graham v. Allis Chalmers*, 188 A.2d 125, 129-30 (Del. 1963) (declining duty of care review of antitrust compliance breakdown). *See generally* Cynthia A. Williams, *Corporate Compliance with the Law in the Era of Efficiency*, 76 N.C. L. REV. 1265, 1384 (1998).

223. GREANIAS & WINDSOR, *supra* note 209, at 1.

presidential candidate, Governor Jimmy Carter, wanted directives and criminal penalties. The Senate unanimously passed a weak bill before the election, but the House recessed before taking up the matter.[224] When the new Congress convened in 1977, Carter had won and the new administration backed a strong bill. The strong version passed unanimously by the end of the year.[225] As Figure IV shows, the scandals unfolded against the backdrop of a volatile stock market in which long-term investors made no money. The market crashed during the Nixon-Ford administrations to recover in the run-up to the 1976 election.[226] But, given the high inflation of the period, the recovery did not make whole the losses. As Congress finally took up the FCPA in 1977, the market again stumbled badly.[227]

Figure IV: Market Context 1972-78



2. *The Enron Era*

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

224. *Id*. at 60-65.
225. *Id*. at 63, 71; Daniel L. Goelzer, *The Accounting Provisions of the Foreign Corrupt Practices Act – The Federalization of Corporate Recordkeeping and Internal Control*, 5 J. CORP. L. 1, 17-18 (1979).
226. GREANIAS & WINDSOR, *supra* note 209, at 1.
227. *Id*. at 59-74.

norm. The result was SOX.[228]

SOX had a quick gestation. The Enron scandal and accompanying media frenzy began with news of paper shredding in January 2002. The House enacted its bill in April, by a vote of 334 to 80.[229] WorldCom fell while the Senate held hearings on the House bill, triggering an accelerated timetable and passage by voice vote on July 15.[230] The Conference Report, passage by both Houses, and presidential approval all followed before the end of the month.[231] The Republicans disliked many provisions, but with an election coming up and a falling stock market (coming on the heels of a precipitous plummet two years earlier), they fell in line. Even the leading business lobbies were split, with the Business Roundtable saying yes and the Chamber of Commerce saying no.[232] So rapidly was the package cobbled together that little of its contents received much in the way of considered attention.[233]

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228. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C. (2000)).

229. *See* Report on Public Law 107-204, http://thomas.loc.gov/cgi-bin/bdquery/z?d107:HR03763:@@@R (last visited August 30, 2006).

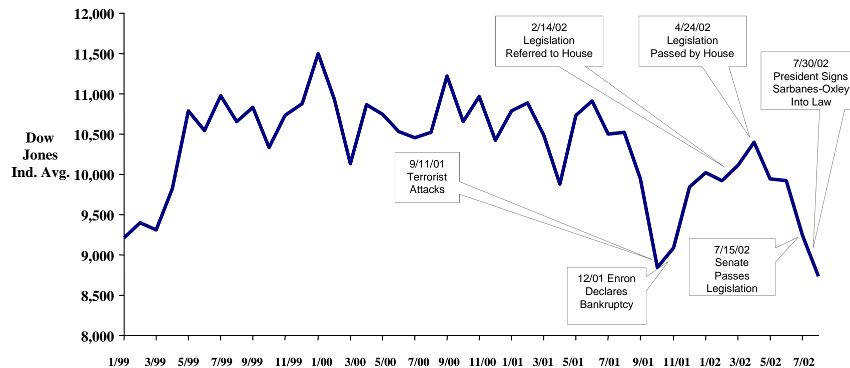
230. *Id*.

231. See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1600-02 (2005).

232. *Id*. at 112.

233. *Id*. at 111, 125. Mark J. Roe, *Backlash*, 98 COLUM. L. REV. 217 (1998), is the leading discussion of the politics that follow upon economic adversity. On the recent scandals, see Joseph A. Grundfest, *Punctuated Equilibria in the Evolution of United States Securities Regulation*, 8 STAN. J.L. BUS. & FIN. 1, 1 (2002) (analogizing the development of the securities laws to the "punctuated equilibrium" theory of evolution in which "species are relatively stable over long periods of time, but 'events of rapid speciation occasionally punctuate this tranquility'"); Kai-Alexander Heeren & Oliver Rieckers, *Legislative Responses in Times of Financial Crisis – New Deal Securities Legislation, Sarbanes-Oxley Act and Their Impact on Future German and EU Regulation*, 14 EUR. BUS. L. REV. 595, 623 (2003) (arguing that Sarbanes-Oxley's purpose was to calm investors by demonstrating congressional activism); Vikramaditya S. Khanna, *Corporate Crime Legislation: A Political Economy Analysis*, 82 WASH. U. L.Q. 95, 105 (2004) (describing corporate crime legislation as normally coming after a public outcry for greater regulation following revelations of corporate wrongdoing, usually during a weak economy). Gregory Mark offers a contrasting description, distinguishing between the economic downturn and the scandals and putting causal emphasis on the former. *See* Gregory A. Mark, *The Legal History of Corporate Scandal: Some Observations on the Ancestry and Significance of the Enron Era*, 35 CONN. L. REV. 1073, 1086 (2003) (suggesting that corporate reforms since the Great Depression have been ill-conceived).

Figure V: Market Context 1999-2002



Some of the SOX mandates pick up where the FCPA left off. For example, SOX requires that the CEO and CFO certify public reports, making them responsible for the maintenance of the firm's internal controls system,[234] along with accompanying criminal penalties.[235] While these go to internal affairs, the affairs they address have long been federalized. Moreover, the integrity of the disclosure system still stands out as the ultimate goal. In effect, the federal government, having instituted the mandatory system, reacts to successive compliance failures by reaching further and further back to cover the internal processes that generate the mandated reports. The federal political response resembles that seen with other regulatory regimes implicating criminal penalties: high profile noncompliance triggers a ratcheting up of duties and penalties, symbolically reassuring the public.[236] No one in Congress wants to be seen as soft on crime, of whatever variety.

SOX also traverses internal affairs in regulating auditor-client relationships, forbidding a list of nonaudit services.[237] But here also the territory had already been federalized; the list of nonaudit services merely tracks a list already instituted by SEC rule.[238] The

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234. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, § 302 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C. (Supp. II 2002)).

235. *Id*. § 906(a) (enumerating penalties for knowing violation of similar certification requirement); *see* Lisa M. Fairfax, *Form over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes-Oxley Act*, 55 RUTGERS L. REV. 1, 63 (2002).

236. *See* Brian T. FitzPatrick, *Congressional Re-election Through Symbolic Politics: The Enhanced Banking Crime Penalties*, 32 AM. CRIM. L. REV. 1, 3, 28 (1994) (discussing the response to the banking scandals of the late 1980s).

237. Sarbanes-Oxley Act § 201.

238. *See* Revision of the Commission's Auditor Independence Requirements,

new audit oversight board instituted by the statute tracks regulatory templates already established for regulation of securities market professionals.

Federally speaking, SOX shocks in requiring audit committees composed entirely of independent directors, defining "independent director," laying down audit committee duties and powers, and requiring disclosure respecting the expert status of committee members.[239] The shock does not follow from the regulation's terms. The committee-based governance agenda dates back to Douglas.[240] The same goes for the other headline internal affairs item in SOX—the ban on corporate loans to officers and directors.[241] When Douglas mentioned this ban in 1934,[242] he was only restating a suggestion made many times in the early decades of the twentieth century.[243] SOX, then, is an ideal manifestation of Kingdon's model of a law reform idea that sits at the bottom of agenda for decades, waiting for a window of political opportunity to open and a normative entrepreneur to put it at the right spot on the agenda at that time.[244]

It also can be noted that SOX's transformation of self-regulatory process devices into mandates implies little in the way of real-world institutional adjustment. Most large firms were organized with audit committees and compliance systems already, reflecting the influence of decades of self-regulatory conversations about best-governance practices. National-level audit committee mandates date from the Watergate era, albeit through the medium of exchange-listing requirements. Indeed, amendments to NYSE listing requirements mooted in 2002 and approved in 2004 track the SOX audit committee provisions and extend them to the compensation and nominating committees before going on to the final redoubt of the boardroom to mandate a majority-independent board.[245] The stock exchange remains the primary source of new mandates from the governance agenda.

The Congress's off-handed but emphatic revision of the internal

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65 Fed. Reg. 76,008-01 (2000) (codified at 17 C.F.R. §§ 210.2-01, 240.14e-101 (2006)).

239. Sarbanes-Oxley Act §§ 301, 407.

240. *See supra* notes 197-204 and accompanying text.

241. Sarbanes-Oxley Act § 402(a).

242. *See* Jayne W. Barnard, *Corporate Loans to Directors and Officers: Every Business Now a Bank?*, 1988 WIS. L. REV. 237, 241-42.

