Social Learning and the Development of Corporate Law

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April 24, 2006

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Abstract

The development of U.S. corporate law has traditionally been explained through a race model: jurisdictions compete for corporate franchise taxes and thus corporate law converges towards efficiency. Recent critiques have undermined this argument without presenting a new model in its place. This paper develops theoretically and tests empirically two alternative theories of corporate law development, and finds some support for an interest group theory, and substantial support for a social learning theory of corporate law development.

This paper's first part is theoretical, and develops the political interest group and the social learning models. An interest group theory portrays self-interested managers, lawyers and workers as able to overcome collective action problems and successfully lobby for corporate law that advantages them. Several corporate law theorists have highlighted the relevance of diverse interest-group claims; this paper synthesizes and systematizes these arguments. A social learning model understands norms as substantial constraints on self-interested behavior, and sees the diffusion of new corporate laws as the result of their legitimacy, which may or may not coincide with efficiency. Sociologists have identified the importance of social norms on corporate manager choices, and political scientists have noted substantial imitation between state legislatures in many other issue areas, but a social learning model of corporate law has not yet been developed.

The paper's second part is empirical. The paper derives predictions from the race, interest group and social learning theories, and examines whether they hold true in the development of U.S. state corporate law. The empirical analysis focuses on the development of second-generation anti-takeover laws, both because these have been a central issue in state corporate law, and because they constitute hard test case for a norms-based theory, given the substantial material interests at stake here. Cumulative adoption patterns, multivariate regressions, and some qualitative evidence lend substantial support to the social learning theory, mixed support to the interest group theory, and very limited support to the race theory. A final empirical section extends this analysis to corporate governance transitions in post-communist countries.

The paper's third part identifies the normative implications of these three theories with regard to the uniformity and quality of corporate law, as well as with regard to the process of corporate law adoption and the effect of non-binding standards. If a social learning model explains important aspects of corporate law development, we need not shift corporate law to the federal level to achieve uniform, high quality governance: non-binding standards could move us effectively in that direction. At the same time, the social learning model implies caution, because inefficient practices can spread just as easily as efficient ones. The fourth part concludes.

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Table of Contents

I. THREE THEORIES OF CORPORATE LAW DEVELOPMENT 3

A. The Race: State Competition for Incorporations 6
B. Political Interest Groups: State Responses to Concentrated Lobbies 10
C. Social Learning: Legitimizing and De-legitimizing Corporate Law Choices 15
1. Micro-mechanisms of Social Learning 15
2. The Diffusion of Policies.. 17
3. The Spread of Corporate Charter Provisions.. 20
4. Testing a Social Learning Model... 24

II. EMPIRICAL EVIDENCE ON THE PROCESS OF CORPORATE LAW ADOPTION 25

A. Adoption of Corporate Laws in the U.S. States 25
1. Broad Patterns of Corporate Law Adoption... 25
2. Adoption of Anti-Takeover Statutes 28
3. Measures of Competition, Interests, and Social Learning................................ 36
4. Determinants of Corporate Law Adoption: Regression Models....................... 44
5. Qualitative Evidence of Corporate Law Adoption Patterns 49
B. Extension: Corporate Law Adoption in Transition Countries 50

III. NORMATIVE IMPLICATIONS AND IMPLICATIONS FOR POLICY REFORM.. 55

A. Corporate Law Uniformity 58
B. Corporate Law Quality 63
C. Effectiveness of Non-binding Standards 67

IV. CONCLUSIONS.. 69

SOCIAL LEARNING AND THE DEVELOPMENT OF CORPORATE LAW

I. THREE THEORIES OF CORPORATE LAW DEVELOPMENT

Many corporate law theorists celebrate the dominance of Delaware corporate law within the United States, and the triumph of the Anglo-American model of corporate governance internationally. They praise both the specific qualities of the laws adopted, and the system of competition between jurisdictions.[1] However, the dominant model of inter-jurisdictional competition has been the subject of heavy criticism in recent years. While this criticism has put the race model in question, no alternative theory has been systematically developed in its place. This paper develops two alternative theoretical models of corporate law development, an interest group model and a social learning model, and examines their empirical validity in comparison to the traditional model of inter-state competition.

According to the race theory, U.S. states compete with one another to attract incorporations, and in the process constantly improve corporate law quality. Despite academic criticism, and despite congressional limitations on state prerogatives, most recently in the form of the Sarbanes-Oxley Act, the race theory still has vocal advocates. For example, in a 2005 evaluation of the race theory, Roberta Romano concludes that "it is the competition of states in producing corporate law that has, however modestly, facilitated the reorganization of the US

[1] *See, e.g.,* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993) (arguing that state competition improves corporate law) [hereinafter ROMANO, GENIUS]; Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation,* 6 J. L. STUD. (1977) (contending that U.S. states are racing towards improved corporate law); Henry Hansman & Reinier Kraakman, *The End of History For Corporate Law, in* CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE (Jeffrey N. Gordon & Mark J. Roe, eds., 2004) (identifying the U.S. model as the globally dominant model towards which other jurisdictions are converging); WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 12 (2003) (celebrating the dominance of the Anglo-American model).

economy in the last several decades, a reorganization that has occurred in spite of much of the federal securities regime."[2]

The theory that US states race towards optimal corporate law has been critiqued for decades, but the nature of the criticism has shifted over time. The oldest school of criticism assumes that states compete with one another, but debates whether this competition leads to improved shareholder returns or to greater protection for managers at shareholder expense.[3] More recent empirical studies go a step further to argue that there may be no race whatsoever. If there ever were a race, they claim, it has long been lost – Delaware now enjoys a monopolist's rents.[4] Still a separate line of argument presents the possibility of federal intervention as a limit on the scope for state independence in corporate law decision-making.[5] Theories regarding international competition for optimal corporate law have also been criticized.[6]

These attacks have undermined important aspects of the dominant race theory, but important empirical observations survive unexplained. If there is no race, then what explains the similarity in outcomes across US states?[7] If countries cannot compete on corporate law, because most corporations must accept the legal and economic package of a particular country as a whole, what explains important similarities between the corporate laws of advanced

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[2] Roberta Romano, *Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?*, 21 OXFORD REV. ECON. POL'Y 229 (2005) [hereinafter Romano, *Competition*].
[3] For an early exposition of the race to the bottom argument, see William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware,* 83 YALE L. J. 663 (1974). For a modern version of the race to the bottom argument, which develops into a political interest group theory, see Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999).
[4] *See* Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters,* 112 YALE L. J. 553 (2002); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 648-85 (2002).
[5] *See, e.g.,* Mark J. Roe, *Delaware's Competition,* 116 HARV. L. REV. 588 (2003).
[6] *See, e.g.,* Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Law and Governance*, from CONVERGENCE AND PERSISTENCE (Jeffrey N. Gordon & Mark J. Roe, eds., 2004) (identifying entrenched interest groups as obstacles to international corporate law convergence).
[7] For a discussion, see *infra* section III.A.

industrialized countries?[8] And what explains the transition of former communist countries from state planning to modern corporate codes in under fifteen years?

Marcel Kahan and Ehud Kamar, Lucian Bebchuk and Alan Ferrell, and Jonathan Macey and Geoffrey Miller among others, suggest that interest group politics is at work.[9] While they present enough evidence to show that politics matter, they do not develop a coherent theory of when and how certain political force manage to change corporate law to serve their interests, and when they fail. Additionally, the possibility of a different explanation, in which policy-makers learn from one another, and their understanding of what is appropriate and legitimate policy substantially constrains self-interested actors, is not consistently considered either.

This essay explores these three theories of corporate law development and engages in an evaluation of supporting and disconfirming evidence. Part I outlines the race theory, its criticisms, and two alternative explanations for the development of corporate governance laws: a political interest groups theory and a social learning theory. Part II examines empirical evidence to test each of these theories. First, this Part examinees the key findings in support of the state competition theory, and shows that this data is also consistent with the social learning theory developed here. Second, this part develops more detailed models of the adoption of anti-takeover laws, to show that even if the race theory explained developments in the 1950s and 1960s, it cannot explain central reform efforts in U.S. state corporate law since 1980. Finally, as an addendum, Part II examines post-communist transition countries' adoptions of corporate laws. Part II finds no evidence in support of the state competition model, some evidence in support of the interest group model, and substantial evidence in support of the social learning model. Part

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[8] For a discussion, *see infra* section II.B.
[9] *See* Kahan & Kamar, *supra* note 4; Bebchuk & Ferrell, *supra* note 3; Macey & Miller, *infra* note 36. The interest group theory is presented and discussed *infra* in section I.B.

III presents the normative implications of this shift in theoretical paradigm for corporate law quality and reform efforts, and Part IV concludes.

A. The Race: State Competition for Incorporations

The race-to-the top argument, developed by Ralph Winter and Roberta Romano, among others, posits that U.S. states compete with one another to attract incorporations, so as to profit from franchise taxes. Jurisdictions compete by improving the quality of their corporate law.[10] Henry Hansmann and Reinier Kraakman develop an analogous argument about how product and financial markets are becoming increasingly international, and thus prompt international competition for improved corporate law. In such a competitive market, "logic" and "example" lead to the dominance of the Anglo-American model, which is apparently both theoretically superior to alternatives and empirically proven to generate higher growth.[11]

The problems with this race model are multiple. Advocates of the race-to-the-top model themselves find the rapid spread of anti-takeover legislation most problematic.[12] This finding in turn is used by their first critics, race-to-the-bottom theorists, to substantiate this variant of the race theory. Race-to-the-bottom theorists accept most of the race-to-the-top theorists' assumptions, except that the former see laws shifting to suit manager, rather than shareholder, interests. States still compete for incorporations under this model, but corporate law deteriorates as a result.

More recently, attacks on the inherent plausibility of the competition mechanism have surfaced. Lucian Bebchuk and Assaf Hamdani, along with Marcel Kahan and Ehud Kamar have

[10] *See, e.g.,* Winter *supra* note 1 and ROMANO, GENIUS, *supra* note 1.
[11] *See* Hansman & Kraakman, *supra* note 1, at 45 - 48.
[12] *See, e.g.,* Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225, 265 (1985) [hereinafter Romano, *Law as a Product*].

argued that the economic barriers prohibit other states to compete with Delaware.[13] Kahan and Kamar have also emphasized political barriers to competing with Delaware. Both sets of researchers have provided empirical support for their positions. Bebchuk and Hamdani studied the reincorporation market to find Delaware dominating all other states, while Kahan and Kamar looked for evidence on whether states restructure their tax and administrative systems to attract reincorporations. They found this not to be the case, except for Delaware.

