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DELAWARE'S POLITICS

Mark Roe

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Delaware's Politics

Mark J. Roe

Abstract

A central question for corporate analysis has been whether interstate competition in making corporate law produces a race to the top, or to the bottom. Less well examined is how the states interact with federal authorities in making corporate law. Yet, this federal-state relationship is critical, often surpassing the interstate race in importance, as federal authorities can and often do displace state authorities in making corporate rules and, even when they do not displace the states, often affect the state rules that arise. Here I examine the core public choice structure of the federal-state relationship. This structure strongly affects what kind of corporate law we have in the United States, inducing moderately "conservative" corporate law, oriented more to managers and investors, and less (than other institutional arrangements would produce) to outside "public" interests, such as those of national policy-makers who want investor-manager rules different from those made in the states, where broad-based economic and fairness concerns are less prominent.

The federal-state structure of corporate lawmaking resembles the well-known Condorcet-Arrow's paradox from public choice theory: agenda order can determine the outcome. The corporate lawmaking agenda is usually first set in Delaware. There, two "players"—managers and investors (or, more properly, the agents of investors)—determine corporate law's initial content. Federal authorities might then oust, reverse or modify the state-made rule, and when they act, particularly when they act in Congress, new public players can influence the results. But by then, the original players have acquiesced in their compromise, and tend to fight off modification at the federal level. Sometimes the core Delaware players win (and win because the agenda was set earlier); sometimes they lose. Even when they lose, the federal result can be shaped by decisions and "coalitions" first made in Delaware. The doctrines that often justify limited federal effort—the internal affairs doctrine, primarily—are a public-regarding justification for deferring to the interests that are prominent on the state level.

Were corporate law first made at the federal level, and not in Delaware, the public choice results could, and I believe would, differ greatly. Why? The first two players—managers and investors—would often seek "outside" allies for their positions at the federal level, instead of, as they do in Delaware, first finding common ground. Managers on some issues would look to employee interests in Congress as allies. Investors seeking to confine managers might to shareholder activists as allies, some of whom have in mind more of a public interest agenda than a shareholder value agenda. Sometimes these alternate coalitions would prevail in Congress, and if they frequently prevailed, as is plausible under a decisional rule that differed from what we have, American corporate law would differ from what it is today. This Arrow-type, Condorcet analysis of state-federal relations seems to explain much of the basic content and tendency of American corporate law, perhaps more than does the interstate race.

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INTRODUCTION

Corporate law analysts have been grappling with the nature of interstate competition for corporate charters since the birth of the large modern corporation at the end of the 19th century. But the interstate race, I argue, whether to the top or the bottom, is not as central a determinant of American corporate law as is commonly thought by both sides. The structure of the federal-Delaware relationship also determines the content of American corporate law.

Here I analyze the public choice structure of that federal-state relationship, which I assert can be reinterpreted as a massive agenda-setting institution. By determining the sequencing of the "plays" on corporate law, and by determining who "plays" in each "game," the federal-state structure weights the result toward moderately-conservative corporate law. In this analysis, the Delaware franchise tax should be reinterpreted as determining who counts in making American corporate law.

And the corporate franchise tax—usually seen as motivating the race—should instead, or in addition, be seen as enhancing the joint authority of managers and shareholders and as excluding the authority of outsiders. Those outsiders often have a regulatory agenda, and excluding them thereby reduces the power of the regulatory agenda and makes the contractarian model of American corporate law plausible. The role of the franchise tax is as much to exclude other corporate players and national policy-makers as it is to motivate an interstate race.

The usual perspective runs like this: state competition limits what any one state can do. In the race-to-the-top view, interstate competition limits inefficiency: states, cognizant of their wards' capital costs and profitability, would lose incorporation business if they provide grossly inefficient corporate law. In the modern race-to-the-bottom view, competition limits states from imposing tight, investor-oriented regulation: states legislatures, cognizant that they'll lose incorporation business if they are too tough on managers, pass lax corporate law and over-turn tough judicial decisions.

The role of the federal lawmaker differs in each "race" view. In the race-to-the-top view, the federal lawmaker is a monopolist, unconstrained by competition. An unconstrained regulator would produce worse, or at least more rigid, corporate law, than do the competing states. It would not adapt as well as the states because it could not get signals and pressures from alternative jurisdictions. In the race-to-the-bottom view, the federal lawmaker, not worried about losing incorporation business, faces one less constraint toward producing good corporate law.

I argue here that the basic issue is not federal monopoly vs. state-to-state competition. Indeed, differing corporate law results would arise in America even if

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* Professor of Law, Harvard Law School. Thanks for early discussion on the subject go to Andrew Guzman, Howell Jackson, and Bill Stuntz.

both federal and Delaware corporate lawmakers had "monopoly" positions, that is, even if Delaware did not need to intensely compete with other states. The key issue is the difference in public choice structures between the two: the difference between who "makes" federal law and who "makes" state—even a monopoly-state's—law, and how the decision-making of the two is sequenced. The players with the upper hand in Delaware do not always have the upper hand in Congress; different players have voice, and sometimes power, in Congress; and it's these differences in political strength that largely determine the nature of American corporate law.

The mechanism of corporate-law-making in the United States can be reduced, at the usual expense of nuance, to a Condorcet, Arrow's Paradox agenda-setting institutional structure. As is well known, and as we shall review, the setting of the agenda and the sequencing of decisions often determines outcomes, and this seems to be vividly true—once we see it—in making corporate law. The institutional federal-state framework determines the agenda, and the key structures in the institutional framework turn out not to be just, or even primarily, interstate competition for chartering revenues. More is at stake. Much may be determined by the federal-state institutional structure and decision-making sequence, perhaps as much as, or more than, is determined by interstate competition.

This Arrow/Condorcet, public choice story allows us to reinterpret the key structures of Delaware corporate law. Most centrally, Delaware's franchise tax revenues figures heavily in the state-to-state race stories, as the "pot" of money that Delaware seeks to preserve for itself with either efficient law (the to-the-top) view, or pro-managerial law (the to-the-bottom) view. But in the public choice story that I advance here, the "pot" of money plays a different, and perhaps more important role. The key players who can directly and immediately take that "pot" away from Delaware are the managers and the shareholders. Traditional analyses look at who, between managers and shareholders, has more muscle in controlling that pot, via having the upper hand in the reincorporation decision. But they both most approve reincorporation out of (or into) Delaware, and typically no one else need approve exit (or entry). Thus the public choice re-interpretation of the franchise tax that I present here is that the franchise tax determines one key dimension of the political inputs. It highlights managers' and shareholders' interests in Delaware, and denigrates everyone else's.[1] It sets, or helps to set, the agenda for making American corporate law. If it's satisfactory to managers and shareholders, it could fly in Delaware. If the proposed rule offends both of them, it won't. And that may be a central, perhaps even the central, determinant of American corporate law.

[1] The other players' input is indirect: Delaware usually does not want to be displaced by federal law. In making its law, Delaware has reason to choose a place on the spectrum that will not instigate the federal players to act.