243. *See supra* notes 197-204 and accompanying text.

244. JOHN W. KINGDON, AGENDAS, ALTERNATIVES, AND PUBLIC POLICIES 216 (1984). *See generally* Romano, *supra* note 231.

245. *See* NYSE LISTED COMPANY MANUAL § 303A (2003), *available at* http://www.nyse.com/pdfs/finalcorpgovrules.pdf.

affairs line drawn after 1934 does upset settled expectations.[246] The present question is whether it implies anything further for corporate federalism. In addressing this question, we put standard cost-benefit criticisms of SOX off to one side[247] to look at the political pattern. FCPA and SOX have sufficient similarities to suggest a template for federal traversals of internal affairs. First, both statutes respond to compliance failures by pushing federal regulation past the end product, the reports themselves, to the generative processes. Both concern compliance with law (or in the case of "questionable payments," quasi law), and respond to political demands appearing in the wake of high-profile noncompliance. In both cases, the political demands could not have been satisfied at the state level, partly due to dispersion of response across fifty states and partly due to the stable equilibrium. Meanwhile, in both cases, the political demand stemmed from the general public, rather than from organized interest groups. (We think that the interest groups benefited, lawyers and accountants primarily, amount to incidental beneficiaries rather than prime movers.) Both statutes draw on a nonideological source, the governance agenda, and surmounted partisan politics in the course of their enactment. Finally, neither statute appears to have disturbed the state equilibrium. Isolated mandates from the governance agenda do not amount to external shocks that force strategies to change at the state level. They apply across the board, putting no competitive pressure on Delaware. Because they supplement the states' enabling framework, no state-level adjustment is necessary. It is management that has to adjust. Congress intervenes against management, not Delaware.

SOX also demonstrates the political implications of the rise of the shareholder class.[248] As the shareholder class rises, sharp stock market reverses and concomitant corporate misdeeds are more likely to hold out national political ramifications. Significantly, federalism concerns did show up prominently in the history of the FCPA—the Ford administration wanted to respect the post-1934 internal affairs boundary. But with SOX twenty-five years later, federalism concerns did nothing to deter either the Congress or the

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246. *See, e.g.*, Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, 26 REG. 26, 26-31 (2003).

247. The complaint is that SOX raises compliance costs more than more compliance benefits firms and shareholders. In particular, the costs bear more heavily on a marginal class of firms that will be discouraged from going public or, if already public, might be forced to go private. In addition, foreign listings may be deterred.

248. For a description, see Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 452-53 (2001).

Republican administration. The political demands, or at least Washington's perception of them, seem to have materially increased in magnitude. So, to the extent Delaware's management customers continue to behave badly, it can expect the zone of federal mandate to continue to expand. When this happens Delaware should blame its customers rather than the Congress, which is only responding to highly representative politics.

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

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

We complete the post-1934 description of federal traversal of state territory with reference to three interventions originating in management demands. The Williams Act of 1968,[249] the National Securities Markets Improvements Act of 1996 ("NSMIA"),[250] and the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").[251] All three pieces of legislation stem from management dissatisfaction with the state system. All three were enacted in rising stock markets. None of the three disturbed the charter market equilibrium, with which management presumably had no dissatisfaction.

1. The Williams Act

The Williams Act imposes, inter alia, disclosure and process constraints on tender offerors and target companies. It modifies what previously had been a state-law zone of free contract between arm's length buyers and sellers of shares. The Act reduces the contracting space with process constraints on the conduct of tender offers. It should be described as management protective: its minimum duration period strengthens the hand of target management, importing a window of opportunity in which to employ

249. Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2000)).

250. Pub. L. No. 104-290, 112 Stat. 3416 (1996) (codified in scattered sections of 15 U.S.C. (2000)).

251. Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified in scattered sections of 15 U.S.C. (2000)).

defensive tactics.[252]

The Act stemmed from concern over the increasing impact of "corporate raiders," and was conceived as a device to curb cash tender offers.[253] Senator Harrison Williams introduced the legislation in 1965,[254] making clear his management-protective motive, speaking of "white collar pirates" who took advantage of the "leniency of our laws" to loot "proud old companies."[255] But Williams's pro-management draft failed to attract support from the SEC and therefore failed to gain traction in the Senate.[256] Then, as later, views on takeovers conflicted.

Williams tried again in 1967, with a less stringent draft.[257] This time he emphasized that the bill was not meant to discourage tender offers per se. Reflecting the view of SEC Chairman Cohen,[258] Williams assured that the bill was neutral towards both bidders and targets.[259] In this case narrow policy networks had an impact: the final Act's modest compass stemmed in no small part from suggestions of the securities industry and academics, who took the bidder's part.[260] With support secured from the SEC[261] and the stock exchanges, the bill passed easily, by a series of voice votes.[262]

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252. David D. Haddock, et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701, 741 (1987); *see also* Jonathan R. Macey & Jeffry M. Netter, *Regulation 13D and the Regulatory Process*, 65 WASH. U. L.Q. 131, 157-58 (1987) (arguing that rules requiring disclosure of bidders' intentions serve no public interest, benefiting lawyers, accountants, and investment bankers in addition to defending managers).

253. *See* Lyman Johnson & David Millon, *Misreading the Williams Act*, 87 MICH. L. REV. 1862, 1891 (1989).

254. *Id*.

255. RALPH C. FERRARA ET AL., TAKEOVERS II: A STRATEGIST'S MANUAL FOR BUSINESS COMBINATIONS IN THE 1990S 8 (2d ed. 1993).

256. Johnson & Millon, *supra* note 253, at 1891.

257. The Williams Act, as eventually passed, had reduced proration periods and limited withdrawal periods compared to those initially considered. *See* Note, *SEC Tender Offer Timing Rules: Upsetting a Congressionally Selected Balance*, 68 CORNELL L. REV. 914, 925 (1983); *see also* Johnson & Millon, *supra* note 253, at 1893 (describing the Act as a compromise between pro and antitakeover views).

258. Note, *supra* note 257, at 925.

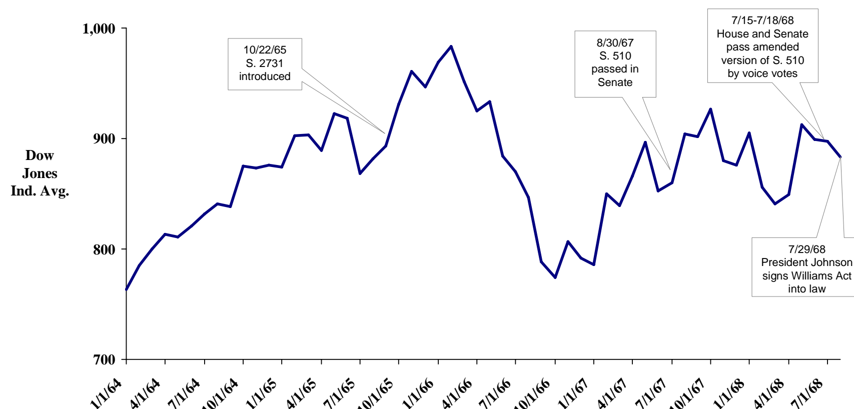
259. *See* Allen E. Kelinsky, Comment, *Tender Offers: Promoting Shareholder Equality in Stock Accumulation Programs for Corporate Control*, 36 AM. U. L. REV. 93, 94-95 (1986).

260. *See* Johnson & Millon, *supra* note 253, at 1897; Note, *supra* note 257, at 926-27.

261. The SEC broadly accepted the Williams Act as passed due to its desire for a bill that neither favored nor disfavored corporate takeover activity through tender offers. *See* Richard W. Stevenson, *Securities Bill Emerges in House as G.O.P. Drops Some Demands*, N.Y. TIMES, Mar. 8, 1996, at D1.

262. *See* 113 Cong. Rec. 24,664 (1967); 114 Cong. Rec. 21,483-84 (1968); 114

Figure VI: Market Context 1964-68 [263]



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

2. Securities and Litigation Reform

The NSMIA of 1996 preempts much of the parallel state system of securities regulation, long called the "blue sky laws." More particularly, the NSMIA (1) preempts state-level merit review and disclosure requirements for firms registered at the federal level, federally registered investment companies, and most private placements;[264] (2) preempts much state-level regulation of broker-dealers;[265] and (3) provides for exclusive federal regulation of advisors to federally registered investment companies and other advisors with large portfolios.[266] Thus constituted, the statute harmonizes and streamlines securities regulation. It does not traverse internal affairs, narrowly defined. Nor does it disturb the charter competition equilibrium: the blue sky laws apply to offers and sales of securities within each state, regardless of the issuer's domicile.