Is there any evidence in support of the race model? As the initial controversy was framed as a race-to-the-top vs. a race-to-the-bottom, the theory was tested by examination of fluctuations in share price following reincorporation decisions, on the assumption that moving to a good corporate law jurisdiction would boost share price and vice-versa.[14] While such tests could give important information on which state has the best laws in place, they would not be able to explain what triggered states to adopt good or bad laws. Large differences in markets' valuations of different states' laws do not shed light on what motivates legislatures to adopt good laws: the conservative orientation of the legislature, the power of managers, neighboring states' choices, the weather conditions of the state in question, or some other random factor could each lead to the adoption of state corporate laws of a particular quality. Instead, direct evidence of the race consists of a single 1985 study, which shows that states that had larger franchise tax receipts in 1960 adopted four important corporate law innovations more speedily in the 1960s.[15]

The above summary of the evidence in support of the race data is different in tone, but not in substance, from the summary advocates of this model present. In 2005, Roberta Romano wrote:

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[13] *See* Bebchuk & Hamdani, *supra* note 4; Kahan & Kamar, *supra* note 4. For discussion, see *infra* section I.B.
[14] *See, e.g.,* Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. (2002). *See also,* ROMANO, GENIUS, *supra* note 1 (surveying older studies).
[15] *See* Romano, *Law as a Product*, *supra* note 12, at 261.

> There are three distinct pieces of data that suggest that states compete for incorporations. First, corporate law innovations diffuse across states in an S-shaped curve. . . . Second, state franchise revenues are significantly positively related to the responsiveness of a state's corporate law to firm demands . . . . And third . . . firms migrate from states with low levels of responsiveness . . . to those with higher levels.[16]

The first claim, regarding an S-shaped curve, is a solid finding repeated in several studies, including the present one, but cannot count as evidence of competition. In the literature on diffusion of innovations, S-shaped curves are typically interpreted as indicative of emulation and learning, but are consistent with diverse explanations.[17]

The second claim, which forms the most direct evidence that states compete with one another, is examined in greater detail in Part II below. Part II shows that while franchise taxes may explain corporate law movements in the 1960s, these movements also correlate with learning variables. Additionally, Part II shows that even if states competed for franchise taxes in the 1960s, there is no evidence that they have continued to do so since the 1980s.

The third claim, that firms reincorporate to more responsive jurisdictions,[18] assumes that state legislators are extremely, indeed unrealistically, sensitive to firm movements. As the data Romano herself provides indicate, this point was never plausible, even for early period that her 1985 study analyzes. Based on Romano's analysis of franchise revenue over the 1950s-1960s, the mean state collected 1.5% of its revenue through franchise taxes, and the median state

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[16] *See* Romano, *Competition*, *supra* note 2, at 16.
[17] For a discussion of this literature, see *infra* section II.A.1.
[18] An implicit assumption in this work, namely that responsive jurisdictions are jurisdictions that implement good corporate law, need not hold -- indeed the evidence on the rapid diffusion of anti-takeover laws presented below concerns highly responsive jurisdictions that end up with what many regard as poor corporate law.

0.5%.[19] If all of a state's corporations suddenly reincorporated, the median state would lose 0.5% of its annual revenue, and legislators would probably pay attention. However, Romano reports that on average, states lost one firm every two years for the period between 1960 and 1982,[20] and each lost firm cost states $2,000 to $50,000 in foregone franchise revenue.[21] Since 1980 tax data indicates that annual state revenue totals ranged from $270 million to $19.4 billion,[22] we must believe that state legislatures make new laws to respond to revenue fluctuations that average under one thousandth of a percentage point.[23] Therefore, even if all firms that reincorporate do so because of corporate law considerations, too little migration to motivate legislators to change these laws occurs. Kahan and Kamar also indicate that in the present period, states only stand to lose trivial of forgone taxes from corporations that reincorporate elsewhere.[24]

The international competition theory has not been examined systematically, perhaps because it is less plausible to begin with. Evidence of convergence in the Hansman and Kraakman original article has little to do with corporate law in particular, and more to do with a shift in understandings of the appropriate scope for public and private ownership.[25] Two

[19] *See* Romano, *Law as a Product*, *supra* note 12, at 240 n.24. This fraction has decreased since. 1980 data, used in the analysis of anti-takeover laws in Part II, show the mean for that year to have fallen to 1%, and the median to 0.3%. *See* OF COMMERCE & BUREAU OF THE CENSUS *infra* note 117.
[20] *See* Romano, *Law as a Product*, *supra* note 12, at 242. Romano reports that she found 638 corporations that reincorporated from 1960 to 1982, or about one per state every two years.
[21] *Id.* at 257. This estimate comes from firms that reported that they reincorporated because due to concerns about franchise taxes, so it may be on the high side.
[22] *See* U.S. DEPT. OF COMMERCE & BUREAU OF THE CENSUS *infra* note 117.
[23] Average loss in franchise revenue ($26,000) / Average total state revenue ($2,738,000,000) = 0.000009. This figure is inaccurate and only intended to provide an order of magnitude estimate at best. For a more precise estimate, the 0.000009 figure should be divided by 2 to account for the facts that a state loses a corporation every two years, adjusted downwards because corporations reincorporate for reasons unrelated to corporate law quality, adjusted upwards because some states experience multiple corporations leaving in a single year, and so forth. However, even if this estimate is off by a factor of 100, the claim that legislators respond to revenue shifts that average less than a tenth of a percentage point remains implausible.
[24] See Kahan & Kamar, *supra* n. 4, at 688-689, 690 tbl.1. They demonstrate this point by estimating how little chartering a large corporation would add to each state's revenues.
[25] Hansman and Kraakman's evidence includes Mitterand's abandonment of state ownership in the 1980s, Japanese firms' poor performance in the 1990s, Germany's failure to push co-determination on firms in other EU member

theoretical challenges confront this argument. First, interest group structures may retain great importance in different countries, blocking reforms that hurt them.[26] Second, product market competition may not be a very direct mechanism to bring about corporate governance changes, if firms' competitiveness depends on a host of factors other than the corporate law of their jurisdictions.

In summary: while the race theory is very popular, it rests on thin evidence. Part II of this paper addresses the best evidence for the race theory -- legislatures' responsiveness to franchise fees -- and finds that franchise fees are uncorrelated with corporate law adoption patterns in the 1980s.

B. Political Interest Groups: State Responses to Concentrated Lobbies

In rejecting the race theory, Kahan and Kamar begin to sketch a political alternative, arguing that "political factors shape legislation in noncompeting states," leading to laws that "favor managers more than they would if states pursued incorporations."[27] Macey and Miller also see interest group politics as a relevant consideration in their models, and in particular discuss the role of the Delaware bar in corporate law development in this state.[28] Mark Roe has written extensively on the importance of labor in shaping both U.S. state corporate law,[29] and

states through a directive, and the collapse of communism in the 1990s. *See* Henry Hansman & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEORGETOWN L. J. 438, 446-447.

[26] *See* Bebchuk & Roe, *supra* note 6.

[27] *See* Kahan & Kamar, *supra* note 4, at 686.

[28] *See, e.g .,* Macey & Miller *infra* note 36. For a refinement of this model that considers the role of indeterminacy in corporate law development, see Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 35 (1990).

[29] See Mark J. Roe, *Symposium: Management and Control of the Modern Business Corporation: Closing Remark: Can Culture Constrain the Economic Model of Corporate Law?* 69 U. CHI. L. REV. 1251, 1267 (arguing that "incumbent labor, after all, has votes", and indicating that the strength of organized labor facilitated the survival of anti-takeover laws in Ohio, Illinois and Pennsylvania).

foreign corporate law.[30] Managers, lawyers and organized labor are thought to play some role in the domestic politics of corporate law development. Institutional investors are also sometimes mentioned in interest group analyses, especially in foreign jurisdictions with concentrated ownership.[31]

The limited literature on interest groups is helpful in offering examples of political actors who have supported or blocked particular corporate law initiatives. While this literature succeeds in critiquing a de-politicized race model, it does not clearly theorize a competing interest group model, nor does it provide systematic empirical evidence for the political influence of interest groups. In existing accounts, the utility model of interest groups is not always well or consistently specified, a problem especially acute when the interests of lawyers are described. Additionally, political considerations are introduced in an ad hoc manner; no effort is made to systematically examine when managers successfully lobby for favorable legislation, and when they lose out.[32]

What is an interest group model, and how does one construct a coherent one? Whereas in an pluralist model of democracy, voters with equal voice would form shifting coalitions to determine public policy,[33] in an interest group model of democracy, on distributive issues, actors potentially facing concentrated benefits can often overcome collective action problems and thus

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[30] *See* MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT (2003) [heireinafter, ROE, POLITICAL DETERMINANTS].

[31] Shareholders are not considered an interest group as their interest is thought to coincide largely or fully with the public interest in corporate law. Moreover, to the extent that shareholder associations or institutional investors have overcome the collective action problems necessary to promote their interests, they have focused their efforts almost exclusively at particular corporations, rather than at effecting legislative change in the United States. *See* Carney, *infra* note 153 at 721.

[32] For a notable exception that examines the political interest group theory systematically across countries, see ROE, POLITICAL DETERMINANTS, *supra* note 30.

[33] *See, e.g.*, ROBERT A. DAHL, DEMOCRACY AND ITS CRITICS (1993).

impose diffuse costs on many others.[34] The stronger the interest group, the more successful it should be in obtaining legislation that serves its goals.

How might managers fit in an interest group model? Corporate managers may have company shareholders' interests at heart on many issues, but likely have conflicting interests on questions related to manager pay, manger employment security, and manager liability. Their ability to modify the applicable legal regime on any of these issues, either through re-incorporation or through lobbying to change the domicile's rules, is a potentially important tool for managers, who have large organizational and political advantages vis-à-vis diffuse and ill-informed shareholders.[35]

What is lawyers' role in bringing about corporate law reform in an interest group model? Jonathan R. Macey and Geoffrey P. Miller suggest that states design their corporate law in order to increase the business of their corporate bar.[36] In their account, policies that attract more companies benefit lawyers, the state, as well as outside companies. However, policies that stimulate litigation by reducing the cost of access to the courts or reducing the clarity of corporate rules are in the interest of the corporate bar but harm others.[37] Kahan and Kamar echo this view and state that "lawyers have an interest in laws that increase the need for their services . . . . Transactional lawyers can benefit from complex laws that generate demand for sophisticated

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[34] *See, e.g.,* MANCUR OLSEN, THE RISE AND DECLINE OF NATIONS (1984); THEODORE LOWI, THE END OF LIBERALISM (1979).