I. THE STANDARD STORY: THE INTERSTATE RACE

A. States Fight for Chartering Revenues

1. By racing to the bottom. States, eager to grab the franchise tax from corporations, pass corporate law to please the managers of large firms, thereby maximizing managers wealth. The classic conclusion is probably still William Cary's, one written after Cary finished his term as chair of the SEC:

> [T]he first step [for improving corporate law] is to escape from the present predicament *in which a pygmy* among the 50 states prescribes, interprets, and indeed *denigrates national corporate policy* as an incentive to encourage incorporation within its borders. …[2]

Delaware panders to managers, often at shareholders' expense. Shareholders cannot reincorporate by themselves, as corporate law requires that they act only after the board—the managers—recommends reincorporation.[3] The first actor in the reincorporation decision is the board, and states in this view give the managers whatever they want. Shareholders are too dispersed in the public corporation to control the situation, and they usually just rubber-stamp managers' recommendations. The standard collective action problem makes it not worthwhile for the shareholders to organize and second-guess managers on reincorporation. More nuanced analyses see Delaware with a network advantage, which gives shareholders a "plus" that Delaware can then take back via pro-managerial substantive rules.[4] And recently analysts have wondered whether the race to the bottom is so strong after all; Delaware might have monopoly power in making corporate law, and in exercising that monopoly power it may not be producing efficient corporate law.[5]

2. By racing to the top. But pandering to managers can go only so far. States that hurt their firms' operations would raise that firm's cost of capital, as eventually capital markets participants understand that the firm is weaker and will earn less than a similar firm from a pro-shareholder state. Over the long run this damage to the firm's capital-raising capacity will take its toll: managers realize that they are weakening the firm by reincorporating in that bad-law state, the pot for all to split (shareholders and managers) shrinks, and that cost pushes the players to reincorporate elsewhere. At the limit the firm could disappear, either in bankruptcy or via a takeover from a stronger firm in a neighboring state with better corporate law.[6] Bad corporate law might persist in a state, but one way or another the firms incorporated under that bad law would not.

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[2] William Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 701 (1974).

[3] E.g., Del. Gen'l Corp. L. §§ 241, 251; Lucian Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437 (1992).

[4] Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995).

[5] Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002); Lucian Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters*, 112 YALE L.J. 553 (2002).

[6] Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. (1977); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 21 (1993);

B. The Federal Behemoth

But federal authorities can, and do, confine state competition, because they often have made American corporate law, and could do more, were they so inclined. Indeed, in nearly every decade of the 20th century the major corporate law issue of the day either was decided at the federal level, or federal authorities threatened to act on it. Delaware has shown itself to be quite conscious of federal action, has good reason to fear federal preemption, and seems to act at times to deter federal action, in a manner similar to the monopolist who uses limit pricing to deter entry.

[Develop further.][7]

C. Delaware as a Quasi-Federal Agency

Here, let us free ourselves from the relentless focus on state competition in corporate lawmaking, or even from a federal-state relationship. Think of Delaware corporate lawmaking as disembodied from the federal-state and state-to-state relations. Think of Delaware as, say, a federal agency, making corporate law, with commissioners—call them chancellors—with 14-year terms, and with bar association committees that petition the agency for corporate law rules. And in doing so, we see a very different picture than is normal for corporate lawmaking. I sketch my view of that picture in the rest of this article. Instead of a thinking of corporate law as being made in a sharp federal-state divide, imagine that Delaware is only the rule-making entity that usually acts first, often without further review, and then the Federal lawmakers (Congress) can then over-turn what Delaware does. Usually they don't, but they always could, and they sometimes do.

Thus Delaware could be conceptualized as a state whose corporate law rules the Feds could overturn with the Interstate Commerce Clause. Or it could be an independent federal agency that the Feds could over-turn via an act of Congress, or via the stranglehold from the relevant committee, or via the SEC inducing new stock exchange rules, or via a tough inquiry from the White House.

II. THE STRUCTURE OF MAKING AMERICAN CORPORATE LAW

A. Who Makes American Corporate Law?

1. In Delaware. Consider who counts in making Delaware corporate law. The key players are managers and shareholders, and their lawyers. Academic inquiry has focused on the relative weight of managers and shareholders in making corporate law, and the role of efficiency in the end-product.

The general polity is not usually involved in Delaware. Employees, for example, or their unions might be interested in corporate law. Environmentalists might

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Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NORTHWESTERN U.L. REV. 913 (1982).

[7] See Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. __ (forthcoming, 2003).

as well. Public interest groups of all stripes are interested in confining corporate power and defining corporate policy. Financial institutions as creditors want to influence the corporate law (usually by inducing stability, strong net capital rules (legal capital) rules). The latter are very important in other countries, e.g., Germany, and conceivably in alliance with one of the other players could be very important in the U.S. For the most part not one of these four strongly influences day-to-day American corporate lawmaking.

Public policy interests are in play as well: surely considering what is best and fairest for the American economy must be in the minds of Delaware lawmakers. But even if one should not challenge Delaware actors as having a bona fide goal of efficient and fair corporate law, one can note that the salience of the public interest might be somewhat paler in Delaware than it can be at the national level. After all, public policy-makers in Washington can, when they are public regarding, consider themselves to be custodians for the American economy in a way that the Delaware players might not feel so strongly. Moreover, Delaware's franchise tax revenues could temper a Delaware politician's public-regarding view (or influence which view, among competing views of the public interest, seems most plausible). Federal authorities, on the other hand, often cannot focus on corporate law, but, when they do, some, perhaps many, of the players will have public-regarding views strongly in mind. (Public-regarding is not, as am I using it here, identical to being in the public interest. Congress might react to headlines, might want to be seen as "doing something" on the volatile issues of the day, and might not have long-term national well-being utmost in mind. The public interest is only a subset of public-regarding actions.)

Hence, as a first approximation, one could say that investors and managers make Delaware corporate law. Other groups and visions in play in Delaware, but they are weaker than they would be in an attentive federal forum. Delaware lawmakers do not have to placate, say, employee representatives, or environmentalists, or consider the current policy-makers' views of what kind of corporate law and allocation of investor-manager authority is most efficient for the American economy as a whole. Or, stated differently but more crudely, if Delaware makes corporate law that offends investors and managers simultaneously, the investors and managers, who by any account control the reincorporation decision, could take the big franchise tax pot of money away from Delaware.[8] For Delaware in the long run, and perhaps even in the short-run, everything else is rendered secondary.

2. In Congress. If corporate law were always made in Congress, not in Delaware and the states, the range of interests in play would differ. Those other groups would have some clout, the franchise tax would be of no consequence, and for some players in Congress public-regarding visions of the allocation of authority inside the corporation would be in play.

It's not that these "outside" groups could form a coalition in congress to beat a managerial-investor alliance. The U.S. polity isn't built like that, at least not when the

[8] More properly, exit would start if Delaware offended two groups of managers simultaneously: the managers of operating firms and the managers who run stockholding institutions. More about that below: the Delaware deal may not even correspond to what ultimate investors want, but what their managers want.

"normal science" of conservative American coalition building is in play. Rather it's that the centrality of investor-manager accommodation in Delaware would recede. Indeed, a managerial-investor deal could break-down in Congress, if one or the other of the two thought it could do better in alliance with one of the otherwise "out" groups that have no sway in Delaware but some power in Congress.

Here's how: Imagine that lawmakers are reviewing rules as to whether managers can be autonomous from shareholders. In Delaware the managers and shareholders work out a deal, or one dominates the other. Other players may talk in Delaware, but they're barely even listened to. After all, they cannot move the franchise tax, and they don't vote in Delaware. But in Congress, the range of players and ideas in play differ. One could imagine an alliance between, say, managers and employees, with both seeking to confine shareholder power, for obvious reasons. In a democracy, managers might find it quite useful to ally with employees, who have more votes than do managers.[9]

Or consider the alliances shareholders might try to make in Congress, alliances unavailable to them in Delaware. Seeking to confine managerial discretion, shareholder activists might seek more direct ways to get themselves or their representatives onto the boards of large American corporations. In Delaware, they'd have to work it out with managers (and their lawyers) to make a deal. But in Congress, they'd have other strategies. Shareholders might find it worthwhile to ally with public interest activists, say environmentalists who also want to confine managerial discretion (albeit in dimensions other than those that concern the shareholders). One could imagine a shareholder-environmentalist deal in which shareholders get three seats, and environmentalists one, on the boards of directors of major American firms. Shareholder activists might prefer rules of pure shareholder primacy, and not favor environmental representation in the boardroom. (In crude terms, shareholders might give something up to environmentalists, if they thought that's what they needed to get a deal done, and they were giving up less to environmentalists than they were getting back from managers.) But they'd need a coalition to get more votes to win in the political institutions. In Delaware, they can't. And even at the federal level, this kind of coalition is hard to imagine in the United States in most circumstances. But it's impossible to imagine in Delaware, and at least possible in Congress. And, the federal-Delaware structure of American lawmaking weakens these kinds of coalitions possibilities in the United States.