Cong. Rec. 21,954 (1968).

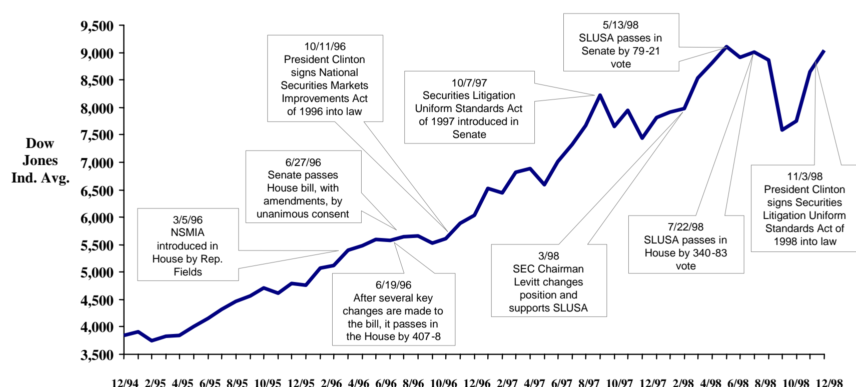
263. Yahoo! Finance, http://finance.yahoo.com (graph developed using the opening level of the Dow Jones Industrial Average on the first trading day of each month over the course of the cycle).

264. 15 U.S.C. § 77r (2000).

265. 15 U.S.C. § 78o(h)(1) (2000).

266. 15 U.S.C. § 77r (2000).

Figure VII: Market Context 1994-98[267]



The Act originated on the Republican side as a deregulatory initiative.[268] The Democrats and the SEC both complained that it went too far in reducing protections for shareholders. The sponsors promptly dropped the most far-reaching proposals.[269] Thereafter, the bill garnered bipartisan support, passing the House by a 407-to-8 vote[270] and the Senate by a voice vote.[271] President Clinton made no objection.[272] As Figure VII shows, the stock market was rising throughout the sequence of events.

The SLUSA was drafted to cover a perceived loophole in the Private Securities Litigation Reform Act of 1995.[273] Forum shopping was alleged—plaintiffs were bringing securities fraud class actions in state court, avoiding new federal-level process strictures.[274] The

267. Yahoo! Finance, http://finance.yahoo.com (graph developed using the opening level of the Dow Jones Industrial Average on the first trading day of each month over the course of the cycle).

268. *See* Stevenson, *supra* note 261, at D1.

269. *Id*. These included provisions that would have impaired the states' ability to regulate small cap companies and otherwise enforce their laws. *See id*. at D1.

270. *See* Report on Pub. L. 104-290, http://thomas.loc.gov/cgi-bin/bdquery/z?d104:HR03005:@@@XlTOM:/bss/d104query.htm (last visited Aug. 30, 2006).

271. *Securities Regulation Bill Is Cleared By Senate*, N.Y. TIMES, June 29, 1996, at 34.

272. *See* Report on Pub. L. 104-290, http://thomas.loc.gov/cgi-bin/bdquery/z?d104:SN01815:@@@X (last visited Aug. 30, 2006).

273. Pub. L. No. 104-67, 109 Stat. 737 (amending scattered sections of 15 U.S.C. (2000)).

274. *See* Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1, 2, 4 (1998).

bill limited both state-level class actions and fraud actions based on state law.[275]

In 1997, the bill was reported out on a bipartisan basis in both the House and the Senate. SEC Chair Arthur Levitt and Senator Paul Sarbanes both voiced opposition at hearings, and the matter stalled for a few months.[276] In 1998, the legislation moved forward with renewed vigor, due in no small part to the steadily rising stock market and the increasing political muscle of Silicon Valley.[277] High-tech companies and other corporations interested in pursuing the new legislation created a lobbying group for the occasion,[278] which was joined by the National Venture Capital Association, the American Institute of Certified Public Accountants, and the American Electronics Association.[279] Several organizations, including some consumer groups and organizations representing state and local governments, lobbied against the bill, but they lacked the political muscle of their opponents.[280] But then, the stock market was going through the roof, as Figure VII attests.[281]

Silicon Valley got what it wanted. Levitt and President Clinton dropped their opposition in exchange for legislative history making it clear that no prohibition of federal suits for recklessness was intended.[282] Although there were significant numbers of dissenters in both houses, the bill went through with strong majorities. But before passage, a Delaware-oriented carve-out was added in the Senate, assuring that state litigation with respect to breach of fiduciary duty would be unaffected.[283]

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275. Delaware was not a target: under prevailing conflict of laws rules, the fraud actions are not decided under the law of the state of incorporation. *See* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2402-12 (1998).

276. In mid-1997 there were many who questioned the need for a uniform standards act for securities litigation. In hearings, SEC Chair Levitt declared that it was still too early to assess whether or not a uniform act was needed; several senators, led by Senator Sarbanes, agreed with this assessment. *See* Eugene P. Caiola, Comment, *Retroactive Legislative History: Scienter Under the Uniform Security Litigation Standards Act of 1998*, 64 ALB. L. REV. 309, 337 (2000). The SLUSA thereafter stalled due to a lack of support. *Id*. at 340.

277. *See* Leslie Eaton, *The Silicon Valley Gang: An Influential Industry with Lots of Money Is Getting Its Way on Capitol Hill*, N.Y. TIMES, June 11, 1998, at D1.

278. Matthew Greco, *Pre-emptive Legislation Expected Soon*, INVESTOR REL. BUS., May 5, 1997.

279. Painter, *supra* note 274, at 49.

280. *Id*. at 50.

281. Figure VII, *supra* at note 267.

282. Painter, *supra* note 274, at 7, 53.

283. *Id*. at 56.

D. Summary

Douglas astutely predicted in 1934 that scandals stemming from management shenanigans in bull markets were going to remain a problem.[284] The FCPA and SOX fulfilled the prediction, both responding to political demands for management accountability in the wake of scandals. In the case of the FCPA, the public responded to the scandal in the mode of the trust paradigm, casting managers as public actors. Power meant responsibility. Corruption was unacceptable, even corruption in pursuit of shareholder value. With the public proving willing to pay for ethical behavior,[285] Congress moved to impose responsibility in law. In contrast, Enron, WorldCom, and SOX were shareholder-value centered. Managers whose stocks had collapsed had failed to comply with law, with the compliance failure bound up with the losses of many investors. Congress felt compelled to toughen the compliance regime.

The broad-based political demands that led to FCPA and SOX occur only rarely. For the public to have an opinion, it first has to be informed and then has to deliberate.[286] This rarely occurs on corporate governance matters, particularly so as to register political demands so strong as to surmount ideological divisions.[287] Retail investors, viewed as an interest group, have little political influence.[288] But well-publicized corruption and noncompliance raise the specter of a median voter interest[289] in corporate matters and thereby bring about the exceptional case. Stock market reverses also figure in. When stocks are rising, people tend not to worry about compliance and politicians are loath to rock the boat. Given

284. Douglas, *Directors*, *supra* note 197, at 1306.

285. *See* Andrei Shleifer, *Does Competition Destroy Ethical Behavior?*, 94 AM. ECON. REV. 414, 418 (2004) (papers & proceedings) (noting that as societies grow rich they prove more willing to pay for ethical behavior through enforcement).

286. SMITH, *supra* note 165, at 28.

287. FCPA and SOX thus can be distinguished from what Smith terms "unifying issues"—issues that unite all business interests. According to Smith, as to such issues, ideological divisions matter and partisan politics make the issues visible. SMITH, *supra* note 165, at 25-26. Success on such issues correlates with national political shifts, with business doing better in the early 1950s, the early 1980s, and the mid-1990s. *Id*. at 85.

288. *See* Donald C. Langevoort, *Structuring Securities Regulation in the European Union: Lessons from the U.S. Experience* 10-11 (European Corporate Governance Inst., working paper No. 41/2005, 2005).

289. One-third of American voters now describe themselves as "investors," and national politicians now cater to the so-called "investor class." *See* Richard S. Dunham & Ann Therese, *Just Who's in the 'Investor Class'?: A Third of the Country, and Growing. No Wonder Bush is Wooding Them so Ardently*, BUS. WK., Sept. 6, 2004, at 42-43.

market volatility due to noise trading and a widening pattern of equity investment, we can expect to see more such national political demands in the wake of compliance breakdowns.