[35] Advocates of the race to the top model clarify that shareholders can still punish manages for such selfish decisions by paying a premium for shares of companies incorporated in shareholder-friendly states. See, e.g. Ralph K. Winter, *The "Race for the Top" Revisited*, 89 COLUM. L. REV. 1526 (1989). However, if managers can use their political clout to impede changes in control, through for example, anti-takeover laws, this scenario seems too rosy.

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

[37] *Id.* at 503-505.

legal advice, and litigators can benefit from standard based laws that entail litigation to resolve disputes, even if such laws reduce incorporations".[38]

Finally, what role does labor play in an interest group model of corporate law? First, labor unions may lobby directly for corporate law provisions that protect employee rights, or against the repeal of such provisions. For example, section 630 of New York's Business Corporation Law, which holds the ten largest shareholders of a non-publicly traded corporation personally liable for employee wages, is thought to be sustained by organized labor, despite the fact that it may deter corporations from incorporating in New York.[39] In Germany, codetermination, which grants employees half the seats of many corporate boardrooms, represents an even more extreme form of corporate law that influences labor directly.[40]

Second, and more generally, even corporate laws that do not influence employer-employee relations directly may impact employment levels, and legislators in states with strong unions may be especially sensitive to such concerns. Anti-takeover laws, described below, for example, are often defended as measures to protect local jobs, because takeovers are often associated with restructuring and job losses.

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[38] Kahan & Kamar, *supra* note 4, at 705-706. Kahan and Kamar actually present a more complicated picture of lawyers' behavior, but not all of it is theoretically coherent and helpful in developing their argument. Kahan and Kamar draw a big distinction between lawyers aiming to reform corporate law to attract incorporations to the state and lawyers interested in defending the interests of existing clients. *Id.* at 704 – 05. This distinction does not seem a relevant critique of the race-to-the top model; in this second case, lawyers operate just like firms would. Indeed, much of the discussion in Romano, *Law as a Product*, *supra* note 12, is premised on the notion that states are competing defensively, to prevent existing in-state corporations from reincorporating. As the hypothesis that lawyers act as an interest group to foil corporate law improvement efforts may still shock some legal professionals, this note also previews subsequent empirical results, which lend no support to this version of interest group influence.

[39] See Kahan & Kamar, *supra* note 4, at 732.

[40] For a discussion of the costs of codetermination for the German securities market, see Mark J. Roe, *German Codetermination and German Securities Markets*, 5 COLUM. J. EUR. L. 199 (1999). For a discussion of the origins and evolution of codetermination in Germany, see generally Katharina Pistor, Codetermination in Germany: A Socio-Political Model wit Governance Externalities, in EMPLOYEES AND CORPORATE GOVERNANCE 163 (Margaret Blair & Mark Roe eds., 1999) (indicating that while codetermination may have taken its present form due to the U.S. occupation of Germany, it persists because of labor). Moreover, a weaker version of explicitly pro-labor corporate law has spread to other parts of Europe. For example, the European Union's Directive 94/95/EC, requiring large transnational corporations to inform employees about decisions affecting them might be seen as the influence of labor on corporate law across E.U. countries.

The interest group model just described is based on several assumptions. First, it is monetary interests, rather than some broader conception of utility, that determines interest group preferences. Second, legislators play no role in formulating good policy: they merely mediate between interest groups and translate the outcome of interest group struggle into law. Third, visible and heated group conflict is what matters; reforms that harm or benefit society at large, or reforms that impact constituents who are not organized are not emphasized. These assumptions both limit the model and give it explanatory power. If, for example, the model employed a broad conception of manager utility, which included both pay maximization and fidelity to the company, the interest group model would explain too much. There would be no way to confirm or disconfirm a thesis about the power of interest groups, and one would instead want to investigate what prompts managers to follow their purse rather than their norms on different occasions.

Two types of evidence would constitute clear support for an interest group model. First, we should expect actors behaving in a self-interested manner. Thus, for example, managers who lobby for anti-takeover legislation are behaving consistently with the model; lawyers who work to clarify the law may well not be. Second, we should expect jurisdictions where interest groups are strong to have laws more favorable to these groups than other jurisdictions.[41]

[41] Interest group strength cannot be defined or measured in terms of interest group success in shaping legislation, as doing so would make the interest group hypothesis a truism. Instead, interest group strength is commonly proxied by interest group size or interest group wealth. Another way to measure interest group strength would be to look for variations over time in conditions favoring particular interest groups; for example, Republican lobby groups may be thought to be stronger during republican administrations. Indeed, a large literature on social democracy finds that unions get many more concessions at times of social democratic administrations.

C. Social Learning: Legitimizing and De-legitimizing Corporate Law Choices

Social learning is a third model that could explain the adoption of corporate law in different jurisdiction. A social learning model predicts that actors mimic one another, in ways that may, but need not, lead to efficiency. This section brings together ideas from related literatures on diffusion, policy transfer, and lesson-drawing, to explain how social learning could explain the development of corporate law.[42] Since a social learning model has not yet been applied to corporate law development, this section does not critique the (non-existing) literature, but instead develops such a model from research in other fields. While a social learning model of corporate law is a novel theory, this paper argues that it better explains important patterns in corporate law adoption that other theorists have emphasized, such as state choices to adopt a narrow number of corporate law innovations, through very similar statutes, in an S-shaped pattern of cumulative adoptions in time, and uncovers important unexamined features of state corporate law-making, such as regional similarities in corporate laws.

1. Micro-mechanisms of Social Learning

How do innovations spread? Economists often explain faddish behavior by a slight modification in a conventional decision-making model: they weaken the assumption of perfect information, and fads result. Let us assume that a lawmaker has some noisy private information about whether corporate law A or corporate law B works better. He will often make mistakes, if he must base his decision-making on this noisy private information. We might be tempted to

[42] Diffusion is often defined as the adoption of a practice in successive jurisdictions, regardless of the reasons for this pattern. Lesson-drawing, learning, and policy-transfer often imply that the mechanism underlying the transfer is cognitive or emotive persuasion. Writers in these traditions often work in different disciplines, focus on different phenomena, use different methods, and, to the extent that they cite one another's work, do so principally to demarcate their traditions' particularities. Such debates are set aside here so as to draw out as much substantive and methodological guidance as possible from diverse fields.

think that if he can observe which law similarly situated neighbors adopted, information will accumulate in the public domain until the law that is in fact better becomes widespread. This is not so. Sushil Bikhchandani, David Hirshleifer and Ivo Welch explain the process of fads and informational cascades through a simple model and summarize some of the empirical literature on this point.[43]

Sociologists in the world polity school identify deeper flaws in standard decision-making models than both political scientists who model policy as a product of perfectly informed interest group pressures, and economists who are willing to consider the role of limited information in biasing decision-making. According to these sociologists, standard models overestimate the influence of proximate decision-makers, and interpret their manifested preferences as the natural, functional, fitting and unique solutions to the problems they face. In the most radical version of this argument, sociological institutionalists posit that organizations exist, take particular forms, survive and spread not because they perform efficiently but rather because they are perceived as legitimate.[44]

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[43] *See* Sushil Bikhchandani, David Hirschleifer & Ivo Welch, *Learning from the Behavior of Others: Conformity, Fads, and Informational Cascades*, 12 J. ECON. PERSP. 151 (1998). The basic insight is that if the first two decision-makers end up with private information that law B is better, and every subsequent decision-maker has private signals that law A is in fact superior, the third decision-maker who weights his private information as much as the public signals will discount his private information and adopt law B, as will every subsequent decision-maker. *Id.* at 155-157. The noisier the information, the smaller the information value from observing others' actions. *Id.* at 156. In their scenario, if an individual's initial information is very noisy, and he has a 0.51 chance of adopting the right action based on his private information alone, this probability only increases to 0.513 when he can observe others' actions. If the private signal is clearer and the probability of adopting the right decision based on private information alone is 0.80, this increases to 0.857 when others' actions are observable. To the extent that corporate law innovations emit noisy signals, more faddish cycling should be expected here, (as compared to, for example, in the diffusion of innovations in production technology, which might emit cleaner, information-rich, signals).

[44] *See* John W. Meyer, John Boli, George M. Thomas, and Francisco Ramirez, *World Society and the Nation-State*, 103 AM. J. SOC. 144 (1997). *See also* WALTER POWELL AND PAUL DIMAGIO, THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS (1991); Martha Finnemore, *Norms, Culture and World Politics: Insights from Sociology's Institutionalism* 50 INT'L ORG. 325 (1996).

In summary, both rational actor models that incorporate information limits, and models of human agency that highlight behavioral responses to legitimacy and to others' choices, could form the micro-mechanisms of a social learning model of corporate law.

2. The Diffusion of Policies

Others' actions do not only shape individual choices; they also shape the choices of entire organizations, including legislatures, as both studies of the U.S. states, and studies of cross-national politics show.[45] When decision-makers face uncertainty, models from other jurisdictions can dramatically alter the policy-making process, by providing new frameworks for the analysis of existing conditions, by offering authoritative policy alternatives, and by determining the timing of policy debates. Researchers have found evidence of learning across U.S. states in areas such as living will laws,[46] abortion laws in the pre-*Roe* era,[47] death penalty laws,[48] welfare benefit laws,[49] and laws regulating diverse other matters.[50]

Which policies are typically imitated? The practices of high status individuals and organizations are often imitated by agents of lower status. For example, the literature on U.S. states indicates that a state's wealth is a good predictor of its likelihood of adopting a new policy -- across innovations, wealthier states tend to adopt policies first, and poorer states follow these

[45] Very few studies have connected micro-level behavioral and cognitive biases to macro-level diffusion patterns. For an interesting exception in the area of pension reform, see Kurt Weyland, *Theories of Policy Diffusion: Lessons from Latin American Pension Reform*, 57 WORLD POL. 262, 264 (2005).
[46] *See* Henry R. Glick & Scott P. Hays, *Innovation and Reinvention in State Policymaking: Theory and Evolution of Living Will Laws*, 53 J. POL. 835 (1991).
[47] *See* Christopher Z. Mooney & Mei-Hsien Lee, *Legislative Morality in the American States: The Case of Pre-Roe Abortion Regulation Reform*, 39 AM. J. POL. SCI. 599 (1995).
[48] *See* Christopher Z. Mooney & Mei-Hsien Lee, *Morality Policy Reinvention: State Death Penalties*, 566 ANNALS AM. ACAD. POL. & SOC. SCI. 80 (1999).
[49] *See* Berry & Baybeck, *infra* note 74, at 518-519.
[50] The next two paragraphs synthesize some of the literature on policy diffusion, and summarize information presented more extensively in my *Note, When Do Policy Innovations Spread? Lessons for Advocates of Lesson-drawing*, 119 HARV. LAW. REV. 1467 (2006). *See also* David Strang & Sarah Soule, *Diffusion in Organizations and Social Movements: From Hybrid Corn to Poison Pills*, 24 ANN. REV. SOC. 265 (1998) (reviewing the diffusion literature in sociology).

leaders.[51] Additionally, choices deemed successful, regardless of their initial adopter, are imitated.