American corporate law is typically not made first in Congress but in Delaware. The Delaware-federal sequencing insulates initial corporate law decision-making from the hurly-burly of big politics in America. The sequence can be displaced by Congress, and often is when a scandal hits the headlines or an issue of over-riding economic importance emerges. When Delaware is displaced, the range of interests in play, and the nature of American corporate law, shifts away from the Delaware manager-investor baseline.

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[9] Cf. Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? At Test Using Takeover Legislation*, 30 RAND J. ECON. 535 (1999) (wages higher in states with stronger, managerial-favoring antitakeover laws).

But before considering shifts from Delaware to Congress, consider first how the sequencing of decision-making affects day-to-day American corporate law.

B. Corporate Law as Arrow's Paradox

Arrow's paradox of social choice, known sometimes for its first discover as the Condorcet problem, is considered "one of the most important [ideas] in political theory."[10] Yet, despite being one of the most important ideas in political theory, it has not been brought to bear on analysis of the making of American corporate law. This social choice problem, layered on top of the natural agenda-setting result of the federal-state relationship, helps to explain much of American corporate law.

Although the Delaware-federal interplay is not a *pure* Arrow's paradox, Arrow's construct is one that's accessible and fairly close to the Delaware-federal public choice structure. So we can "grab" the construct, slightly modify it, and make the essential public choice points we need to make.

1. Agenda control. Simplify the choice structure for corporate law at first. Three groups (1, 2, and 3) consider three policies, A, B, and C. Group 1 prefers A to B to C. Group 2 prefers B to C to A. And Group 3 prefers C to A to B. In paired election contests, A beats B. Then C squares off against, the winner, A, and C beats the A-B winner. Then C, the temporary champion, squares off against B, and this time B wins. There is no obvious democratic winner, and the winner is set by how the agenda is determined. When do we stop the sequencing? When we stop, we have a winner. (If we don't stop, we cycle—another Arrow-problem that we discuss briefly below.) Whoever determines the voting sequence, or whoever determines when we stop, determines the winner.

2. The Delaware-federal agenda. Let's adapt this scenario to the Delaware-federal sequencing, to see how the real sequencing of American corporate law tends to diminish the influence of groups other than managers and investors.

Group 1 is made up of the managers, who prefer corporate law that makes managers autonomous (A=autonomous). Group 2 is made up of investors, who prefer corporate law that maximizes shareholder wealth (B=SWM). Group 3 is a single, homogenous "public interest" group. We initially (unrealistically, but for clarity) lump together employees, environmentalists, the politically correct, and the Washington public policy-makers as favoring a public-oriented corporate policy, C.

Specifying a single policy for this group is not my intention. It's really a group of interests and policy-makers whose single unifying characteristic is that they are neither managers nor investors. They are unified on few issues. (So actually we should refer to these issues as C_1, C_2, C_3, etc., with C_1 being high social responsibility, beyond what law and main stream culture require, and, C_2 being the economic policy and corporate structures that public policy-makers want, policies and structures disfavored by the managerial-shareholder contract.) Say, for example, at the expense of some simplicity, that the policy-makers favor a tough antitrust policy (bad for shareholder

[10] PETER C. ORDESHOOK, A POLITICAL THEORY PRIMER 25 (1992), who succinctly sets out the theorem and its consequences. Id. at 24-32. [KENNETH A. ARROW, SOCIAL CHOICE AND INDIVIDUAL VALUES (2d ed. 1963).]

profits) and a tough cap on executive compensation (bad for managers and, for those shareholders who think high compensation motivates managers to produce profits, bad for shareholders). These public policy-makers think that high compensation doesn't contribute much to corporate performance and de-legitimizes the American corporation. But managers want the state law result intensely, and most investors are indifferent. Moreover, and this may be important, the Delaware players are not precisely managers and shareholders, but managers of operating companies and managers of shareholding institutions. One can imagine that policy-makers would like to overturn many results that the two managerial groups come to.[11]

The critical observation here is that at the state level, class 3 players—those who favor C_2 and other C-class policies—are politically weak relative to class 1 and class 2 players, the managers and investors who control the franchise tax. That observation leads to a modified Arrow's paradox structure for corporate law. Managers, prefer policy A, autonomy, to shareholder value (B) and prefer basic shareholder value to the public policy-makers' preferences (C): A>B>C. Shareholders prefer policy B, basic shareholder primacy, as better than managerial autonomy (A) and the public policy-makers' preferences (C): B>A=C. (This last relationship modifies, for some modest realism, the standard Arrow set-up. Shareholders are indifferent between giving value away to shareholders and giving it away to environmentalists or the politically correct, or paying for a better economy for everyone.)

The general polity, group 3, prefers (or some of its sub-groups prefer some of) overall economic efficiency, distributional adjustments, social responsibility, a pro-environmental agenda, and so on. For them, C (or a sub-set of C) beats either managerial autonomy of shareholder wealth maximization: C>A=B.

With this set-up in mind, we can see that the winner (among managers, shareholders, and the general polity) can be determined by where the game is played, in Congress or in Delaware.

Consider C vs. A. If it's played in Congress, it's a toss-up. But if it's played in Delaware, policy A wins, because the because general polity doesn't vote in Delaware; it's just managers vs. shareholders, the players who control the franchise tax.

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[11] Similarly, but less intuitively, public policy-makers may want to prevent fraud to legitimize the market, not to improve performance. Investors might prefer not to have fraud, and would pay a little to reduce it somewhat, but public policy-makers may want them to pay much more to reduce much more of it more frequently.

And, another example alluded to in the text: Recall that it is typically agents of investors and agents of the corporation who will influence Delaware corporate law. Policy-makers may conclude that a much stronger shareholder primacy policy will lead to the strongest national economic performance. Managers, for standard reasons, might oppose such a policy in Delaware. Less obviously, stockholding institutions might also oppose such a policy. Cf., Robert C. Pozen, *Institutional Investors: Reluctant Activists*, HARV. BUS. REV., Jan.-Feb. 1994, at 140-49 (Robert Pozen was General Counsel and then President of fidelity, the nation's largest mutual fund complex). The leaders of such institutions have succeeded in a world without hyper-shareholder wealth maximization policy. A change in policy could erode their positions as well as sap the strength of their institution, because a new way of making money would be introduced, one in which the incumbents might trail new entrants. The Delaware players prefer something on the A to B spectrum, while public policy-makers in Washington might prefer a C_4 policy for national reasons, despite the local opposition of investing institutions and managers.

Or consider A vs. B. If A is played against B in Delaware, it's either a toss-up, or A wins, if managers have more votes, money, and power. Or, more plausibly, since it's a continuum not either/or, the Delaware result is somewhere between A and B, but closer to pure A than to B. Neither shareholders nor investors can turn to those who prefer C (or a sub-category of C) to find a coalition partner, because those interests aren't present in Delaware.

But, although A wins easily in Delaware, if A is played against B in Congress, it's a toss-up, with the result depending on whether I) A and B coalesce to beat all comers, or II) one of the two coalesces with some of those who prefer C, or with sub-groups thereof, to pull together a majority.[12]

The groups, policy goals, and relative power differ when corporate decisions are made in Congress as compared to when they are made in Delaware.

3. And if Delaware moves first? Since Delaware usually moves first, C has little chance directly, and A typically beats B. (Or groups 1 and 2 reach a compromise favoring A, assuming managers have the upper hand in Delaware.) Thereafter, federal authorities decide whether to act. Then it could be A, autonomy, the initial winner in Delaware, vs. C. And when it's A vs. C, shareholders cast their vote for A, or are at least indifferent between A and C. Managers continue to win. But, as we have seen, if the decision were first made at the federal level, then sometimes B and C could form a coalition to beat A. Shareholders seeking greater direct representation in the boardroom might ally with some policy-makers who favor this, and those who prefer some other public policy perspective for the public corporation.