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

Even when SOX breaks a historic federal-state subject-matter pattern with its audit committee mandate, it only tracks more extensive mandatory interventions coming from the stock exchange acting independently. Only the per se rule on loans to officers arguably takes SOX outside the national level box onto state fiduciary territory. But, in fact, executive compensation has always been a federal topic, with a strong interest in the matter reflected in the insider-trading regime. In any event, federalization of conflict-of-interest transactions has a long way to go before it materially impacts the states. There is no risk of that happening in the present context. Indeed, with SLUSA, we saw the Congress take special care to avoid impairment of Delaware's litigation business. With FCPA and SOX, the loser is not Delaware, but management, which loses freedom of action in the shift from enabling to mandatory.[290]

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

290. Whether the shareholders won or lost is an open cost-benefit question.

external shocks. Any response must be national.

If Delaware were to shift strategies and compete with the SEC in taking the shareholders' part on matters such as voting rights and rights of initiative, the shift would be viewed as a defection against the management interest and would disrupt the equilibrium. The same is true of the public interest in compliance with law. Delaware has never and cannot take the public's part on matters of executive compliance with law and ex post punishment. Delaware does not criminalize; it neither jails nor fines. We do get rhetoric from Delaware on the importance of compliance.[291] But we have not seen Delaware apply its duty of care so that directors of firms with compliance breakdowns are required to pay money judgments. We are highly unlikely ever to do so. There is no strategy available to Delaware that lets it protect its interest in subject-matter territory by anticipating federal intervention and addressing and defusing the federal concern.[292]

FCPA and SOX show us the federal strategy followed when political demands flow against management. The Williams Act, NSMIA, and SLUSA show us a different class of federal play, the play that follows from the same sort of influence activity that determines results in the states. Here, the general public has no knowledge of, and hence no opinion on, the subject matter. The issues are what Mark Smith calls particularistic, that is, reflecting the interests of one business interest group, or conflictual, that is, triggering a difference of opinion within the business community.[293] Here, Democratic and Republican positions often blend into one another and elective politics have no direct bearing.[294] Interest group influence tends to register more directly, giving management the same advantage at the federal level that it enjoys in the states. As at the state level, such management political operations tend to succeed against the backdrop of strong stock markets. But the federal-state political overlap is not complete. The difference lies in the SEC, which skews the federal agenda to weight the shareholder interest more heavily than the shareholder interest is or could be

291. *See In re* Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959, 967-70 (Del. Ch. 1996).

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

293. SMITH, *supra* note 165, at 21.

294. *Id*. at 24, 31.

weighted at the state level under the stable equilibrium.[295]

III. DELAWARE

Delaware's competitive position gets stronger all the time. We have seen that its market share has increased steadily since its 1967 code revision. Delaware has done equally well by other measures. Major reincorporations to Delaware peaked at the height of the takeover wars of the 1980s, with fifty-six in 1987.[296] The numbers fell thereafter, but remained steady—there were 208 reincorporations between 1991 and 2001.[297] In 1983, the total number of firms chartered in Delaware was 153,044; in 1990, the figure was 202,893, and by 2000, the figure had grown to 322,971 to fall off slightly in the recession years that followed.[298] Table I shows that revenues from franchise taxes and corporation fees, taken as a percentage of all state revenues, a historically volatile figure, regained the twenty percent level in 1992 and hovered around twenty percent ever since.

Table I: Revenues from Franchise Taxes and Corporation Fees as a Percent of all Revenues in Delaware[299]

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

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

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

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

295. *See* Langevoort, *supra* note 288, at 10-12, 14 (describing the culture of the SEC and rejecting a regulatory capture description).

296. Demetrios G. Kaouris, Note, *Is Delaware Still a Haven for Incorporation?*, 20 DEL. J. CORP. L. 965, 1012 tbl.1 (1995).

297. Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1821 tbl.1 (2002).

298. Email from Richard J. Geisenberger, Assistant Secretary of State, State of Delaware to author (June 25, 2004) (on file with author).

299. *Id*. Table 1 picks up where the figures in NADER, ET AL., *supra* note 19, at 535 tbl.2, leave off, bringing the data to date.

In this Part we look at Delaware's evolution in the wake of the federal incorporation threat of the 1970s and the takeover wars of the 1980s, both of which destabilized the state equilibrium. Delaware's courts emerge as model strategic players. Given a threat from a federal or state opponent, they pause between plays for rational introspection and adjust their strategies for future rounds of play. Even as they adjust, they tend to do everything possible to leave the state equilibrium undisturbed. In only one case do we see the judges experiment with a strategy that turns out to be inconsistent with management's equilibrium expectations. The courts then learn from the mistake, successfully remaking Delaware's profile in an era obsessed with law compliance by empowered actors.

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

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

Part III.C turns to Delaware in the era of shareholder capitalism. Time has been on Delaware's side. The federal government has lost all interest in takeovers. And, even as institutional shareholders remain dissatisfied with takeover defenses, their complaints register only in a narrow network. Ironically, their primary role at the state level has been to

strengthen Delaware's position in the charter market. Today, due to the activist institutions, the shareholder veto on reincorporations means more than in the past, making even less likely the emergence of a competing state marketing a more management-favorable product.

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

A. Fiduciary Law

Rent extraction, when visible, can come at the cost of diminished reputation.[300] Cary imposed that cost on the Delaware courts when he accused them of monolithic support of management rent seeking, citing a cluster of cases as evidence.[301] The Delaware courts proved sensitive to Cary's allegations of corruption,[302] becoming more noticeably responsive to the shareholder interest in the three decades since 1974.[303] Most of the cases Cary cited are no longer good law.[304]

300. PERSSON & TABELLINI, *supra* note 78, at 18.

301. Cary, *supra* note 93, at 673-98.

302. *Id*. at 684, 696-98.

303. For empirical confirmation, see Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85, 104-08 (1990). Branson's study of Supreme Court cases decided between 1974 and 1987 finds a larger number of proshareholder results than promanagement results.

304. *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964), a mainstay of management takeover defensive practice, fell to *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985) (reversing *Cheff* and applying an expanded review of tender offer defensive tactics under proportionality test) and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (inventing a duty of management defending tender offer to auction company in limited circumstances), during the takeover wars of the 1980s. *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125 (Del. 1963), fell more recently, untenable in light of a generation of contrary management practice under the monitoring model of corporate governance. *See In re* Caremark Int'l Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996). A similar fate could be suggested for *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883, 887 (Del. 1970). *See* E. Norman Veasey & William E. Manning, *Codified Standard–Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared to Delaware Law*, 35 BUS. LAW. 919, 929-30 (1980) (discussing *Graham*). *American Hardware Corp. v. Savage Arms Corp.,* 136 A.2d 690, 694 (Del. 1957) (refusing to enjoin a defensive shareholders meeting called on short notice or to act respecting a proxy statement the court acknowledged to be incomplete) might well come out differently today, given *Unocal* and other cases more closely

The break with the past first manifested itself in 1977, when *Singer v. Magnavox Co.*[305] imposed strict fiduciary standards on parent firms in cash out mergers. *Singer* is famous for having come down just after the Supreme Court removed the threat of federal preemption of state fiduciary rules under the antifraud rules of the securities laws.[306] The story told at the time was that the brush with preemption at the hands of the federal judiciary and the critical atmosphere provoked by Cary, Nader, and others prompted the Delaware Supreme Court to reverse its direction so as to better accommodate the interests of investors and thereby diminish the possibility of future threats of intervention. Indeed, around the time the case was decided in 1977, the SEC proposed a rule that required substantive fairness in the class of transactions covered by the case.[307] Delaware's defensive adjustment yielded results in the SEC's rulemaking proceeding—the final rule promulgated two years later dropped the fairness test and limited its reach to disclosure.[308] Thus did a federal threat impress upon the Delaware courts the practical importance of solicitude to shareholder interests.[309]

The post-Cary behavior pattern persisted as the courts articulated unexpected new shareholder-protective applications of

scrutinizing management procedural manipulations and misrepresentations. S*ee* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 653-58 (Del. Ch. 1988); Zirn v. VLI Corp., 621 A.2d 773, 778 (Del. 1993) (confirming director duty of full disclosure of shareholders in connection with merger). Two cases Cary cited, *Federal United Corp. v. Havender,* 11 A.2d 331, 339 (Del. 1940) (permitting firms to use charter amendments effected through common shareholder voting power to strip preferred stockholders of contract rights) and *Hariton v. Arco Electronics Inc.*, 188 A.2d 123, 125 (Del. 1963) (extending the doctrine of independent legal significance to mergers and acquisitions), are still good law, but operate in a less relentlessly management-favorable context. A good faith duty to preferred stockholders has been acknowledged. S*ee, e.g.*, HB Korenvaes Invs., L.P. v. Marriott Corp., Fed Sec. L. Rep. (CCH) ¶ 97,728 (Del. Ch. 1993), and mergers are subject a more broad-ranging fiduciary scrutiny. Only *Sinclair Oil Corp. v. Levien,* 280 A.2d 717, 721 (Del. 1971) (leaving burden of proof on complaining minority shareholders), stands unqualified, and few today complain about it.