Which relationships facilitate innovation? The proximity thesis states that geographic distance influences diffusion patterns; the shorter the distance, the greater the probability of emulation. This thesis has found empirical support in research on the U.S. states, where states are especially likely to copy their neighbors,[52] as well as in diverse other contexts.[53] The fit thesis states that the values, administrative structures, and existing policies that could interact with the proposed innovation, all condition the innovation's chances of adoption. For example, common law countries disproportionately imitate the laws of other common law countries, and civil law countries are also more likely to copy other civil law countries' laws.[54]

At the aggregate level, perhaps the clearest evidence of a diffusion model is the rapid spread of modern commercial and financial laws to former communist countries, coupled with huge inefficiencies and implementation difficulties in practice.[55] For example while a large majority of former communist countries score in the top two indicator categories for commercial law and financial regulation extensiveness,[56] the EBRD surveys implementation as well and

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[51] *See* Frances Stokes Berry & William D. Berry, *Innovation and Diffusion Models in Policy Research*, in THEORIES OF THE POLICY PROCESS 169, 170, 176 - 77 (Paul A. Sabatier ed., 1999).

[52] *See id.*, at 175 - 76. However, Andrew Karch suggests that technological progress changes diffusion patterns; while earlier studies of the U.S. states investigate periods when networks were regional, learning now occurs through national networks. *See* Andrew Karch, Analytical Foundations Introduction 39 (2005) (unpublished manuscript).

[53] *See* Strang & Soule, *supra* note 50, at 275.

[54] *See generally* Frederick Schauer, The Politics and Incentives of Legal Transplantation (Ctr. for Int'l Dev. at Harvard Univ., Working Paper No. 44., 2000).

[55] For an analogous argument using decoupling between laws and practice as evidence of socialization among states in the area of human rights law, see Ryan Goodman & Derek Jinks, *How to Influence States: Socialization and International Human Rights Law*, 54 DUKE L. J. 621, 649 (2004) (summarizing diverse studies to argue that "convergence (across states) is accompanied by substantial and persistent 'decoupling' (within states): official purposes and formal structure are disconnected from functional demands. Rather than correlating with local task demands, structural attributes and official goals of the state correlate in important ways with attributes and goals of other states in the world.").

[56] *See* David S. Bernstein, *Process Drives Success: Key Lessons from a Decade of Legal Reform*, *in* EBRD, LAW IN TRANSITION: TEN YEARS OF LEGAL REFORM 16-17 (2002).

reports a "troublingly consistent implementation gap".[57] Katharina Pistor, Martin Raiser and Stanislaw Gelfer highlight the same phenomenon.[58] Output levels were not much higher in these countries in 2000, than in 1989.[59] While such findings will be examined in greater detail below, at first sight, they seem inconsistent with a model that these innovations spread because they were efficient.

The social learning model assumes that state legislators will have a general desire to devise good corporate law, but the specific content of such law will depend on legislators' beliefs about possible and appropriate way to balance their constituencies' interests. These beliefs will be shaped by others' choices. (In turn, managers', lawyers', and workers' requests might be conditioned by what they consider reasonable, and reasonableness may depend on what other jurisdictions have offered each constituency). Outside ideas will not be equally influential; choices of more prosperous jurisdictions, choices considered successful, choices of proximate jurisdictions and choices of similarly structured polities, will be especially powerful.

Whether imitation spreads efficient or inefficient practices should depend on whether efficiency is a prerequisite for legitimacy. If one believes that the only practices that become legitimate are universally optimal solutions, then imitation based on a model's legitimacy leads to systemic efficiency. If instead one believes that inefficient practices may become legitimate, or that efficient practices for a particular place and time may spread beyond such place and time, then the social learning model leads to different predictions from the competition model.[60] Part

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[57] *Id.* at 7.
[58] *See* Katharina Pistor, Martin Raiser & Stanislaw Gelfer, *Law and Finance in Transition Economies* (EBRD Working Paper #492004, 2004).
[59] *See Transition: Experience and Policy Issues*, *in* IMF WORLD ECONOMIC OUTLOOK 96 (2000).
[60] Where Hansman and Kraakman, *supra* note 1, see the clear empirical and theoretical triumph of private ownership and shareholder primacy, economists reviewing the empirical evidence seem more cautious, warning that 25 years ago their counterparts would have found much more empirical support for state rather than private ownership. *See* William L. Megginson & Jeffrey M. Netter, *From State to Market, A Survey of Empirical Studies on Privatization*,

III of this paper discusses the normative implications of the social learning model, along with the normative implications of the race and interest group models, in greater detail.

3. The Spread of Corporate Charter Provisions

Is there any evidence that decision-makers are constrained by notions of legitimacy in a sector where the monetary stakes are very clear and very high? To underscore the plausibility of a social learning model in the corporate sector, this section discusses research on the diffusion of corporate charter provisions comparable to the anti-takeover laws examined in Part II. Roberta Romano examines whether companies adopt shark repellent rules, and especially whether managers put such amendments to a shareholder vote, to argue that states adopting certain anti-takeover laws may in fact be increasing shareholder utility.[61] This section shows that boards of directors are highly sensitive to changing notions of legitimacy in amending corporate charters, and argues that legislators are expected to be even more sensitive to legitimacy concerns in drafting corporate laws.

The subsequent analysis discusses two practices that clearly serve the material interests of managers -- poison pills and golden parachutes -- to illustrate how concerns about legitimacy influenced their adoption. Academics condemn poison pills as impediments to takeovers, and thus as losses of substantial premiums for shareholders, while golden parachutes are thought to align manager and shareholder incentives appropriately. Gerald Davis and Henrich Greve's research examined how managers perceived their own actions in adopting these devices, and

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39 J. ECON. LITERATURE 321, 321 (2001). Models with more recent origin, models that have been studied or tested less, and models whose performance is difficult to measure may be especially likely to diffuse even if inefficient.

[61] *See* Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 145-48 (1987) [hereinafter Romano, *Political Economy*]. She "reject[s] market failure explanations" for the adoption of certain anti-takeover laws and instead develops a model where shareholders would rationally vote for fair price amendments. *Id.* at 147-48.

how this influenced their diffusion.[62] When poison pills and parachutes were first introduced, managers had very different intuitions than academics. To managers, parachutes appeared blatant tools of self-enrichment. Instead, poison pills seemed legitimate tools, intended to give enough room to managers to provide for a firm's long-term strategy in the face of raiders interested only in short term profits.

Does legitimacy have any added explanatory power in the case of poison pills, where manager self interests and normative concerns seem to coincide? For one, legitimation dramatically increased the speed with which corporations adopted such devices. Even more telling is Gerald Davis' finding that interlocking directorates increase a firm's propensity to adopt a poison pill, controlling for a large variety of firm characteristics such as ownership structure, board structure, size, and sector of firm activity.[63] Having a board director who serves on another board that has already adopted a pill dramatically increases the chances that a company will adopt a pill.[64] What such a board member presumably offers is not technical expertise on how exactly to structure a pill, expertise which could be easily obtainable from outside consultants in the era the following the Delaware Supreme Court's decision in *Moran vs. Household International*.[65] Instead he offers an understanding that poison pills are appropriate and legitimate tools. Subsequent literature identified interlocking directorates as facilitating the diffusion of a wide variety of innovations.[66]

What about golden parachutes? Although clearly benefiting managers, Davis and Greve suggest that these were questioned by many managers as illegitimate, and did not spread rapidly

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[62] *See* Gerald F. Davis & Henrich R. Greve, *Corporate Elite Networks and Governance Changes in the 1980s*, 103 AM. J. SOC. 1 (1997).
[63] *See* Gerald F. Davis, *Agents without Principles? The spread of the Poison Pill through the Intercorporate Network*, 36 ADMIN. SCI. Q. 583 (1991).
[64] *Id.*
[65] Moran v. Household International, Inc., 500 A.2d 1346 (1985).
[66] For a useful review of this literature, *see* Mark S. Mizruchi, *What Do Interlocks Do? An Analysis, Critique, and Assessment of Research on Interlocking Directorates.* 22 ANN. REV. SOCIOL. 271 (1996).

at first. Michael Jensen, Kevin Murphy and Eric Wruck suggest that government action intended to limit the use of golden parachutes was what ended up speeding their diffusion.[67] In 1984, the U.S. introduced a special tax on payments associated with change-in-control agreements that exceeded three times the executive's recent pay.

> Ironically, although the cap was meant to reduce the generosity of parachute payments, the government action appeared to increase them. The new rules were followed by the introduction of golden parachutes in companies that had no change-in-control agreements. Apparently compensation committees and managers took the regulation as effectively endorsing such change-in-control agreements as well as the three times average compensation (which became the standard).[68]

Firms responded in a similar way to a 1992 Act limiting the deductability of CEO compensation above $1 million that was unrelated to performance. "It appears … that once the Act defined $1 million as reasonable many companies increased cash compensation to $1 million, and then began to add on the performance based pay that satisfied the act."[69]

Lawyers drafting corporate laws may be motivated by concerns about non-monetary benefits and may function as another channel through which legitimacy concerns are channeled. In the race model, lawyers are not especially relevant, and might be thought of as neutral agents of their clients. In the interest group model, lawyers' monetary interests push them away from their clients on questions of how vague laws should be and how easy access to the courts should be. In the social learning model, lawyers are actors benefiting in non-monetary ways from the production of high quality corporate law. Perhaps the most telling evidence that this last

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[67] *See* Michael Jensen, Kevin Murphy & Eric Wruck, *CEO Pay . . . And How to Fix It* (Harvard Business School NOM Research Paper No. 04-28, at 2) (available at http://ssrn.com/abstract=561305).
[68] *Id.* at 28-29.
[69] *Id.* at 30.

motivation is important comes from theorists who first structure a rational actor model of corporate law production, and then indicate that their own experience suggests otherwise. Roberta Romano, for example, suggests that lawyers, in her opinion, matter more than either shareholders or managers in prompting corporate law revisions, and presents some anecdotal evidence that lawyers prompted corporate law revisions in Michigan.[70] Similarly, William Carney creates a theoretical model that has many features of an interest group model. He then identifies non-monetary benefits that accrue to lawyers from writing corporate laws,[71] and suggests that in his experience in drafting Georgia corporate laws "altruism, in terms of creating a public good for the state, also plays a significant role."[72]

The above discussion illustrates that boards of directors adopt corporate charter provisions when such provisions become legitimate. The legitimacy of particular amendments depends on whether other corporations have adopted these, and also on whether laws referencing particular practices are passed, even when the laws are designed to set outer limits. Legislators may be even more sensitive to concerns about legitimacy than corporate managers and directors.[73] Legislators tend to serve broader constituencies than boards of directors; they may often understand their role as serving the public, rather than maximizing profits; and legislators participate in more open decision-making processes whose outputs are more likely to receive publicity and public scrutiny. For these reasons, evidence on how legitimacy shapes board decisions increases the plausibility of the social learning model as a model of corporate-law-making.