Or those who prefer policies A and B, pursuing their first-best solution in Congress, don't coalesce in time with each other to beat C. This might describe Sarbanes-Oxley's passage, or a dimension of it.

In this vision, it's not just that the federal authorities can check Delaware and reverse them, but that agenda order affects the probability that they will do so. The following are very different institutional sequences: a) Delaware acts, then Congress decide whether to act. b) Congress decides whether to act or whether to defer to Delaware initially. In (a), Delaware's narrow players can coalesce to beat off the outsiders; in (b) the entire polity is deciding, with some knowledge of the outcome if the big polity defers to Delaware. No "transitivity" in sequencing

4. Shareholders' and managers' interest in minimizing federal influence. An alternate but similar verbal public choice perspective can be seen here. Think of the managers and shareholders as usually allied in the federal-state dimension. They know that in Delaware, managers and shareholders split up the corporate pie. Shareholders might conclude that they could do better *vis-à-vis managers* if the decision-making moved to the federal level on a particular issue. But they might decide not to go there because the price of beating managers could be leakage to *other* groups not otherwise present in Delaware, making shareholders net benefit zero, or negative.

The overall situation is more complex, and seems to militate to even more reticence to invoke federal authorities. That is, shareholders may not on a particular

[12] Or, more plausibly, since we have a continuum, the result is closer to farther from A than in Delaware, with significant ingredients of C added in.

issue be happy with Delaware's pro-managerial result. They would prefer a pure shareholder wealth maximization regime. They conclude that the improvement they'd get in Congress vis-à-vis managers on that issue would be sufficiently high that it would "pay" for the expected leakage to third parties who are weak in Delaware but to be reckoned with in Congress. But they might nevertheless not go federal, fearing that if more corporate law were federal, there'd be more leakage of the corporate pie (normally split by managers and shareholders) to third parties on other issues, leakage that they wouldn't face (or that they would minimize) if corporate law were kept primarily in Delaware.

One might think that free-rider effects might induce any individual Delaware player—an investor here, a manager there—to go federal, not taking into account the large potential externality of future federal intrusion of other interests. But the decision to go federal is tempered by associations: the Business Roundtable for managers; the Council of Institutional Investors for one large class of stockholders, the Investment Company Institute for another. These associations can overcome free-rider calculations of long-term interest. Since for shareholders or managers to go federal, one or the other lobbying organization must swing into action, each group's long-term interest in keeping federal authorities out of making corporate law can often be implemented.

5. The Delaware-federal public choice contrast. These public choice analyses can be illustrated, and extended, with indifference curves.

In Figure 1, we have Delaware's two-dimensional play, between managers and shareholders.

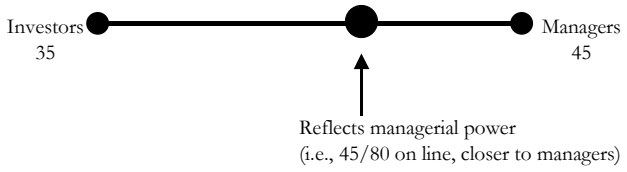


Figure 1: The Delaware Deal

More realistic illustration would portray the Delaware corporate industry: the lawyers, government officials, and others who profit from Delaware being the major incorporating state.[13] But we leave these out of the picture to see the basic Delaware result, one we next contrast with the federal play. So, basic Delaware corporate law tends to be an amalgam of managerial and investor interests. We arbitrarily assign managers a power level of 45, and investors a power level of 30. The two compromise, and Delaware corporate law is closer to the A policy (managerial autonomy) that managers prefer.

Consider next the picture of federal corporate lawmaking. If the issue arose first in the federal arena, the space in which corporate law could be made is three-dimensional. We have that third party who prefers C (or, more accurately, a range of

[13] Jonathan Macey & Geoffrey Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEXAS L. REV. 469 (1987).

parties who prefer a range of sub-issues not in play in Delaware). Congress passes legislation when any group assembles a majority. C has a power level of 25. The open white space in Figure 2 shows the space in which Congressional policy could be made.

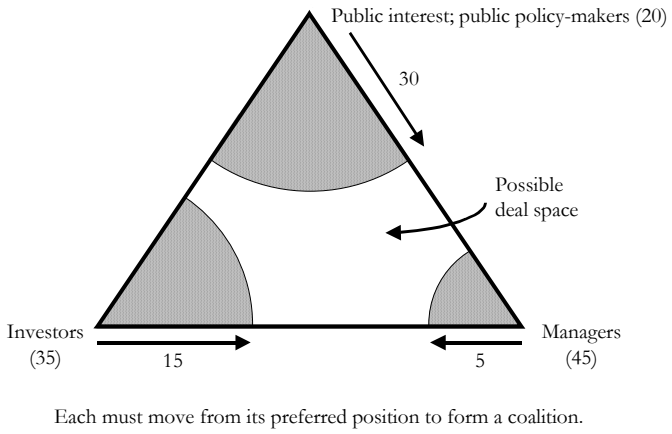


Figure 2: The Congressional Deal Space, if Congress Acts First

Consider the preferences in Congress when Delaware has already acted. Neither managers nor shareholders, if they already have the Delaware result pictured in Figure 1, would prefer to move to much of the open area in Figure 2. Figure 3 shows the space in which each is indifferent (but which would provoke the opposition of the other player) and the legislative space that would provoke their united opposition, after they have a Delaware deal.

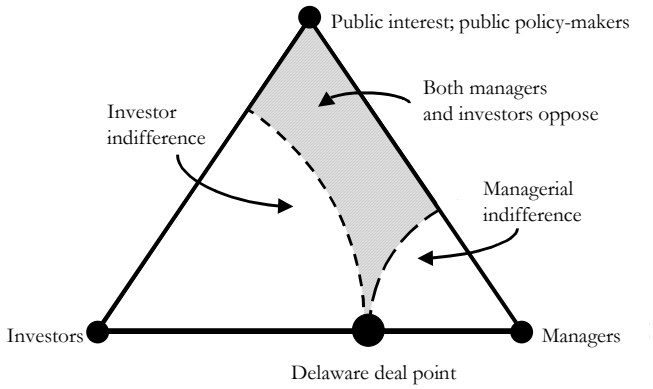
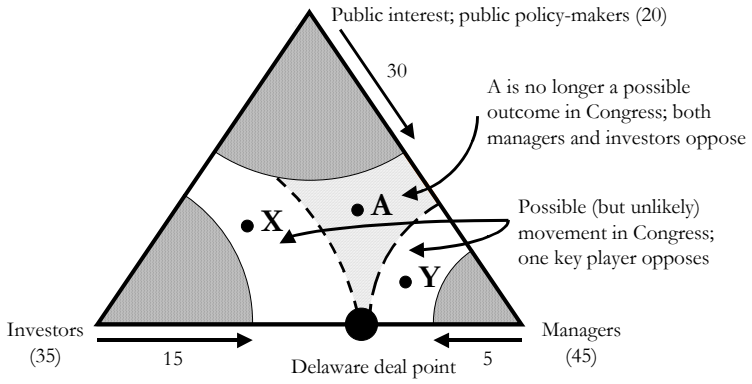


Figure 3. The Delaware Players' Indifference Curves, if Congress Considers after Delaware Acts

Figure 4 superimposes Figure 3 on top of Figure 2, to show the substantial area that would have been part of the Congressional deal space, had Congress acted first, in which managers and shareholders would unite to "kill" a federal proposal, after the two have a Delaware deal. Only some space would improve either managers or shareholders position. *No* point would approve both. Since Congress is typically harder to start up than it is to block, Delaware results will often stand, even if they were

results that Congress would not reach had it considered the issue initially. Agenda setting can control results, and Delaware can set the agenda.