305. 380 A.2d 969, 980 (Del. 1977).

306. *See supra* text accompanying note 181. The case was *Santa Fe Industries v. Green*, 430 U.S. 462, 479-80 (1977).

307. *See* Securities Exchange Act Release No. 14185 (Nov. 17, 1977).

308. *See* Securities Act Release Nos. 6100, 6101 (Aug. 2 1979); Ralph C. Ferrara & Marc I. Steinberg, *A Reappraisal of* Santa Fe*: Rule 10b-5 and the New Federalism*, 129 U. PA. L. REV. 263, 272-73 n.49 (1980).

309. Note also that judicial reputations depend on comparisons with the performance of judges on other courts, state and federal. Thus a critical atmosphere can arouse reputational concerns even with a less immediate federal threat.

basic fiduciary rules. The most famous examples concerned takeovers—*Unocal Corp. v. Mesa Petroleum Co.*[310] and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc*.[311] which established a regime of fiduciary scrutiny of takeover defensive tactics. Friendly mergers also came under scrutiny—*Smith v. Van Gorkom*[312] and *Cede & Co. v. Technicolor, Inc.* [313] surprised everyone with surprisingly aggressive applications of the duty of care to board approvals of proposed mergers. *Paramount Communications, Inc. v. QVC Network Inc.*[314] later brought the takeover and the merger cases together with a broadly phrased directive to managers under hostile attack to enhance shareholder value.[315]

But the pattern has been volatile. Equally famous cases restrict the application of the new rules. In fact, the *Singer* rule did not last long, being in turn rejected in 1983 for a looser, process-based approach to cashout mergers in *Weinberger v. UOP, Inc*. [316] *Weinberger* later was itself cut back, when short-form mergers were excepted from the category subject to fiduciary scrutiny.[317] The promises of *Unocal* and *Revlon* also went unfulfilled. Under *Moran v. Household International, Inc.*[318] and its progeny, the poison pill remains a potent and largely unregulated defense.[319] In the eyes of critical observers, Delaware's cases amount to little more than a conjuring trick. The courts garnered publicity in a handful of highly

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310. 493 A.2d 946, 954-55 (Del. 1985) (reversing *Cheff* and applying an expanded review of tender offer defensive tactics under the proportionality test).

311. 506 A.2d 173, 182 (Del. 1986) (inventing a duty of management defending a tender offer to auction company in limited circumstances).

312. 488 A.2d 858, 873-81 (Del. 1985) (expanding the duty of care suddenly to cover board approval of arm's length merger).

313. 634 A.2d 345, 366-71 (Del. 1993) (applying a heightened duty of care scrutiny of boardroom merger decision and suggesting an expanded remedial concept inclusive of post-merger gain).

314. 637 A.2d 34, 43 (Del. 1994) (holding that management has an obligation to achieve best value reasonably available for shareholders).

315. Less surprising but equally important is the recent invalidation of a delayed-redemption poison pill in *Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281, 1293 (Del. 1998).

316. 457 A.2d 701, 704, 715 (Del. 1983) (overruling *Singer* in favor of less restrictive process scrutiny of cash-out mergers).

317. *See* Glassman v. Unocal Exploration Corp., 777 A.2d 242, 244 (Del. 2001).

318. 500 A.2d 1346, 1356-57 (Del. 1985) (sustaining poison pill defense under *Unocal*).

319. *Paramount Communications, Inc. v. Time Inc.,* 571 A.2d 1140, 1150-54 (Del. 1989), made this clear with its allowance of extraordinary latitude to managers defending a tender offer that disrupts preexisting plans for a friendly merger.

publicized cases, ruling against management and announcing vague standards that held out the prospect of shareholder value enhancement. But in less well-publicized subsequent cases, they used the camouflage of complex facts to refrain from applying the standards in management-constraining ways.[320] The full set of results tallied by the lawyers signaled considerably more room for managerial maneuvering than did the public profile signaled by the leading cases.

Whatever the merits of the cases' holdings, Delaware's judges have transformed the state into a respectable lawmaker. This partly results from the quality of the bench—even when ruling for management in cases of palpable shareholder injury, its analyses are thoughtful. The bench's awareness of its national role also figures in. As judges, they have an independent reputational incentive to advocate for their system's legitimacy.[321] They now maintain a dialog on governance issues with the bar, financial intermediaries, and academics.[322] Outsiders when Cary wrote, they are now important players in the elite governance policy network. They make a convincing case, explaining that they pursue the state's interest in balancing conflicting interest group demands, acting in a meditative capacity. They take care to point out that they not only mediate between management and shareholders, but as also protect market risk-taking even as they impose ethical constraints.[323] It has become hard to imagine a bench that could do a better job, given the constraints imposed by the state equilibrium.[324]

320. For a reading of the cases after *Unocal* along these lines, see VICTOR BRUDNEY & WILLIAM W. BRATTON, BRUDNEY & CHIRELSTEIN'S CASES AND MATERIALS ON CORPORATE FINANCE 1087-95, 1129-30 (4th ed. 1993).

321. *See* Eric Rasmusen, *Judicial Legitimacy as a Repeated Game*, 10 J.L. ECON. & ORG. 63, 72-74, 78-80 (1994) (offering a repeat game model of judicial motivation showing that judges follow precedent if there is a self-enforcing system based the need to uphold systemic legitimacy); *see also* Thomas J. Miceli & Mertin M. Co gel, *Reputation and Judicial Decision-making*, 23 J. ECON. BEHAV. & ORG. 31, 44-49 (1994) (modeling the preferences of judges on a utility function that includes both a private and a reputational component).

322. *See* Marcel Kahan & Edward Rock, *Our Corporate Federalism and the Shape of Corporate Law* 31 (New York University Law School, Working Paper No. 04-020, 2004), *available at* http://ssrn.com/abstract=564685.

323. *See* Andrew G.T. Moore, II & Bayless Manning, *State Competition: Panel Response*, 8 CARDOZO L. REV. 779, 779-800 (1987) (at the time Moore was a Justice of the Delaware Supreme Court). They also have acknowledged the federal threat. *See* William T. Quillen, *The Federal-State Corporate Law Relationship—A Response to Professor Seligman's Call for Federal Preemption of State Corporate Fiduciary Law*, 59 BROOK. L. REV. 107, 129 (1993).

324. For a contrasting approbation of the Delaware courts, see Kahan &

Two facets of the case law demonstrate the astuteness and innovation that the Delaware bench brings to its mediations. The first is the special committee of independent directors, which can be traced to a footnote in *Weinberger v. UOP, Inc.*[325] The predecessor case, *Singer,* had effected Delaware's fiduciary about-face, employing substantive review directed to the fairness or unfairness of the corporate action taken, very much in the mode of the trust paradigm. *Weinberger* dropped that approach to draw instead on the process-based governance agenda in scrutinizing transactions impacting the rights of minority shareholders. The court held out relaxed scrutiny, provided that a committee of independent directors was constituted to negotiate on behalf of the minority. It was a brilliant compromise: judicial scrutiny of the transaction still would be necessary, but scrutiny would extend only to the conduct of the constructed negotiation; this in turn obviated the need for direct, mandatory review of the transaction. Process was better than substance for two reasons: first, it diminished the likelihood of judicial confrontation with the salient question of whether the majority was robbing the minority; second, it avoided confrontation with fact questions concerning the value of the firm. Since *Weinberger*, the independent committee device has been widely drawn on in Delaware fiduciary cases.[326] An additional, incidental benefit has appeared over time. Issues about the composition of special committees and their conduct of proceedings bring the Delaware courts to the forefront of debates about corporate best practices and the governance agenda.[327] The Delaware bench emerges as a focal point in the self-regulatory discussion. This is exactly the right strategy.

The second salient aspect of Delaware's cases is the habit of making normative pronouncements on a prospective basis and avoiding imposition of damages. Delaware judges use their cases' complex fact patterns to make moral pronouncements about management behavior. The culpable manger is not, however, necessarily hit with an injunction against his or her deal; a money judgment is still less likely.[328] Instead, the court announces its

Rock, *supra* note 322, at 29 (comparing Delaware case law to nineteenth-century jurisprudence and explaining that structural weakness causes Delaware cases to take on a neutral, technocratic gloss).

325. 457 A.2d 701, 709 n.7 (Del. 1983).

326. *See, e.g.*, Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1116 (Del. 1994).

327. *See, e.g.*, *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 920 (Del. Ch. 2003) (expounding on the meaning of directorial independence).

328. Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1015, 1039 (1997). Although a money

dissatisfaction with the manager's conduct in the course of denying an injunction against the transaction or dismissing the complaint. It is the actor in the next deal who replicates the disapproved conduct that faces a litigation risk.[329] Edward Rock argues that this works well: Delaware judges communicate normative standards to the business community through a network of lawyers and investment bankers. Significantly, the resulting behavioral deterrent is reputational rather than financial.[330]

The Delaware courts learned to take this kid-gloves approach the hard way. The Delaware Supreme Court's innovative and aggressive application of the duty of care in *Smith v. Van Gorkum* did hold out an immediate prospect of a money judgment against independent directors.[331] The result was nervousness in boardrooms, a substantial increase in insurance premiums, and much criticism of Delaware. The legislature had to intervene to undo the result of the strategic misfire. Prompted by the corporate committee of the state bar, it amended Delaware's code to permit firms to opt out of the duty of care by charter amendment.[332] The courts would not make the same mistake again: we know of only one case in the two decades since *Van Gorkum* in which a Delaware court imposed a significant damage award on director defendants.[333]

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

payment (probably in the form of a settlement) may follow where the injunction against the deal is denied but the complaint is not dismissed. *Id*. at 1039.

329. *Id*. at 1023-39.

330. *Id*. at 1012-16.

331. Smith v. Van Gorkom, 488 A.2d 858, 893 (Del. 1985).

332. DEL. CODE ANN., tit. 8 § 102(b)(7) (2001) (permitting opting out of personal liability for directors for duty of care violations).

333. *See In re* Emerging Commc'n, Inc. Shareholders Litigation, No. Civ.A. 16415, 2004 WL 1305745, at *38-40 (Del. Ch. May 3, 2004) (holding outside but financially sophisticated director jointly and severally liable with the corporate principals for approving an unfair going private transaction).

of money judgments or lost deals. Clearly the lawyers also are satisfied. For the shareholders, the system remains problematic even in the era of shareholder capitalism.

But it still is clearly superior to the pre-Cary system. In the 1970s, the Delaware courts decided that they would have to police in order to maintain the state's credibility as a national lawmaking center. Police they have, but in a unique fashion. In the federal state context, they have become the good cop to the federal government's bad cop.[334] Delaware's courts try to avoid falling into the conventional judicial role of enforcing positive law, even as the federal government's role as compliance officer expands and extends deeper into state territory with mandates and prosecutions. This distinguishes Delaware not only from the federal government, but also from the other states, the judges of which cannot be expected to play the game with such finesse.

Summing up, the Delaware courts responded to the instability, criticism, and challenges of the 1970s with a new strategy that merged fiduciary review with the self-regulatory governance agenda. To look only at the case holdings is to see an unstable body of law.[335] To look at the cases in the wider equilibrium context is to see a stable strategy. The Delaware courts have learned that the salient part of the case can be the remedy rather than the holding. At the federal level, Delaware's prominence as a governance and dispute resolution center diminish its vulnerability to attack. With Delaware now holding a prestigious place within elite governance networks, federal agenda setters are unlikely to view it as a problem. As its value increases in its customers' eyes, Delaware will have more than adequate political support in Washington. Thus did Congress except Delaware from the SLUSA in 1998. The same did not follow with SOX. But SOX addressed political demands that

334. The federal enforcement apparatus looms especially large in the context of state-federal comparison. Whether the actual enforcement numbers impress—the SEC brings only 500 to 600 enforcement actions per year and settles the vast majority, *see* Langevoort, *supra* note 288, at 6-7—depends on the perspective of the observer; s*ee also* Bernard Black et al., *Liability Risk for Outside Directors: A Cross-Border Analysis,* 11 EUR. FIN. MGMT. 153 (2005) (surveying Australia, Canada, Britain, the United States, France, Germany, and Japan and showing that outside directors of public companies face only a tiny risk of liability).

335. It has been suggested that Delaware cases' indeterminacy stems from strategic concerns and amounts to an abuse of the state's dominant position in the charter market. Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1919, 1927-28, 1931, 1935 (1998). We are unpersuaded. *See* William W. Bratton, *Delaware Law as Applied Public Choice Theory: Bill Cary and the Basic Course After Twenty-Five Years*, 34 GA. L. REV. 447, 469-72 (2000).

Delaware's evolutionarily stable strategy makes it powerless to anticipate or confront.[336] And, despite its entry into internal affairs, SOX in no way impairs the charter market or Delaware's rent flows. A counterfactual suggestion arises. Delaware's new respectability assured that the Enron crisis worked itself out as a federal enforcement event. No one suggested that state-level self-regulation bore responsibility.[337] Indeed, Delaware judges have taken to voicing complaints about SOX and SEC governance initiatives in national venues, extolling the virtues of their good-cop system.[338] If they had serious worries about federal intervention, they would not be entering these public dissents.

B. Takeovers and the Federal Threat

Now we backtrack to Delaware's response to the instability precipitated by the takeover wars of the 1980s. Six months after *CTS*, thirty-four other states had enacted antitakeover legislation.[339] Management was pressuring Delaware to do the same.[340] However,

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336. For a contrary view, see Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 654-62 (2004). Professor Jones sees the Delaware courts making a belated, but still preemptive, response to SOX in recent cases. We have no quarrels with her description of the operative judicial behavior pattern. But, in our view, such decisions amount to small-scale interventions that impact on corporate practice in only marginal ways.

337. This point can be restated from an institutional perspective: federal-state relations are a function of socially constructed roles and institutional roles; actors have mutable preferences that change due to socialization, learning or persuasion. MARK A. POLLACK, THE ENGINES OF EUROPEAN INTEGRATION: DELEGATION, AGENCY, AND AGENDA SETTING IN THE EU 57-59 (2003). Institutions are points of communicative interaction among actors socialized within common norms. They discover their preferences through processes of deliberation within these institutional frameworks. Kathleen R. McNamara, *Rational Fictions: Central Bank Independence and the Social Logic of Delegation*, 25 W. EUR. POL. 47, 66 (2002). Given deliberations about corporate governance and compliance in the wake of an external shock, Delaware's new respectability makes it much less likely that actors at the federal level will change their inherited preferences respecting the federal-state allocation so as to disturb the state equilibrium.

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

339. *See supra* text accompanying notes 183-89.

340. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 625 (2003) (noting that Martin Lipton was recommending reincorporation out of Delaware).

actors in the Reagan administration were pressuring Delaware not to do the same, threatening to preempt its takeover regulation if it did.[341] Delaware finally enacted a weak statute.[342] Commentators put contrasting glosses on these events. One view emphasizes that Delaware's weak response reflected shareholder-side demands unique to the national chartering state. In other states the statutes followed from the influence of local firms: all potential targets. Delaware, in contrast, is home to bidders as well as targets,[343] and the countervailing capital market interest also registers there.[344] The other view emphasizes the federal threat.[345] Under this view, the events of the era stand as an exemplar of constructive back and forth within the federation, with threatened federal intervention curbing Delaware's structural preference for the management interest.

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

But the Washington actors who tried to protect the hostile takeover in the 1980s lacked the political wherewithal to follow through. As we have seen, the Congress was gridlocked on the subject.[346] Moreover, even given congressional support for takeover protection, it is not at all clear that federal intervention would have disturbed the state equilibrium. The takeover protection legislation, introduced in the House in 1987,[347] would have given the SEC authority to promulgate rules prohibiting defensive tactics and to

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

342. *See* DEL. CODE ANN., tit. 8 § 203 (2001).

343. Romano, *supra* note 108, at 468.

344. *Id*.

345. Roe, *supra* note 340, at 629-30; *see also* Bebchuk, *supra* note 119, at 1455; Cary, *supra* note 93, at 688-89; Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1512 (1989). Anecdotal evidence shows that Delaware lawmakers keep federal intervention in mind when they take politically sensitive steps. *See* Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 906-08 (1990).

346. *See supra* text accompanying note 189.

347. H.R. 2172, 100th Cong. (1st Sess. 1987).

create "standards for the fair conduct of contests for corporate control," subject to a shareholder "opt in" privilege.[348] The provision would have terminated Delaware's takeover case law under *Unocal* and *Revlon*, but otherwise would have left things in place. That result might even have benefited Delaware by removing the competitive threat posed by tighter antitakeover provisions enacted in other states.

The greater threat already had passed, the threat posed in the 1970s by the cases that would have federalized much of fiduciary law and the 1980 federal fiduciary standards bill.[349] But the 1980 bill ended the long series of federal chartering threats with more of a whimper than a shot across Delaware's bow. To look at the longer history is to see federal chartering as a reform initiative that fell lower and lower on legislative agendas as the twentieth century unfolded. It lay at the top of the Taft administration's agenda.[350] It dropped to the second tier of the second Roosevelt administration's agenda.[351] By the 1970s, it remained alive only in the offices of a handful of Congress members.[352] After 1980, it disappeared. Even as actors in the Reagan administration threatened to preempt defensive tactics, they were committed to a cooperative federal-state equilibrium and had no truck with federal chartering. By 2002 popular demands completed the transformation of federal corporate politics. Now shareholder value triggers political emergencies.