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[70] *See*, *e.g.*, Romano, *Law as a Product*, *supra* note 12, at 276 n.74.
[71] *See* Carney, *infra* note 153, at 725. "Law creation may involve a consumption good—the chance to reflect and consult with peers in a nonadversary setting about ideal statutory solutions to various problems—the counterpart to academic conferences." *Id.*
[72] *Id.*
[73] *See, e.g.,* Catherine Casey, *Bureaucracy Re-enchanted? Spirit, Experts and Authority in Organizations*, 11 ORGANIZATION 59 (2004) (discussing how norms shape bureaucracies' behaviors).

4. Testing a Social Learning Model

Two broad types of evidence would support a social learning model. First, actors should appear to be driven by considerations of appropriateness and legitimacy. The clearest evidence for this behavior would be situations where legitimacy concerns impose severe constraints on self-interested wealth-maximizing behavior. Second, at the aggregate level, we should expect policy change to cluster geographically, similarities in the diffusion patterns of different innovations, diffusion waves that are not tightly related to changes in material circumstances, and gaps between policy diffusion and the intended outcomes of such policies.

In a prominent 2005 study, William Berry and Brady Baybeck developed a methodology to distinguish inter-state diffusion based on competition from inter-state diffusion based on learning.[74] They examine two policy areas: state lotteries, and state welfare benefit policies.[75] To determine whether states are competing with one another to increase revenue and avoid benefit payouts, respectively, Berry and Baybeck first determine how concerned legislators in each state should be about losing revenue from residents who may cross state lines to play the lottery in a neighboring state and about spending revenue on people who may come from a neighboring state to seek welfare benefits. They then examine how the probability of adopting a policy depends on legislator concern, which they use as a measure for the competition theory, and how the probability of adopting the policy depends on the number of states that have previously adopted a policy, which they use as a measure of the learning theory.[76] They find that

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[74] *See* William D. Berry & Brady Baybeck, *Using Geographic Information Systems to Study Interstate Competition*, 99 AM. POL. SCI. REV. 505 (2005).
[75] *Id.* at 506.
[76] *Id.* at 507.

a competition model best explains lottery adoption, while a learning model best explains welfare policy.[77]

A very similar methodology is adopted in the analysis below. That is, as the race theory predicts, legislators in states that have high franchise revenues should be most concerned about losing revenues when corporations migrate, and should adopt corporate law innovations quickly. Instead, a learning model would predict that policy adoption depends on whether other states have previously adopted the policy.

II. Empirical Evidence on The Process of Corporate Law Adoption

This second part of the paper examines empirical evidence that sheds light on the process of corporate law adoption. First, general evidence of diffusion patterns of corporate laws across U.S. states is presented. Second, regression models predicting the adoption of anti-takeover laws across U.S. states are developed. Third, the theories are extended briefly to the international context, to suggest that the social learning theory supported by the U.S. state evidence is also consistent with some literature and data on corporate law adoption in post-communist transition countries. In general, the evidence indicates substantial support for the social learning theory, and some support for the interest group model.

A. Adoption of Corporate Laws in the U.S. States

1. Broad Patterns of Corporate Law Adoption

The three theories of corporate law development predict different patterns about the process of corporate law innovation and diffusion. In the race theory, franchise revenues provide

[77] *Id.* at 518-519.

a constant incentive to innovate and improve upon other states' corporate governance: to attract reincorporations from other states, and even to maintain the home state's current corporations, states operating in a competitive environment must be vigilant. If the race model is correct, a relatively constant and fast stream of innovations should occur. The social learning theory is more consistent with a punctuated equilibrium model of innovation. That is, laws remain stable until some large exogenous change prompts norm revision. Norm revision is followed by rapid change in the corporate laws of jurisdictions susceptible to the norm's influence. Afterwards, stability in corporate law persists until the next norm revision. The interest model predicts change following a change in power of relevant domestic interest groups. In general, the interest group model is consistent with gradual change: as managers, lawyers or workers grow in strength, they should be able to chip away at limits on their power. If instead, managers, lawyers or workers suddenly grow in strength in some jurisdiction, a more radical rethinking of its corporate law should be possible.

Examining the pattern of cumulative adoptions is a first step towards distinguishing the theories. By construction, cumulative adoption graphs have positive slopes, but these slopes can take on a variety of shapes. For example, if innovations are adopted at a steady rate, cumulative adoption graphs should show a straight line. In the theories based on competition or social learning, S-shaped curves could characterize cumulative adoptions. Roberta Romano has examined the cumulative adoption patterns of four corporate law statutes prominent in the 1960s: statutes elaborating director and officer indemnification; statutes exempting certain mergers from stockholder votes; statutes eliminating appraisal rights in certain publicly traded corporations, and first generation anti-takeover statutes."[78] Although Romano reports S-shaped curves and

[78] *See* Romano, *Law as a Product*, *supra* note 12, at 233 – 35. In a recent working paper, she has updated her analysis of these statutes, and also analyzed the cumulative adoption of other statute. See Roberta Romano, *The*

connects these findings to her preferred theory of competition, in a footnote she acknowledges that there is no necessary connection between the two.[79] Indeed, a large literature on diffusion reports S-shaped curves resulting from the diffusion of everything from fashion to moral prohibitions, through mechanisms that have little if anything to do with competition.[80]

Romano also notes that the speed of a state's adoption of any of these four reforms was highly correlated with its adoption of the remaining three. As some harm shareholders while others do not, this pattern is not 100% consistent with a race-to-the-top theory. Instead, it may be more consistent with a theory that some states are more susceptible to the calls of modernity, and in a better position to respond.

Would an S-shaped cumulative adoption curve be consistent with an interest group theory? Only a sudden increase in interest group power could prompt a pronounced spike in anti-takeover law adoptions. At first cut, the evidence does not match this hypothesis. Labor has certainly not increased in power in the relevant time period -- instead dramatic declines in unionization have occurred.[81] Manager power has increased over time, but this happened after, not before, the spread of anti-takeover laws. Jensen and his coauthors trace developments in

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States as a Laboratory: Legal Innovation and State Competition for Corporate Charters (European Corporate Governance Institute, Working Paper no. 34/2005, 2005) [Hereinafter Romano, *Laboratory*]. This paper presents cumulative adoption graphs to present corporate law patterns, but does not contain further empirical analysis, such as correlations or regressions, to explain the observed patterns. *See also*, Romano, *Political Economy*, *supra* note 61. In this 1987 paper, Romano does use regressions to predict the adoption of anti-takeover laws. However, since this paper is written very early on, prior to *CTS* and prior to the widespread adoption of second-generation anti-takeover statutes, since Romano does not test her preferred race theory, but instead develops an ad-hoc explanation for this paper alone, and since she does not base subsequent discussions of the race theory on this paper, re-examination of the determinants of anti-takeover laws is warranted.

[79] *See* Romano, *Law as a Product*, *supra* note 12, at 235 n.11 ("There is no generally accepted theoretical model for the empirical findings on innovation; although an external bandwagon thesis has been suggested by economists, its proponents have not linked it to a theory of optimal decisionmaking.").

[80] *See* EVERETT M. ROGERS, DIFFUSION OF INNOVATIONS (5th ed. 2003) (reviewing the diffusion literature across diverse fields). *See also* David Strang & Sarah Soule, *supra* note 50 (reviewing the diffusion literature in sociology).

[81] Between 1977 and 1987, the number of union workers in manufacturing declined by 2.6 million, even though the total number of jobs in this sector increased by 1.8 million. *See* INSTITUTE FOR INTERNATIONAL ECONOMICS, OVERVIEW: THE DECLINE OF US LABOR UNIONS AND THE ROLE OF TRADE at 1 n.2, available at http://www.iie.com/publications/chapters_preview/352/1iie3411.pdf.

executive pay over time, and suggest that through the 1980s, executive pay grew slowly, if at all, relative to previous decades.[82] It was only in the 1990s that pay skyrocketed. However, the big changes in takeover laws protecting managers occurred in the 1980s, that is before manager power seems like a plausible prompt. Such evidence does not speak to other elements of the interest group theory -- for example, the notions that anti-takeover laws benefit managers, or that in some jurisdictions managers may well have lobbied for these. Indeed, it would not be surprising if states adopting anti-takeover legislation early on did so with great manager pressure, but in latecomers this was not necessary, as anti-takeover laws had become legitimate.

Consistent with prior literature, the next section of the paper shows that S-shaped curves characterize the adoption of various anti-takeover laws. While this pattern is a first indication of the plausibility of a social learning model, more detailed regression models are presented in section 3 to distinguish between the theories.

2. Adoption of Anti-Takeover Statutes

The subsequent empirical material tests the three theories of corporate law development by analyzing a series of anti-takeover laws in greater detail, along with the forces that led to their adoption. State laws restricting takeovers are perhaps the most significant and contentious aspect of state corporate law regulation.[83] Indeed, the expansion of federal jurisdiction in regulating corporate governance through securities fraud litigation and Sarbanes-Oxley has limited state

[82] *See* Jensen, Murphy & Wruck, *supra* note 67, at 1, 25-26 (highlighting that CEO pay for top NYSE companies was comparable in real terms in the 1934-38, and 1982-88 periods, and graphing CEO pay for S&P 500 companies from 1970 to the present).