If A is proposed, both managers and shareholders invoke "internal affairs" doctrine;
A is not viable, compared to status quo (after Delaware acts).
Either managers or investors oppose X and Y.

Figure 4. The Constricted Deal Space, if Congress Considers after Delaware Acts

At times those who prefer C, or a sub-group of C, have power at a level more than 25, or A has much less than 45. Sarbanes-Oxley's passage may have been one such time; the securities laws' passage in 1933 and 1934 might have been another. For some key national issues, Delaware cannot set the agenda (or more accurately federal authorities quickly re-set it). Figures 1, 2, and 3 illustrate the "normal science" of day-to-day corporate lawmaking, when the issues are not salient on the Congressional agenda. More about salience and displacement below.

6. Why does interest group power differ in Delaware and in Congress? Consider just Congress as the Federal authority. Delaware, the usual thinking runs, is very sensitive to anything that might cost it franchise revenues. Those revenues constitute about 20% of the state budget. In the first instance, shareholders and managers threaten those revenues, but those who favor one of the "C" policies—activists, public policy-makers, employees, etc.—do not.

The point again is not that the latter, C, can usually win in Congress. Usually they cannot. But if the issue became a live one in Congress, managers might ally with some in the Delaware out-group, on some sub-issue in C, to beat back investors, who might be trying to ally with those favoring another sub-issue of C. These latter, out-group players influence Delaware, but indirectly. Because they have some clout in Congress, Delaware might take into account the probability and likely direction of any Congressional re-set, and tilt to minimize the chances of federal preemption. Indirectly, these groups influence Delaware. It's not a "pure" two-level game: decision-makers in the first game have their eye on the probability of there being a second game, and usually try to reduce that probability.

(a.) The franchise tax. Delaware, in the usual view, is drawing lines and rules between managers and shareholders. The franchise tax pot motivates Delaware in deciding where to draw that line: In the race-to-the-top view, Delaware must efficiently draw the line, otherwise it will lose the franchise tax; in the "bottom" view, managers get more because they control incorporation and reincorporation more than shareholders do. In each case, something is being divided between managers and shareholders, and it's the franchise tax that motivates Delaware.

In the view I present here, however, the role of the franchise tax is not just to motivate Delaware in drawing the line between managers and shareholders, but *to keep every other player in America out of the process.* Why? Managers and shareholders, *if united*, can deny that franchise tax booty to Delaware, but no one else can do so directly, without federal action. Hence, the (until-now-unseen?) first effect of the franchise tax is not just to affect who wins between managers and shareholders, but who gets to play. Managers and shareholders get to play. No one else does.

State competition's role might be (merely?) to help managers win when the first move is made. Then the Condorcet machinery takes over, and it determines the ultimate winner. But even here state competition could be of limited import if managers would win in Delaware even without state competition.

(b.) Who elects Congress? [to come]

(c.) What motivates the federal players? The federal players are Congress, the SEC, Presidency, the courts, and the stock exchanges (who often act under SEC direction. [Note public choice difference when SEC directs stock exchange to study an issue (brokers and investors have the upper hand) from when SEC waits for Delaware to act.] I focus here primarily on Congress.

[Discuss and extend. Examples.] …

(d.) Why don't managers fully dominate Delaware? In our diagrams, we assigned managers a "power" level of 45 in Delaware, a level that's a minority on the federal level, but a majority in Delaware. That raises the question: Why don't managers take all the marbles in Delaware, moving to the right-hand corner? After all, shareholders can't reincorporate out of Delaware without managers assent; Delaware already has 50 or 60% of the incorporations. And, yes, while there's a stream of future reincorporations that Delaware wants, politicians are often thought to be shortsighted.

Several reasons present themselves: Delaware lawmakers may want to make good policy, and rules somewhere in the middle might be good policy. Future reincorporations into Delaware need those firms' shareholders' assent, so Delaware policy cannot be so anti-shareholder. These reasons may be sufficient for Delaware not to defer totally to incumbent managers.

But the federal triangle in Figure 3 suggests another, perhaps more fundamental reason why Delaware compromises instead of allowing the winner to take all. If Delaware and the managers moved into the right corner "black hole" segment, a federal counter-coalition could readily form. When they move elsewhere in the federal triangle, the counter-coalition is harder to arise and less likely to motivate congress to act. The federal influence on Delaware would pull Delaware leftward (and upward) from where Delaware would "naturally" come out on its own.

This diagram helps to explain Delaware's moderate takeover law. When Delaware considered its takeover law in the late 1980s, after most other states had enacted tough antitakeover statutes, one question that arose was why the proposal wouldn't just shut down the hostile takeover market for Delaware targets entirely. Managers, it seems, had a winning hand. But consider the statement of the law's primary drafter:

> [W]hy … moderate …? Why [not] the most restrictive thing that we can pass? … [T]o the extent that our legislation is viewed either in the short run or the long run as unbalanced and unreasonable, *we all know* that ultimately … we might have to pay the price … of the *federal government coming in and taking … the privilege from us.*[14]

Even when managers had the votes in Delaware, shareholders had some authority in Reagan-era Washington, and, on an issue of national importance, defeated shareholders might appeal to Washington to re-set the deal, where the play of interests would differ. At the time, significant policy-makers in Washington, favored C, a policy with a more open takeover field.

7. Antitrust and Arrow's paradox. The late 19th and early 20th century corporate law maneuverings illustrate Arrow's paradox of corporate law. At the time, critical antitrust issues were decided at the state level. The nation's producers in several industries had entered into unstable cartels, then sought to stabilize them via trust arrangements, whereby the stock of constituent companies was held by a centralized trustee who could coordinate production. The trust form arose because states barred holding companies that owned the stock of "foreign" companies (i.e., companies incorporate in other states). New Jersey, and then Delaware, produced corporate law that facilitated the integration of the producers into a single company. This led to calls for a federal incorporation law and, eventually, to federal antitrust enforcement.

We can re-analyze this process as fitting the Arrow's paradox, agenda-setting sequence we've thus far discussed. At the state level the relevant players were management and investors. (And back then the latter probably carried more weight than managers did then and than investors do now.) They wanted corporate law mechanisms that would facilitate monopolization and cartelization. They got those mechanisms. The trusts were clumsy but they arose if only because so much monopoly money was to be had. Some states—usually states like Ohio with players beyond managers and investors, players who preferred "C"-type public-regarding policies—attacked the trusts, but smaller states, like New Jersey and Delaware, enacted policies that owners and managers favored, policies in the A and B range, not in the C range. On the small state level, the "other" forces—progressives, public interest advocates, and anti-big-business players (TR, Sherman, and Brandeis)—were, overall lesser players than they were on the federal level.

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[14] Hearing on H.B. 396 Before the Delaware H.R., 134th Gen. Assembly (Jan. 26, 1988) (testimony of A. Gilchrist Sparks III, chairman of the Delaware Bar Ass'n Corp. Law Council), as reported in Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law,* 55 STAN. L. REV. 679, 741 n.230 (2003) (emphasis added).

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

(This process at first glance might not seem to be a Condorcet problem, because agenda setting seems not to have determined the end-result. Antitrust won, eventually. But, first, it illustrates how and when state movers, even if united, could lose when the play switches into another arena, where other political players hold the winning cards. And the pro-trust forces *did* win for a time at the state level. Because the public interest players and average American voters were underrepresented in key, usually small states, the pro-trust forces got their monopolizing corporate law mechanisms, and it took a decade or two for federal authorities to catch up with them. During that time, players who could dominate a small state, but could not in time fully dominate the federal authorities, reaped monopoly profits. E.g., the U.S. Steel merger in 1901 yielded a monopoly that was lost by 1920, but J.P. Morgan and his syndicate made much money with the interim monopoly. The Standard Oil monopoly formed via a trust in 1880s, benefited from New Jersey's corporate law in the 1890s, and it persisted until destroyed at the Federal level in 1911. Agenda sequencing counted. Were the sequence: the federal authorities acted first, and then decided whether to defer to states, then the monopolies would not have won for a few decades.)