None of this should be taken to deny the fact that Delaware's agents are averse to any exercise of federal preemptive power.[353] Moreover, federal rumblings certainly affected their behavior in the mid-1970s and mid-1980s. But, similar rumblings have not been heard since, even as Congress made a significant intervention in SOX. But because the Enron crisis concerned compliance, the state equilibrium gave Delaware no room for maneuver.[354]

Federal chartering does remain in John Kingdon's bottom

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

349. *See supra* text accompanying notes 173-190.

350. *See* Brabner-Smith, *supra* note 49, at 162-63.

351. *See supra* text accompanying note 155.

352. *See supra* text accompanying note 173.

353. *See* William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 953-60 (2003).

354. Congress in any event acted so quickly as to leave any window of opportunity closed.

drawer, ready to be revived if Delaware ever steps out of line. A federal threat accordingly figures into Delaware's strategy at a deep structural level. To the extent it actively impacts Delaware's play, it presumably imports risk aversion respecting any state law innovation that disrupts the equilibrium in management's favor. This shows in the historical pattern. The last time Delaware initiated sua sponte a legislative process designed to catch management's eye by providing it new benefits was in the 1960s.[355] Significantly, deteriorating market share made Delaware feel compelled to act. We also see such risk aversion in the historical pattern that ties legislative innovation to rising stock markets. Management-favorable innovation is less likely to raise eyebrows in prosperous conditions. It follows that whatever the bottom is, Delaware will not go there, just as it will never tilt markedly in the shareholders favor. Finally, note that barriers to entry into the charter market have imported stability since Delaware regained market share after 1967. The barriers provide shareholders an incidental systemic benefit even as they block the analogy to a first-best product market. If entry were easy, the competitor could cater to management, enervating the fiduciary regime or otherwise curbing litigation.

C. *Delaware in the Era of Shareholder Capitalism*

The shareholder interest only nominally lost the takeover wars of the 1980s. Although legal innovations during the 1980s made tender offers more expensive and less likely to occur, the normative agenda of the hostile offerors and their proponents in policy discussions did win the day. The offerors demanded shareholder value maximization and the managers and state legislatures resisted. In the 1990s, management did an about-face and assimilated the norm.[356] Incentivized by stock options, managers began building their careers by maximizing value. Disinvestment and conglomerate unbundling, which came by force in the 1980s, became an ordinary business agenda item. At the same time, institutional shareholders, outraged by the antitakeover triumph of the 1980s, learned to ameliorate the shareholder collective action problem by organizing and making their voice heard in boardrooms and at the annual meetings.[357] Performance pressures on executives

355. *See supra* note 65.

356. *See* Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1278-87 (1999).

357. Ironically, Delaware's position is enhanced only because the primary avenue for shareholder intervention—the proxy rules—already has been federalized.

intensified. So did conversations about items on the governance agenda, leading to apparent improvements in practice.

Many question the depth of these changes now that the shareholder-value era has given way to the Enron era. Whatever the quality of the change in the practice, there can be no question that the changes worked to Delaware's advantage. The diffusion of the shareholder-value norm and the shift of interest group influence toward a more even balance between management and an emerging class of shareholders,[358] taken together, meant a better protected shareholder interest. There resulted a lessening in intensity of the ongoing debate over the separation of ownership and control. Where thirty years ago there prevailed a managerialist model of corporate governance that endorsed the delegation of substantial discretion to managers,[359] today the absolutist view represents a minority perspective.[360] The deflation of managerialism implies a concomitant diminution of antimanagerialism. As a result, corporate governance debates have lost much of their ideological coloration and corporate federalism has become depoliticized. Today, debates tend to devolve on functional questions about value creation and agency costs, a context in which Delaware often comes up looking very good.

The federal threat accordingly recedes further into the deep structure of corporate federalism. The state-enabling regime still remains vulnerable to federal mandates, perhaps even more vulnerable. Shareholder capitalism has brought the conduct of business and stock market results forward in the national consciousness,[361] making negative shocks politically salient in Washington. Yet, despite the notable incursion on internal affairs in SOX, it holds out no apparent disruption of the state equilibrium. Delaware being a business, only a threat to the state equilibrium matters to its bottom line. As to this, the federal government has proved surprisingly cooperative.

Shareholder activism also helps Delaware by reducing the threat of potential competition. Through much of the 1980s, it remained conceivable that Delaware could suffer a significant number of outbound reincorporations to the stronger antitakeover states. To the extent shareholders rubber stamped shark-repellant

358. *See* Hansmann & Kraakman, *supra* note 248, at 443.

359. *See id*. at 444.

360. Steve Bainbridge is the leading proponent. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 818 (2002); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 605 (2003).

361. ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 71-95 (2000).

charter amendments, they also would rubber stamp a management-protective reincorporation. That assumption has not been safe for some time.[362] Shareholders now vote no on such proposals. It follows that even as management retains agenda control over reincorporation, the shareholder veto has become meaningful. The exit door from Delaware to a neocharter monger would certainly be sticky, and very well may be locked in most cases.[363] And even if an exit-seeking management could get the votes, it still might hesitate—the reincorporation process might send a bad signal to the financial markets. It follows that the only competitive threat to Delaware would come from a state that devised a superior strategy addressed to issues as to which management and shareholder interests stand aligned. That seems an unlikely event, given Delaware's ability to learn and modify its approach in response to changes in practice.

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

Hostile takeovers are the sticking point in this description. Delaware remains an antitakeover state, with its poison pills, classified boards, and cooperative judiciary more than making up for the weakness of its antitakeover statute. Its continued adherence to the management side and rejection of short-term value maximization continues to occupy a top spot on the agendas of shareholder activists and academic commentators.[364]

But this appears to be another case of a narrow, elite political network fighting a rearguard action against a stable equilibrium.

362. Robert Daines & Michael Klausner, *Do IPO Charters Maximize Value*, 17 J.L. ECON. & ORG. 83, 87-88 (2001).

363. Here we note that a negative inference arises from Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1783 (2002), which surveys reincorporation activity to find that competition does tend to reward the antitakeover states. *But see* Subramanian, *supra* note 297, at 1843-44 (finding recapture antitakeover statutes and mandatory classified boards have hurt the ability of adopting states to retain companies).

364. *See, e.g.*, Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards*, 54 STAN. L. REV. 887, 950 (2002) (promoting effective staggered boards as the most powerful antitakeover device).

Takeovers have disappeared from the federal political agenda. Between 1987 and 1990, thirty-two bills concerning hostile takeovers and defensive tactics were introduced in the Congress.[365] Between 1991 and 1994, there were seven such bills, and after 1994, only one.[366] With the Congress quiescent, the states' antitakeover equilibrium stays in place. This political result is easily explained. Takeover protection never had much political traction in Washington, due to management opposition and public indifference or hostility.[367] The newly vocal shareholder interest apparently still makes for an insufficient counter. Nor is it clear that it would make sense for the lead institutions to direct their political energies to takeovers. Other governance matters, like committee practice and access to the proxy statement, take precedence today.

Other structural factors also can be cited. Federal intervention in internal affairs tends to follow stock market reverses, because losses trigger political demands. Merger and acquisition activity, including hostile offers, tends to coincide with rising stock markets,[368] a time when the management interest registers especially effectively. Red ink may speak more loudly than opportunity costs in any event. While the 1990s did yield clear-cut cases of opportunity costs to shareholders due to tough management defensive play,[369] the cases were sporadic. The prevailing picture was one of free-flowing premiums incident to friendly deals.[370] Hostile takeovers were politically salient during the 1980s, when they provided the shareholder interest a stick to yield against suboptimal earnings-retention practices and conglomerate structures.[371] By the 1990s, norms and incentive structures had shifted. Managers in industries experiencing external shocks voluntarily responded by entering into restructuring transactions

365. Memorandum from Elizabeth Glasgow, student research assistant, to author, (August 2004) (on file with author).

366. *Id.*

367. *See* Romano, *supra* note 109, at 490-503.

368. *Id*.

369. Bebchuk et al., *supra* note 364, at 919-25.

370. WILLIAM W. BRATTON, CASES AND MATERIALS ON CORPORATE FINANCE 688-89 (5th ed. 2003). Even as the absolute number of hostile offers stay constant, *see* John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable are U.S. Public Corporations?*, 24 J. CORP. L. 837, 855 (1999), the percentage of overall activity involving a hostile bid dropped significantly, from fourteen percent of all transactions in the 1980s to three percent in the 1990s. George Andrade et al., *New Evidence and Perspectives on Mergers*, 15 J. ECON. PERSP. 103, 104-09 (2001).

371. Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121, 127-32 (2001).

D. Delaware as a National Agency

Several commentators,[372] including us,[373] have suggested that corporate federalism be understood by analogy to the relationship between the legislature and an administrative agency. This delegation analogy has attractive aspects. The spread of Delaware charters nationwide makes Delaware a de facto national lawmaker. As such it serves a harmonization function in the national marketplace. It also can be noted that Delaware owes its national impact to the Supreme Court's interpretation of the Constitution to require states to admit firms chartered elsewhere, and accordingly collects rents only as a result of a federal dispensation of grace. The Congress has the authority to federalize the subject matter in any event. It follows that even though the Congress never formally delegated lawmaking authority to Delaware, it fairly may be viewed as an arm of the national government. Arguably, to the extent the analogy succeeds, the federal allocation is justified and with it Delaware's national role. We think that the analogy is descriptively robust, but that it has limited justificatory impact for federalism discussions.

Political theorists posit a menu of functions that agencies serve for legislative principals. Two stand out as candidates for describing Delaware. The first is substantive credibility. Sometimes the legislature cannot credibly commit to stick to policy choices, due to the vagaries of elective politics and constituent demands.[374] The legislature delegates to an agent that can establish the desired credible commitment and develop the necessary expertise. The more insulated the agency from external political pressures the better it serves this function. The delegation of monetary policy to a central bank is the classic case.[375] Extending the point to Delaware,

372. *See* Macey, *supra* note 196, 267-68 (using the agency analogy as the basis for a public choice explanation of the existence of state regulation); Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2493, 2530-36 (2005) (comparing Delaware to a central bank and noting limitations on the analogy).

373. *See* Bratton & McCahery, *supra* note 122, at 1867-72 (drawing on agency literature to suggest self-regulatory strategies).

374. *See* POLLACK, *supra* note 337, at 23-24. The legislature may want the agency to take the blame for unpopular policies. *See* Morris P. Fiorina, *Legislative Choice of Regulatory Forms: Legal Process or Administrative Process?*, 39 PUB. CHOICE 33, 55-58 (1982) (arguing that an administrative solution often becomes the compromise accepted both by those fearing that a legal solution might offer "too much" regulation and by those fearing that such a solution might offer "too little" legislation). Macey draws on this literature in his federal-state agency discussion but does not apply the analogy to corporate law. *See* Macey, *supra* note 196, at 284-86.

375. *See* Giandomenico Majone, *Two Logics of Delegation: Agency and Fiduciary Relations in EU Governance*, 2 EUR. UNION POL. 103, 110-11 (2001)

we see a need for a credible commitment from government in order to induce investment and can identify just that credible commitment in Delaware's evolutionarily stable strategy.

Does the analogy, thus drawn, carry through to import presumptive immunity from federal interference in internal affairs? We do not think so. The central bank analogy is descriptively problematic because the delegation's objective is the vesting of political property rights in the agency.[376] Delaware has no such rights and has steadily seen its regulatory turf contained. Worse, we can go to back to the credibility concept and apply it to the SEC: the SEC vests a voice for the shareholders and insulates the mandatory disclosure system from compromise due to management influence, importing credibility for the purpose of encouraging investment. That the SEC was created in order to correct state-level results bespeaks a state-level adverse selection problem.

At this point, the analogy's proponent can fall back a step and restate the point, addressing the system as modified by the federal securities laws. Like all principal-agent relationships, those between legislatures and agencies implicate agency costs, and ex post legislative overruling is a standard disciplinary device.[377] Congress did just this in enacting the securities laws. To the extent that Delaware is easily overruled and a threat of additional incursions imposes ongoing discipline in Delaware,[378] the agency analogy holds well.[379] It thereby comes to bear against those who argue for total preemption. But, politically speaking, that argument

(discussing Kenneth Rogoff's theory that governments tend to delegate "monetary policy to a central banker who is more 'conservative' (i.e., more inflation averse) than the government" and commenting on the high level of independence bestowed upon the European Central Bank by the Maastricht Treaty); *see also* Kenneth Rogoff, *The Optimal Degree of Commitment to an Intermediate Monetary Target*, 100 Q. J. ECON. 1169, *passim* (1985).

376. Majone, *supra* note 375, at 114.

377. POLLACK, *supra* note 337, at 26-28.

378. *See* Barry R. Weingast & Mark J. Moran, *Bureaucratic Discretion or Congressional Control? Regulatory Policymaking by the Federal Trade Commission*, 91 J. POL. ECON. 765, 768-69 (1983) (discussing the "congressional dominance" approach to principal-agent relations).

379. *See* ARTHUR LUPIA & MATHEW D. MCCUBBINS, THE DEMOCRATIC DILEMMA: CAN CITIZENS LEARN WHAT THEY NEED TO KNOW? 79-81, 85-92 (1998), which evaluates the success of a delegation in terms of two factors—knowledge and incentives: if the principal either knows what the agent is doing, or the agent's action makes the principal better off than would the status quo. Delaware is transparent, making oversight easy; often Delaware's actions make the federation better off. Lupia and McCubbins offer a tougher standard in the alternative. *Id*. at 91-92. Under this the delegation succeeds only when the agent takes action that improves the principal's welfare. Viewed this way, the Delaware delegation fails in some instances.

has fallen off the agenda. Today's federalism discussion concerns the magnitude of the presumption against nonintervention. At this point, the agency analogy works against charter market advocates who argue for a strong restraint against federal incursions into internal affairs. Delegation analysis legitimizes such federal incursions on the ground that the principal's preferences should prevail. We are left to judge the federal intervention in cost-benefit terms, with no special presumption skewing the analysis, at least so long as the intervention does not disrupt the state-level equilibrium,[380] a result that federal authorities do not appear to prefer.

Now, let us try a second line of political theory. Under this scenario, the agency serves a function analogous to that of a congressional committee:[381] it sets the agenda, avoiding cycling, and perhaps also skewing the agenda in a desired direction.[382] Mark Roe draws this analogy forcefully, pointing out that the delegation to Delaware orders the agenda and limits the players to the management and shareholder interests, relegating public interest advocates to secondary influence at the federal level.[383] This too is descriptively accurate. But its justificatory impact on the federalism discussion is similarly narrow. It provides an argument against total preemption, but it does not, for example, support an argument against federal intervention to preempt antitakeover legislation or invalidate corporate defensive devices. We also would add a historical caveat. The description works better and better as one goes back in time, and federal chartering motivated by a public interest agenda becomes an active agenda item under the trust paradigm. As one moves forward in time, the overall federal regulatory scheme more and more instantiates the strategy of contract and outside regulation for outside constituents and the public interest, with federal corporate law politics becoming more shareholder-value oriented. To the extent federal corporate politics focuses only on the governance agenda, and it has been thus focused for twenty-five years, the structural importance of agenda control at the state level matters less and less for shareholder capitalism.

380. At this point the proponent of state discretion can argue that Delaware should be insulated as if it were a central bank. But now the description has failed and the point merely restates the normative claim made in the federalism discussion.

381. *See* D. RODERICK KIEWIET & MATHEW D. MCCUBBINS, THE LOGIC OF DELEGATION: CONGRESSIONAL PARTIES AND THE APPROPRIATIONS PROCESS 22-25 (1991).

382. POLLACK, *supra* note 337, at 25.

383. Roe, *supra* note 372, at 2504-19.

IV. CONCLUSION

Federal intervention that interferes with the state equilibrium could be justified if done for the purpose of encouraging keener charter competition and a more even-handed strategic balance between the shareholder and management interests. But we perceive no political incentives that might encourage federal micromanagement of the charter market. Failing that, corporate federalism remains robust, so long as the federal government and stock exchanges continue to refrain from allocating to themselves so much subject matter as to cause Delaware's customers to question the efficacy of their rent payments. Those who would prefer to see no further expansion of federal territory are likely to be frustrated. The shareholder class having risen, corporate law is hardwired into national politics. Only two developments could change the pattern: either managers assimilate a strong norm of financial truth-telling and compliance with law, or shareholders assimilate the precepts of fundamental value investment. We predict no change.

Meanwhile, Delaware is safe in the present context. It would take a dramatic shift in federal policy preferences to threaten it. Such a development seems unlikely. We have seen striking changes in political preferences since 1888, yet these have given rise to few, if any, serious attempts to transfer corporate lawmaking in whole to the federal government. Positive political economy suggests that once an institutional structure has run in one direction for a long period, one is unlikely to see new constraints that alter the original understanding.[384]

384. *See supra* note 198 and accompanying text.