[83] As of 1987, "[t]he most lively debate in corporate law [concerned] takeovers." Romano, *Political Economy*, *supra* note 61, at 111. Interest in takeover law may have peaked in the 1980s, but has been substantial since. A lexis search indicates that from 1980 to the present, 213 articles in U.S. and Canadian law reviews contain the term "takeover" in their titles, a majority of which were written after 1990. For comparison, from 1980 to the present, 477 articles in the lexis database "corporate law" in their title.

corporate law decision-making "almost entirely [to] two contexts - acquisitions and self-dealing transactions."[84] Not only are anti-takeover laws central to state corporate law, but they also form a hard test case for the proposed social learning theory of corporate governance. The main critique of norm-based theories is that norms are at best weak forces; they may shape behavior in a minor way when no money is at stake, but do not matter otherwise. Takeover regulation is instead a corporate law issue that directly and substantially influences managers and shareholder welfare; indeed interest group theorists often present anti-takeover regulation as their paradigmatic case.[85] Looking at the relative influence of norms in such a hard case makes evidence of a social learning theory more plausibly generalizable. Finally, researchers have extensively examined how managers respond to anti-takeover provisions, and developed conflicting implications for the race debate through this indirect evidence. Roberta Romano findings' on manager choices are interpreted as supportive of the race to the top;[86] Guhan Subramanian's findings that corporations sometimes move towards jurisdictions with anti-takeover statutes has been interpreted as supportive of manager incentives to protect themselves at shareholder expense;[87] and Gray Davis' findings that anti-takeover charter amendments spread through interlocking directorates could be interpreted as evidence to support a social learning model.[88] Looking directly at how state legislators - rather than corporate managers - act, would provide a more direct test of these theories. The subsequent discussion presents the context for and content of state anti-takeover statutes.

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[84] Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 861 (2003) (examining the shift in securities fraud litigation from state to federal law claims through empirical evidence).
[85] *See, e.g.,* Bebchuk & Ferrell, *supra* note 39 (discussing the role of managers in promoting state anti-takeover laws).
[86] *See* Romano, Law as a Product, *supra* note 12.
[87] *See* Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1801-02 (2002).
[88] *See* Davis, *supra* note 63.

Typologies of Anti-Takeover Statutes

While federal law sets some parameters for tender offers, through the Securities Act of 1933, the Securities Exchange Act of 1934, and the 1968 Williams Acts, states have regulated takeovers much more aggressively.[89] The Williams Act introduced timing and disclosure requirements for bidders.[90] However, the Williams Act was not intended to shut down the takeover market.[91] States were not as diffident as the federal government, and between 1968 and 1981, 37 states enacted anti-takeover laws.[92] These first generation state anti-takeover codes posed significant obstacles to bidders, in the form of mandatory waiting periods and lengthy public scrutiny of tender offers.[93] Moreover, first generation anti-takeover statutes covered corporations with relatively tenuous connections to the state.[94]

In 1982, in *Edgar v. MITE*, the Supreme Court struck down the Illinois anti-takeover statute, as a burden on interstate commerce.[95] As the Illinois anti-takeover statute was similar to, if somewhat more extreme than, other state statutes, *MITE* prompted states to develop a second generation of anti-takeover statutes. These statutes are less burdensome than first-generation statutes: they permit firms to opt out of them,[96] only apply to corporations with strong state ties,[97]

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[89] For more detailed accounts of the history of anti-takeover laws, see Bebchuk & Ferrell, *Federalism and Takeover Law: The Race to Protect Managers from Takeovers*, *in* REGULATORY COMPETITION AND ECONOMIC INTEGRATION: COMPARATIVE PERSPECTIVES at 75 - 89 (Daniel C. Esty & Damien Geradin, eds., 2001). See ALSO INVESTOR RESPONSIBILITY RESEARCH CENTER, INC., STATE TAKEOVER LAWS B1-B14 (2003) [Heireinafter IRRC, STATE TAKEOVER LAWS].

[90] Requirements were more extensive for large stock purchases.

[91] IRRC, STATE TAKEOVER LAWS, *supra* note 89, at B-2.

[92] *See* Romano, *Law as a Product*, *supra* note 12, at 234.

[93] IRRC, STATE TAKEOVER LAWS, *supra* note 89, at B-4.

[94] *Id.*

[95] Edgar v. MITE Corp., 457 U.S. 624 (1982). The *MITE* decision was heavily splintered, with a plurality holding that the Illinois statute directly violated the commerce clause, a fifth Justice joining this opinion despite not wishing to reach the merits, a minority holding that the Illinois Statute was preempted by the Williams Act, and the dissenters identifying procedural reasons to avoid settling the controversy.

[96] See Romano, *Laboratory*, *supra* note 78,at 13, for an argument about the importance of opt-outs. *But see* Bebchuk & Ferrell, *supra* note 89,at 85, for an argument that opt-outs have little value to shareholders when managers control the opt-out process.

and do not impose insuperable procedural delays on takeover bids.[98] Nonetheless, as discussed below, they pose substantial barriers to takeovers, especially since many states have adopted several anti-takeover measures.

The first response to *MITE* was a control share acquisition law, which Ohio pioneered in 1982.[99] Such statutes require the approval of disinterested shareholders for the acquisition of control, and for share acquisitions that move the acquirer between specified voting levels.[100] For example, the Indiana Control Share Acquisition Act provides that an acquisition of 20%, 33% or 50% of an Indiana company's shares requires approval by a majority of disinterested shareholders.[101] In a 1987 decision, *CTS Corp. v. Dynamics Corp.*, the Supreme Court upheld Indiana's control share acquisition statute against a commerce clause challenge.[102] Between 1982 and the present, 27 states have adopted control share acquisition statutes.

Between the Supreme Court's 1982 *MITE* decision striking down first generation anti-takeover laws, and the 1987 *CTS* decision upholding control share acquisition statutes, states experimented with several other types of anti-takeover statutes as well.[103] A second response to *MITE* was Maryland's fair price statute, enacted in 1983. Aiming to eliminate two-tier offers,

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[97] *See* IRRC, STATE TAKEOVER LAWS, *supra* note 89, at B-8. However, they do not only cover corporations incorporated in-state, but sometimes also protect corporations with substantial in-state activity incorporated elsewhere. *See infra* TAN for a discussion of this point.
[98] See Romano, *Political Economy*, *supra* note 61, at 115.
[99] Ohio Rev. Cod. Ann. §1701.83.1
[100] *Id.* For a discussion of this Statute, see Romano, *Political Economy*, *supra* note 61, at 115 -16.
[101] *See* IRRC, STATE TAKEOVER LAWS, *supra* note 89, at A-2.
[102] *See* CTS Corp. v. Dynamics Corp., 481 U.S. 69 (1987). In distinguishing this statute from the Illinois act it had previously invalidated, the Supreme Court noted that:

> Unlike the MITE statute, the Indiana Act does not give either management or the offeror an advantage in communicating with the shareholders about the impending offer. The Act also does not impose an indefinite delay on tender offers. Nothing in the Act prohibits an offeror from consummating an offer on the 20th business day, the earliest day permitted under applicable federal regulations, see 17 CFR § 240.14e-1(a) (1986). Nor does the Act allow the state government to interpose its views of fairness between willing buyers and seller of shares of the target company. Rather, the Act allows *shareholders* to evaluate the fairness of the offer collectively.
>
> *Id.* at 83-84 (emphasis in original).

[103] 21 states adopted second generation anti-takeover laws between these two decisions. *See* IRRC, STATE TAKEOVER LAWS, *supra* note 89, at B-8.

fair price statutes require business combinations of a certain size to gain either approval from shareholder supermajorities, or approval of a disinterested board of directors, or to provide disinterested shareholders with a fair price.[104] A fair price is defined in various ways but is generally the highest price paid for the companies shares at or immediately before the combination.[105] 27 states have adopted fair price statutes.

A third response, pioneered in New York in 1985, was a freeze-out statute. Such statutes impose a waiting period, typically lasting between 2-5 years, during which interested shareholders cannot engage in business combinations with targeted companies.[106] Such statutes discourage acquisitions aiming to merge the aquirer's and the target's assets in the medium term, and thereby limit financing options for takeovers, as these statutes prohibit using the target's assets to repay debt raised for the takeover.[107] These laws were often combined with fair price statutes in the early 1980s. However, Delaware's adoption of a free-standing freeze-out statute in 1988 illustrated that the freeze-out was a powerful anti-takeover device in itself.[108] 33 states have adopted freeze-out statutes.

A fourth type of statute, pioneered in Kentucky in 1984, consisted in state approval of the most controversial corporate takeover defense - the poison pill.[109] Endorsement of the poison pill is intended to make legal challenges to poison pills more difficult,[110] which in turn encourages more firms to adopt poison fills, and discourages challengers. 27 states have adopted poison pill endorsements.

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[104] *See* Md. Corps. & Ass'ns Code Ann. §§ 3-601 -3-603. *See also*, Romano, *Political Economy*, *supra* note 61, at 116; IRRC, STATE TAKEOVER LAWS, *supra* note 89, at A4-A5.
[105] *See* Romano, *Political Economy*, *supra* note 61, at 116.
[106] *See* IRRC, STATE TAKEOVER LAWS, *supra* note 89, at A5-A6
[107] *See id.*, at A-5.
[108] *See id. See also* Romano, *Laboratory*, *supra* note 78, at 17-19, noting that Delaware's version of a freeze-out statute, a version lacking a fair price provision, was rapidly imitated after 1988.
[109] *See* IRRC, STATE TAKEOVER LAWS, *supra* note 89, at Kentucky-2.
[110] *Id.* at A-8.

A final type of response were statutes permitting directors to consider constituencies other than shareholders in their decisions. Interests that could be considered, in both decisions on control shift and other corporate matters, include those of employees, the community, the longer term interests of the corporations and so forth.[111] These laws were pioneered in Ohio in 1984, and are now adopted by 31 states.