This antitrust example puts a negative connotation on state insulation. One could imagine other settings in which Delaware's first-mover advantage makes for a more efficient corporate law than would a purely federal corporate law. Depending on one's views of the policy-matters, one or another the following examples might be positive ones.

8. Other examples: Foreign corrupt practices, takeovers, and constituency statutes. Three other examples illustrate how moving the issue from Delaware to the federal arena changes the players and pressures.

(a.) Foreign corrupt practices. Neither shareholders nor managers had special reason to reduce American corporate bribery of foreign government officials. Bribery could backfire, but so could other investment or business decisions. In the narrow sense, the decision to try to bribe a foreign official to sell warplanes, build a dam, or get a tax concession could be seen by managers and investors as just another business decision.

But that bribery could undermine American foreign policy, and so policy-makers might want to stop it, for moral or nationalistic reasons. Moving the play from Delaware could, and did, change the range of players with power to decide, and changed the state law result.

(b.) Takeovers?

(i.) Lipton & Flom oppose strong Delaware anti-takeover law, because it might prompt federal preemption[??]

(ii.) Is this fear of other forces entering the federal arena in making takeover law?

(A.) Check the exact text of their statement

(B.) Were there proposals to bring employees in, to help ratify or oppose the takeovers

(c.) Constituency statutes. C-type, "other" interests are *not always* on the periphery of state corporate law.[15] It depends on which state, and what issue. Consider state law constituency statutes in the big states. These bring the "public interest" forces into corporate governance, although only (as yet) via managerial discretion and typically only in the face of hostile takeovers. True, their effect has largely been to give managers even more discretion than have had to oppose takeovers. But they can be seen as managers going *up* from the baseline of the triangle, allying with employee and locality constituencies, so as to get rules that favor them (managers) over shareholders. It's just the kind of alliance that Congress could, and often would, produce.

Big states produced these constituency laws, big states with a polity that more resembles the national polity (and Congress) than it resembles Delaware. [Name states with strongest constituency states] passed such statutes, but such goals have been fairly weak in Delaware. Delaware has no constituency statute.[16]

More generally in corporate law: Were corporate law made in the federal arena, the federal authorities would be pressed, depending on the political winds in Washington at the time, to allow/mandate directors to take into account environmental, employee, locality and, in general, constituency concerns. The big states mirror some of the forces that would be in play in Congress. Forty-one states have constituency statutes,[17] and one imagines that a Congress made up of these forces would produce one. Delaware can often insulate firms from such direct pressures. Thus, if one thinks that constituency statutes are detouring away from normal American corporate law, keep in mind that these laws are the kind of thing that would frequently be in play if Congress always were the first mover in making American corporate law.[18]

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[15] Cf. Principles of Corporate Governance § 6.02(b)(2) (1994) (target board may act in "regard for interests or groups (other than shareholders) with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long-term interests of shareholders."); Leo E. Strine, Jr., *The Social Responsibility of Boards of Directors and Stockholders in Change of Control Transactions: Is There Any "There" There*?, 75 SO. CAL. L. REV. 1169 (2002).

[16] Joseph D. Springer, Annual Survey of American Law, 1999 Ann. Surv. Am. L. 5 (1999) ("[The] 1989 amendment strengthening [Pennsylvania's constituency] statute was co-sponsored by the local AFL-CIO. … [A]cademic champions [usually] justify their position not [as favoring] management, but rather [out of] concern for other constituencies … .").

[17] Ryan J. York, *Visages of Janus: The Heavy Burden of Other Constituency Anti-takeover Statutes on Shareholders and the Efficient Market for Corporate Control*, WILLAMETTE L. REV., Winter 2002.

[18] A cynic's view of congress is sometimes "There is no rule of corporate of financial law that is so bad that the United States Congress with a little attention cannot make worse." [Who said this?] Perhaps it comes from a conservative cynic. Opening up the "Delaware coalition," which moving an issue to the U.S. Congress facilitates, makes the cynic's view plausible: however "bad" the (semi-)private lawmaking is in Delaware, more groups are likely to be cut in if the rule-making moves to Washington.

C. Parallels to the Federal Reserve System

The Delaware-federal relationship resembles the Federal Reserve-Congressional relationship.

Monetary policy analysts often conclude that monetary policy should be insulated from current political trends. The polity would prefer short-term monetary laxity, the usual story goes; and politicians facing an election campaign in a few months would give that shortsighted policy to the voters, at the expense of long-term growth. This view puts a positive spin on insulating the Federal Reserve from day-to-day political pressure.

Central bank independence, even if it's short of total independence, is seen in the academic literature as important to implementing that policy. Alan Blinder, for example, an academic and former vice-chair of the Federal Reserve, argues that a key reason for central bank independence is that monetary policy, by its nature, requires a very long time horizon."[19] (Presumably he means very long compared to the elected political institutions' and the public's usual short horizon.)

> So, if politicians made monetary policy on a day-to-day basis, the temptation to reach for short-term gains at the expense of the future (that is, to inflate too much) would be hard to resist. Knowing this, many governments wisely try to depoliticize monetary policy by, e.g., putting it in the hands of unelected technocrats with long terms of office and insulation from the hurly-burly of politics.[20]

The public would not fight inflation as much, preferring immediate economic gains, and highest possible immediate employment.[21]

Analogies to Delaware corporate lawmaking, while imperfect, do not need much stretching to see here. Delaware, like the Fed, typically makes their decisions first. Congress typically acquiesces. The corporate dimension for Delaware is not so much "time" (as it is for making monetary policy) but the range of permissible pressures in the boardroom. By giving Delaware first crack at the rule limits the range of pressure on corporate law. Unelected Delaware chancellors with long terms of office typically first make corporate rules. They are structurally insulated from the hurly-burly of national politics. A Delaware legislature that listens to a corporate bar committee and does just about the same thing as the Delaware courts: the bar committee represents managers and shareholders, and the Delaware legislature is less worried about general environmental policy than congress might be, or than the legislature might worry about that franchise tax.

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[19] ALAN BLINDER, CENTRAL BANKING IN THEORY AND PRACTICE (1998); see sources in ALLAN DRAZEN, POLITICAL ECONOMY IN MACROECONOMICS 142 n.19, 143 (2000).

[20] BLINDER, supra note 19, at 56-57.

[21] DRAZEN, supra note 19, at 144, citing Kenneth Rogoff, *The Optimal Degree of Commitment to an Intermediate Monetary Target*, 100 Q. J. ECON. 1169 (1985).

Analogies to Delaware could even be tightened, when we see that in most democratic polities the central banker can be dismissed, similar to the federal authorities ousting Delaware:

> Lohmann (1992) suggest appointment a conservative central banker, but with the option to dismiss him at a cost. Her argument is that the high variance of unemployment with … [a] conservative central banker reflects a 'distorted' response to output shocks, since the deadweight loss is larger for extreme shocks. The option to dismiss a conservative central banker will lead him to accommodate large shocks. This solution is much like using a rule with an escape clause [for extreme circumstances]….[22]

The Federal Reserve watches the election returns, and thus sometimes doesn't fulfill its mandate of moving monetary policy into the long-term,[23] making insulating structure's net effect to dampen and limit, but not to eliminate, public influence. Delaware is similar: Federal authorities, subject to wider influences than Delaware is, sometimes take corporate law-making away from Delaware. Delaware, seeking to stymie federal action so the state maintains its authority, sometimes seems to go just far enough to deter the Feds from acting.[24] The result in both instances resembles the economist's notion of limit pricing: the monopolist prices high enough to make a monopoly profit, but not so high that the attractive price would invite competitive entry.[25]

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

Of course, the analogy is imperfect on some secondary dimensions. The Fed's institutional buffer is, in the usual models, temporal: everyone "wants" the Feds policy when we get to that later time, but short-term interests would deter us from getting there if the buffer did not slow down the political juggernaut. The interests outside the core corporate law players—outsiders such as public interest groups, public policy-makers, employees, etc.—have a public interest vision that differs from the corporate players as what the true public interest is. So the particulars differ, but the institutional role—the Fed and Delaware as buffers—is still there.