Other types of statutes were also adopted, but by very few states each. These include redemption rights statutes, which give shareholders the right sell their shares to the acquirer of a large share of stock at the acquiring price;[112] greenmail restrictions, which prohibit companies from repurchasing large amounts of stock from persons who have held this stock for very short period of time; restrictions on extraordinary compensation of managers during tender offers; laws protecting employees from takeover-induced disruptions; and recapture of profit laws.[113]

The charts below illustrate the diffusion each of the five types of anti-takeover statutes discussed above. The horizontal axis represents adoption dates, while the vertical axis represents cumulative adoptions. All except perhaps for fair price statutes exhibit clear S-shaped curves. Critically, the vertical part of the S-curve occurs around 1987, at the time of the Supreme Court's decision in *CTS*. *CTS* may have influenced actor incentives, by reducing uncertainty about the constitutionality of control share acquisition statutes. If so, the rational response for welfare maximizing, risk-averse state legislators, as well as for managers lobbying these legislators, would be to promote the adoption of control share acquisition statutes, perhaps to the detriment of other, untested, anti-takeover devices. *CTS* may have also influenced the legitimacy of takeover laws more generally - a legitimacy that had been questioned in *MITE*. If *CTS*

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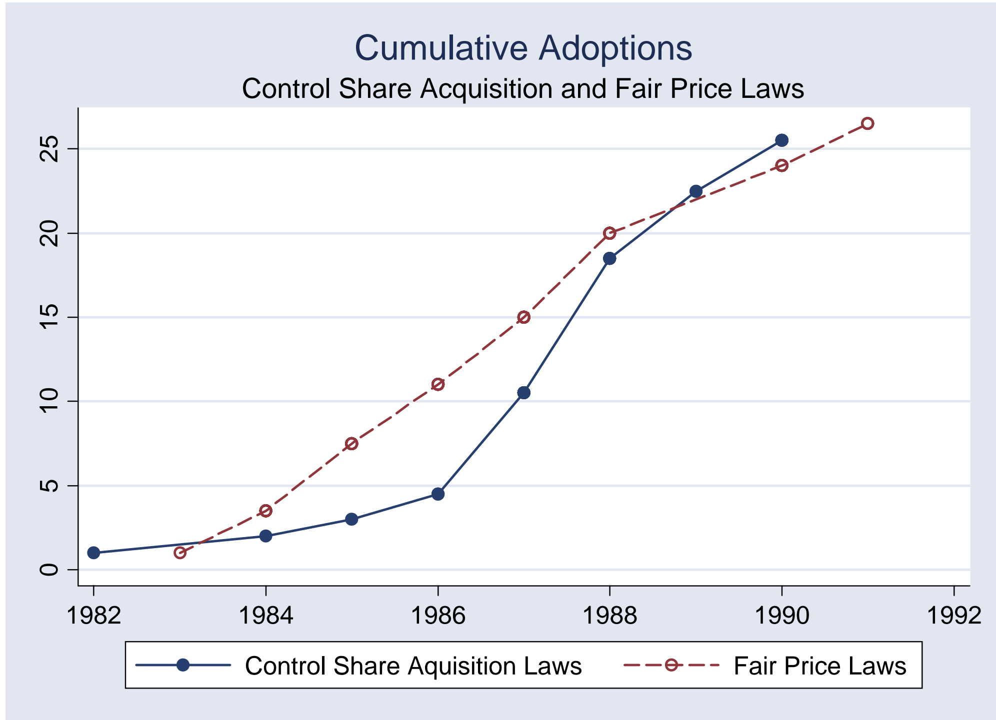
[111] *Id.* at A-5.
[112] *Id.* at A-6.
[113] *Id.* at A-4 - A-9. Analyzing why these laws did not spread while others did is an essential topic for future research.

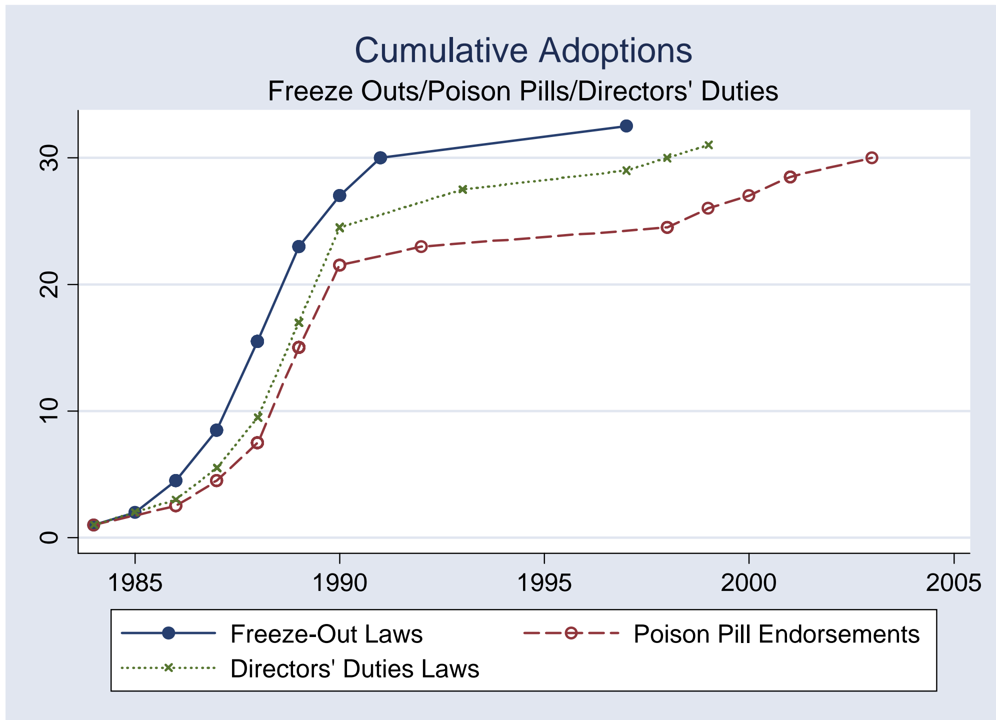
legitimized a broader array of tools, then we should see states adopting this diverse array following the decision.

In summary: the S-shaped curves that characterize the adoption of anti-takeover laws lend plausibility to social learning and competition theories, as compared to interest group theories. The fact that diverse anti-takeover provisions, rather than control share acquisition laws in particular, are rapidly adopted following *CTS* is consistent with a theory that *CTS* legitimized anti-takeover laws generally, as opposed to a theory whereby *CTS* altered the costs and benefits of adopting one particular type of anti-takeover law. The next section goes into greater depth on the determinants of the adoption of anti-takeover laws.

Graph 1: Cumulative Adoptions of Freeze-Out, Poison Pill, and Directors' Duties Laws



Graph 2: Cumulative Adoptions of Freeze-Out, Poison Pill, and Directors' Duties Laws



3. Measures of Competition, Interests, and Social Learning

While cumulative adoption patterns offer general evidence on the race, interest group, and social learning theories, examining which jurisdictions will adopt a new innovation quickly, and which will delay in this process, is even more informative. To test the theories empirically, this paper begins by using Roberta Romano's measures for the race theory and for the speed of corporate law adoption in the 1960s, develops analogous and additional tests for the adoption of second generation anti-takeover laws, and concludes with suggestive evidence on cross-national diffusion patterns. This section outlines the measures used as proxies for each of the theories. Special emphasis is spent on describing the social learning measure, as this is a novel measure for the corporate law literature.

A central empirical finding supporting the race theory is Romano's observation that states with the greatest dependence on franchise taxes respond most rapidly to corporate law innovations. Kahan and Kamar also acknowledge the importance of this finding to race theory, and focus on it, suggesting alternative explanations, without however testing these.[114] Romano found that this responsiveness score was positively correlated with the ratio of franchise tax revenue to overall tax revenue.[115] This is a crude test, in that other potential variables are not controlled for. More critically, this correlation is sensitive to the concern that the causality goes in the other direction – namely states that for some reason or other adopt firm-friendly legal provisions quickly attract larger revenues. Nonetheless, as discussed above, the positive relationship between early adoption of corporate laws and high state dependence on franchise

[114] *See* Kahan & Kamar, *supra* note 4, at 700-701 (suggesting that states with significant tax revenues may have large corporate bars protective of local corporations, or that Romano's finding may be driven by the diffusion of first generation anti-takeover statutes, again to advantage companies that do business in a state).
[115] *See* Romano, *Law as a Product*, *supra* note 12, at 238. Romano develops a general responsiveness measure because she finds that the sequence in which states adopted a particular corporate law reform correlates with the sequence in which other corporate law reforms were adopted – that is, there exists a pattern whereby some states are more responsive than others across innovations.

taxes is the strongest evidence of the race theory.[116] Because anti-takeover laws of the 1980s are analyzed in the subsequent regressions, franchise tax data for 1980 are used as an independent variable.[117]

As outlined above, three variants of the interest group theory exist: theories that identify managers, lawyers and workers, respectively, as the interest group responsible for the adoption of anti-takeover laws.[118] Most interest group theories focus on managers. However, the evidence for this theory is not systematically collected or examined. This evidence consists of analysis of manager incentives, on the thought that if managers profit from a law they must have pushed for its adoption, as well as case studies, indicating that many state legislatures adopted anti-takeover statutes at a time when a key in-state company was being threatened by a takeover. The measure for manager strength used in this paper is drawn from a recent economic analysis of home-state bias in investment decisions.[119] Harrison Hong, Jeffrey D. Kubik and Jeremy Stein measure the ratio of firm book value to household income in each state.[120] They report that this measure is indeed linked to investment decisions and biases. However, contrary to their expectations, and contrary to cross-national studies of home-state biases, states with few companies have relatively over-valued companies.[121] The concentration of firms in each state is used here as a measure for the power of managers -- if the state economy depends heavily on corporations, one might expect legislators to be especially sensitive to manager requests. Of course, the reverse relationship also remains a possibility - states with very few firms might be

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[116] *See infra* Section I.A.
[117] See U.S. DEPT. OF COMMERCE & BUREAU OF THE CENSUS, STATE GOVERNMENT TAX COLLECTIONS IN 1980 (1981). Following Romano, *Law as a Product*, *supra* note 12, the measure used is franchise taxes as a percentage of total state tax revenue.
[118] *See infra* Section I.B.
[119] *See* Harrison Hong, Jeffrey D. Kubik & Jeremy Stein, *The Only Game in Town: Stock Price Consequences of Local Bias* (working paper, June 2004).
[120] Id. at *1.
[121] Id. at *27.

especially sensitive to their potential re-incorporation. Which of the two effects, if either matters most, is a matter for the empirical investigations that follow.

Hong, Kubik and Stein's measure is based on corporate headquarters, rather than on state of incorporation. This is unlikely to be a problem, because for many corporations, the state of incorporation and the state in which the company is headquartered coincide, because several state anti-takeover laws cover corporations with substantial in-state activity that are incorporated elsewhere,[122] and because Delaware has higher values on this measure than any other state. Since laws that were adopted starting in the 1980s are investigated, the ratios for 1980 are used here.