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[22] DRAZEN, supra note 19, at 145. See also GØSTA ESPING-ANDERSON, THREE WORLDS OF WELFARE CAPITALISM 14-15 (1990). Similar to Senate vs. House in Madison's frame-work.

[23] Burns/Mason public choice guy; Rowley? Cf. Mark Toma, *Inflationary bias of the Federal Reserve System: A bureaucratic perspective*, 10 J. MONETARY ECON. 163 (1982).

[24] See examples and structure discussed in Roe, *Delaware's Competition*, supra note 7.

[25] And one reason Delaware fuzzes up what they're doing could be so that the costs of Federal action, and the costs of interest group lobbying at the national level, are raised. Similarly, the Federal Reserve chair may make Delphic pronouncements, partly to best manage his job, but also to deter Congressional pressure.

D. What are Managers and Investors Buying from Delaware?

Capital and management are buying something from Delaware, via the franchise tax, and they are buying something more than the usual analysis of responsive lawmakers and first-rate judges. They are buying an institution that can dampen the intrusion of other players into corporate lawmaking.

This insulation, this dampening effect, might explain, in part, why other states aren't interested in the corporation business. That is, as Kahan and Kamar, have found, the costs of Delaware's advantages—the courts, the judge's salaries, etc—are much less than the benefits to Delaware: the franchise tax garners hundreds of millions of dollars, much more than is needed for its excellent courts. Why then don't the other states play?[26]

One answer is that many other states' polities more resemble that in Congress than does Delaware's. They would not be content to exclude the "C" policy issues from their corporate agenda. Thus the other states cannot charge investors and managers *both* a high franchise tax *and* an occasional "C"-type policy that takes value away from managers and/or investors. It's one or the other, not both. Or, equivalently, Delaware charges, via the franchise tax, some of the costs that other states would impose on the manager-shareholder group via a "C" policy.

That is, managers and investors are buying Delaware's agenda setting institutions. Managers and investors fight it out in Delaware and compromise. They then form a winning coalition against "popular" forces at the federal level.

Even if state competition produced a race to the bottom on managerial-investor rules, American corporate law might be "ingenious" for business interests and, plausibly, for economic efficiency in keeping the other interest groups out from corporate law-making most of the time. If corporate law decision-making were made in a more open environment (e.g., the United States Congress), each group—managers and investors—would a) often find themselves coalescing with other groups to get their basic issues. Managers and shareholders jointly have reason to promote doctrines of "internal affairs"—that corporate law should be made by states (which generally means Delaware), not by Congress

That is, investor groups might in Congress coalesce with social action types to get rules that would confine managers. Or, e.g., managers would have to coalesce with employees/labor to get rules that would yield managers relative autonomy from investors. But once they get their deal done in Delaware, managers and investors can coalesce against everyone else when the decision is to be made on whether to re-visit the issue in Congress. The institutional structure of American corporate lawmaking starts off with managers and investors cutting their deal. *Then* the two face off against the rest of the political world. With the franchise tax, managers and investors pay Delaware to set the agenda, and that agenda frequently determines the result, one that keeps the other players on the sidelines.

And therein, depending on your view of who should make corporate law, lies the genius of American corporate law.

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[26] Kahan & Kamar, supra note 14.

III. DISPLACING DELAWARE: SCANDALS AND POWER

Thus, the two main players in Delaware generally want to keep the game played in Delaware. When major issues threaten to go to Washington, one could expect to hear strong rhetoric about how the internal affairs doctrine must be respected.

There are two major reasons why the game would move to Washington. One player might be so dissatisfied with the Delaware result that it calls on Congress to re-set the deal. This possibility helps to explain why neither player will take all of the chips *even* if it has the power to do so *inside* Delaware, as we have already seen.

The second reason is outside forces. Neither player wants to move to Washington, but the outside players do not like the Delaware result. They are, even if only temporarily, powerful enough to over-come the Arrow/Condorcet agenda-setting power of Delaware. Sarbanes-Oxley is one example. There are others. In fact, every decade in the 20th century seems to have had a corporate issue of such importance that it moved into the federal arena, or seriously threatened to do so. Some of these were media-salient issues, but some were also the most important structural and transactional issues of their time.[27]

Political scientists have sketched out the general characteristics of issues that burst onto the congressional agenda. John Kingdon describes policy issues that are on the policy agenda for years, but go nowhere in Congress. Then a) the nation mood shifts, b) a focusing event occurs, and c) there's a turnover of lawmakers.[28]

Mathew McCubbins and Thomas Schwartz contrast two methods of congressional control, when analyzing congressional control of the federal agencies: Congress can control via police patrols or via fire alarms. In the first, it continuously keeps an eye on what the agency (in our case, Delaware) is doing. In the second, it does nothing unless constituents scream, fire alarms go off, and the media spots a big issue.[29] Congress, I submit, oversees corporate law via the second mechanism. The fire alarm is a scandal or bad economic performance. (The SEC, not the primary focus in this article, uses more of the first mechanism to keep an eye on state-made corporate law via continuous monitoring.)

The Arrow/Condorcet agenda setting is thereby overcome in congress when the media show gross mismanagement or when national economic performance is poor and plausibly tied to corporate governance. Congressional action is thus sporadic, but sporadic doesn't mean unimportant. It's public-interested (which is not to say public-regarding in the best sense of the latter term).[30] Or, in terms of the Arrow preference aggregation model, there are times when a C-favoring group gets more than a power-level of 25, and the forces for managerial autonomy are weaker than their usual power level of 45.

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[27] Roe, *Delaware's Competition*, supra note 7.

[28] [JOHN KINGDON, CONGRESSMEN'S VOTING DECISION (1989); Roberta Romano, Sarbanes-Oxley (2003, working paper).]

[29] Mathew D. McCubbins & Thomas Schwartz, *Congressional Oversight Overlooked: Police Patrols versus Fire Alarms*, 28 AM. J. POL. SCI. 167 (1984).

[30] See Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. 167 (1980).

So, the structure is this: first federal deference to the (quasi-)private contracting via the Delaware legislature; Delaware has incentives to keep making corporate law; so Delaware law is as much private contracting as the polity can stand. I.e., private contracting up to the point that the Feds (the public) would take the lawmaking away.

IV. WHAT MAKES THE CONTRACTARIAN PARADIGM PLAUSIBLE?

A. Contractarianism

A standard view is that corporate law should be largely contractarian, with few mandatory terms. Corporate law should reflect the terms the players (shareholders and managers) would have adapted were they building the corporation "up" from basic contract law. And those terms should be malleable for those shareholders and managers that want differing relationships. Analysts argue that Delaware corporate law comes close to reflecting the contractarian agenda.[31]

The contractarian structure of Delaware corporate law is made possible by the structure of Delaware lawmaking. Corporate lawyers propose new corporate law to Delaware. The form is a meta-contract: investors, managers and their lawyers are represented on the bar committees; the law is itself a quasi-contract between managers and shareholders. And the law as passed also typically defers to further firm-by-firm shareholder-management contractual fine-tuning.

Would mandatory terms be used because of third-party effects? That is, mandatory terms might be put in play if the lawmakers did not think that the investor-manager deal would reflect the legitimate interests of third parties, such as creditors (via minimum capital rules) or employees, or other interests groups. Or to heighten the relative power of other groups, corporate law might diminish the power of the two.[32]

B. Internal Affairs Doctrine as Promoting the Contractarian Model

The internal affairs norm facilitates federal deference to state lawmaking, which turns out to be contractarian, partly because the players represented at the state level tend to be the parties to the 2-player contract, managers and shareholders. It's a norm internalized by SEC Commissioners and by courts.

Surely the doctrine has an ideological life of its own: public-minded players could, and some surely do, believe the high-road basis for state lawmaking. But behind the internal affairs standard is the *realpolitik* that deference to internal affairs is equivalent to deference to the manager-shareholder deal. For some players the ideology may only thinly mask self-interest, and be a convenient excuse. As Gordon

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[31] FRANK EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 4 (1991).

[32] E.g., no shareholder may serve on the board, Delaware law might say. Or, as a matter of corporate law, the firm must notify all employees prior to any major down-sizing. Or, prior to a merger, the merger must be presented by the board to its shareholders and to its employees, with the employees required to approve or to be consulted. Cf. French, German results, or, at the limit, German codetermination.

Tullock remarked, most citizens "realize that the government can be expected to do things in their personal interest only if it at least superficially fits the public image."[33] Many are surely sincere in their ideology, which matches their self-interest.

The ideology is stated by SEC commissioners, by congress, by the courts,[34] and, more relevant, by corporate players. Bruce Atwater, for example, a big-company CEO and major corporate spokesman in the 1980s, when opposing federal preemption of the states on takeovers, invoked the doctrine. The doctrine's effect is to restrain the federal authorities. When it's successfully invoked, it raises a presumption against immediate and strong federal action. Its effect is to weaken the players that have most strength on the federal level, and to strengthen those players that are relatively stronger at the state level

C. Limits to the Contractarian Model

Thus it's plausible to think of Delaware as facilitating the contract. Because of the structure of the interest groups in play in Delaware, its corporate law can resemble an investor-manager contract, because the other players are not present, or are weak. They cannot by themselves alone move the franchise tax to another state.

And when other parties want to enter, what do they do? They typically find the federal authorities a more likely venue.

Early New Jersey again provides an example that fits. When New Jersey became the Mother of Trusts, its acts were consistent with the "contractarian" model. Corporations could combine, merge, etc. While other states disliked monopoly (e.g., the Ohio attorney-general attacked the Standard Oil Trust; Ohio barred Ohio firms from owning stock in "foreign" corporations), New Jersey facilitated the contract. But when the contract attracted public attention, the federal authorities acted on it, to the extent it didn't like the contractarian results. I.e., Sherman Act, Standard Oil in 1911, Trenton Potteries, Northern Securities, etc.

Similarly, when populist and progressive forces wanted to cut-down the power of financial institutions, they usually sought federal law, not Delaware or New Jersey corporate law, to implement their policy goals. Federal laws kept financial institutions small and powerless.[35] Once financial power—the Morgan interests as symbolic—were cut down to size, policy-makers could *then* defer to state-law corporate contracts. Populism/progressivism operated on corporate structure, but at the federal level, partly because the "costs" of non-progressivism are externalities to any particular state.[36]

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

[34] CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 91 (1987) ("It thus is an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares."). Notice that internal affairs aficionados refer to Delaware and its siblings as "States," and not "states."

[35] MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994). Insurance company laws, which came from the states, are the exception.

[36] In modern times, when Nader-types sought to reform the corporation, they looked to federal authorities, not state corporate law institutions, to re-set the corporate contract. RALPH NADER, MARK GREEN & JOEL SELIGMAN, TAMING THE GIANT CORPORATION (1976). And directors would

[What did William O. Douglas have in mind in Democracy and Finance? Was it just shareholders, and shareholder democracy? Or something broader?]

V. IS DELAWARE CAUSE OR EFFECT?

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

We cannot know for sure, because we cannot run the real-world experiment of turning corporate law off in Delaware and requiring that Congress make all corporate law for two or three decades to see if the tilt changes.

But cause and effect questions can plausibly be reconciled. The broad American polity is prepared to defer to the private players (managers and shareholders) on most corporate law issues, but this deference needs an institutional mechanism. Delaware corporate law is that mechanism. Were no mechanism for deference available, that deference would be weaker.

There's a deep political science literature on institutions as both stabilizing Arrow-type cycling and setting the agenda in a way that affects outcomes. Central to that literature is the concept that the institutional structure organizing the Congress is important. Committees shift outcomes away from the "median" voter in the each house of Congress.[37] My purpose here is not evaluate this literature, but to note its parallel with the organization of American corporate law, with Delaware as the "committee" subject to the will of the entire Congress. The structure might not affect corporate outcomes in a binary way, shifting all results, but affect the frequency: If corporate law were purely federal, we'd get moderately conservative results, say, 60% of the time. The institutional structure means that we get those moderately conservative results 90% of the time. Consider the stakes, even the differential is not small.

CONCLUSION

The standard story is that states make corporate law, with state competition as a critical determinant of state law. But the key issues of corporate lawmaking may lie in

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have separate "portfolios" of responsibility, representing nine categories: employees, consumer, the environment, shareholders, legal compliance, finance, marketing, management, research. Id. at 125, 180 et seq. (About half are mainstream, half would push the envelope outward.)

[37] Kenneth A. Shepsle, *Institutional arrangements and equilibrium in multidimensional models*, 23 AM. J. POL. SCI. 27 (1979); Kenneth A. Shepsle & Barry R. Weingast, *Structure induced equilibrium and legislative choice*, 37 PUBLIC CHOICE 503 (1981); id., *The institutional foundations of committee power*, 81 AM. POL. SCI. REV. 85 (1987); id., *Why are congressional committees powerful*?, 81 AM. POL. SCI. REV. 935 (1987); Barry R. Weingast & William J. Marshall, *The industrial organization of Congress; or, why legislatures, like firms, are not organized as markets*, 96 J. POL. ECON. 132 (1988).

the federal-state relationship, with the federal authorities always potentially threatening to displace state lawmaking, and frequently displacing the states on the big issues. Corporate law issues can always "go federal" or attract federal attention. These possibilities confine the range of state lawmaking and, on occasion, condition state lawmaking due to the threat of federal removal if the states "go too far."

I have here outlined a public choice, institutional structure analysis of what's at stake in who makes American corporate law. The structure privileges deal-making at the state level between managers and investors, with managers historically having the upper hand. But when the issue is big and attracts federal attention, different coalitions can, and do, emerge at the federal level. Sometimes the managers or the investors find new coalition partners on the federal level and thereby "break" the Delaware deal. Sometimes the managers and investors unite to defeat "outside" attacks; this sequence can correspond to an Arrow's paradox/Condorcet structure: Delaware limits the first agenda of decision-making by keeping corporate "outsiders" and public policy-makers out. Managers and investors make their deal and then they unite at the federal level to fight off other forces. The other outside players affect American corporate law through two federal-related but constricted channels: sometimes the Delaware players fear that the outside forces will take the decision away from them, or that one of the usual Delaware players will so chagrined that it will go federal.[38] And sometimes Delaware loses control of the agenda, when the public is sufficiently motivated that Congress acts because the economy is weak or a scandal dominates the media, as Congress did most recently with Sarbanes-Oxley after the Enron and WorldCom scandals.

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Notice what we have just done here. We have found rich public choice explanations for where Delaware and American corporate law is, without referring to a state-to-state race for the franchise tax. We've reinterpreted the function of the franchise tax, as an institution that excludes many players from making corporate law. We've seen how the internal affairs doctrine reflects deference to some interest groups and not others. We've seen how the Delaware-federal sequence reflects a Condorcet agenda-setting structure.

The interaction between federal power and Delaware interests can explain, and does explain, much of American corporate law, perhaps as much as, and maybe more than, interstate competition or a Delaware monopoly. We have in this paper gone a long way, I believe, to explaining American and Delaware corporate law, without much reference to the interstate debate, but just by using public choice analysis to scrutinize the relationship between Delaware and the federal authorities.

[38] This could explain why managers do not always go as far as they can at the state level. Cf. Sparks comment, supra note 14. They would like to keep the coalition more or less intact when and if the issue moves federal. I.e., a mild anti-takeover law might keep investors, or at least some of them, on-board if the federal actors—SEC, Congress, or the stock exchanges—take up the issue.