As mentioned above, some studies have argued that lawyers drive corporate law adoption.[123] To measure lawyer strength, this paper uses data on legal services as a percentage of state income.[124]

A third interest group that could be driving the adoption of anti-takeover laws are workers, as takeovers often involve substantial restructuring and layoffs. Unionization rates serve as a proxy for worker strength.[125]

The social learning theory predicts that actors who are most integrated and most connected should be most responsive. The measure used here for the social learning theory comes from the literature examining the neighboring states hypothesis. This is the most prominent hypothesis on state-to-state diffusion of various innovations, and suggests that the relevant connecting variable may be ones' neighbors' policies. According to a large literature on

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[122] *See infra* TAN 36-38.
[123] *See infra* TAN 140.
[124] Data is for 1983. This data is collected by the Census Bureau, and is available at http://www.bea.gov/bea/regional/gsp/action.cfm
[125] Unionization rates have been used extensively in political economy literature to measure worker strength vis-à-vis employers.

diffusion across the U.S. states, before national networks of state governments became dominant, regional connections mattered heavily.[126] Indeed, a prominent recent analysis of the diffusion of innovations across U.S. states, intended specifically to disentangle competition and learning effects, uses neighboring states choices as a proxy for social learning.[127] This paper uses standard regional groupings (New England, Middle Atlantic, South, Midwest, Southwest, West) to predict a state's responsiveness on the basis of what its neighbors did. Specifically, a state's choices are correlated with the average choices of its neighbors.

Could this measure of neighboring states' choices also pick up other effects? It is unlikely to pick up competition effects, as the race theory is framed as one where competition is national - not regional.[128] Similarly, this measure should not be contaminated by interest group effects, unless one believes these work through highly unusual pathways. For example, this contamination would be a problem if one believed that Wisconsin's unions could influence Michigan's policies, through a pathway other than the proposed one , i.e. not via Wisconsin's laws' influence on Michigan's laws. While regional averages are unlikely to reflect competition and interest group dynamics, the models below do not control for all possible regional shocks, a concern the next version of this paper should address.[129]

An Alternative Interpretation of Roberta Romano's 1960s Data

Before examining regional patterns of anti-takeover laws, this paper turns to an earlier generation of corporate statutes used to establish the race theory. Romano Romano ranks states

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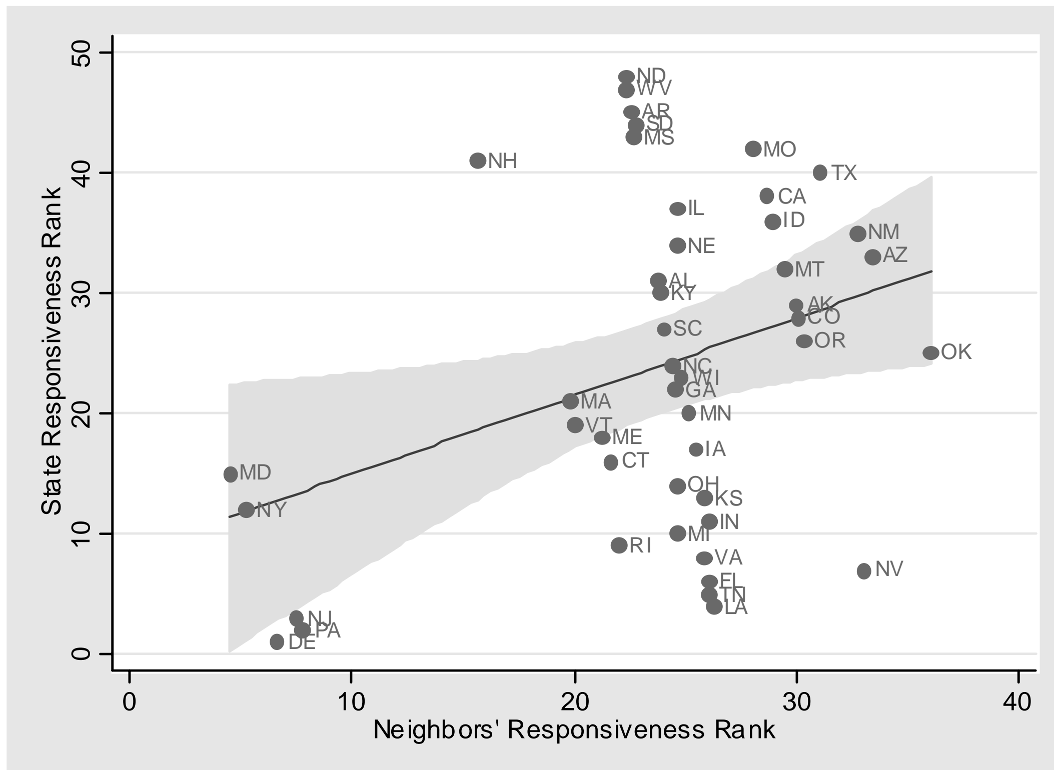
[126] See *supra* TAN 46 - 54.
[127] See Brady & Baybeck, *supra* note 74.
[128] That is, it is not plausible to interpret a regional effect as a race to meet or beat Delaware, as the race literature currently suggests. It would be more possible to interpret the findings as indicative of regional competition or shocks, but such a reinterpretation of the race theory would be radical. It would have very different implications for the optimality of corporate law in a federal systems, and would i involve very different policy prescriptions from those of the current race theory.
[129] Controlling for such shocks through a time trend would be possible in a time-series cross-sectional study, which is the next step in this work.

from least to most responsive in adopting 4 corporate law innovations in the 1960s.[130] While she correlates these responses with franchise taxes and her preferred race theory, the graph below examines whether responsiveness might also be linked to social learning. A positive, statistically significant relationship emerges, with a large coefficient. A 1 point improvement in a state's neighbors' responsiveness ranking should lead to a 0.6 point improvement in the state's own ranking. This is far from the definitive explanation of why states develop corporate laws; it merely indicates that there is strong support to alternatives to the state competition theory. The graph below illustrates this relationship; the bow shaped area is the 95% confidence interval.

Graph 3: States Adopt Corporate Laws Quickly when their Neighbors Are Quick



The model presented is a very crude test for the social learning hypothesis; this relationship would likely be stronger if the quality of the data were improved. And the outliers

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130 *See* Romano, *Law as a Product*, *supra* note 12, at 247.

make sense. For instance, at the lower right hand corner, we see Nevada as the major outlier – Nevada's policy choices are not well explained by its neighbors' actions. This is consistent with the literature that Nevada is actively seeking to improve its corporate law to attract incorporations, rather than waiting more passively for norms to diffuse, as many of the other states seem to be doing.[131]

Maps of Anti-Takeover Law Adoption

Before proceeding to regression models, I map the distribution of anti-takeover laws across U.S. states. Lighter regions indicate early adoptions; darkest regions indicate no adoption at all. Visual inspection of these maps indicates regional clustering in adoption patterns, as the neighboring states hypothesis predicts. In all maps, we can see neighboring states adopting particular laws at the same time. This effect is most prominent in the case of fair price laws, where states near and east of the Mississippi are the early adopters, and least prominent in the case of laws broadening directors' duties to constituencies beyond shareholders. These maps indicate the plausibility of state-to-state socialization and learning in explaining corporate law development.

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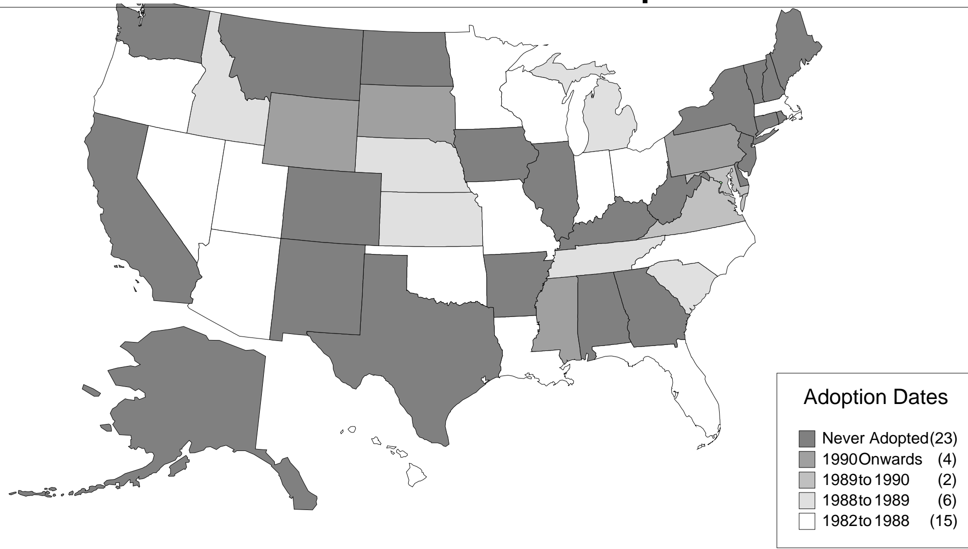
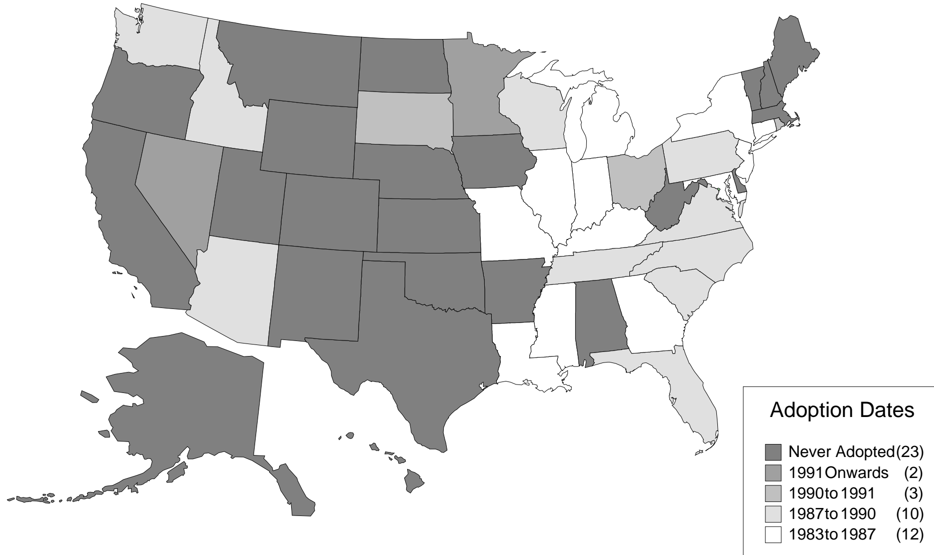
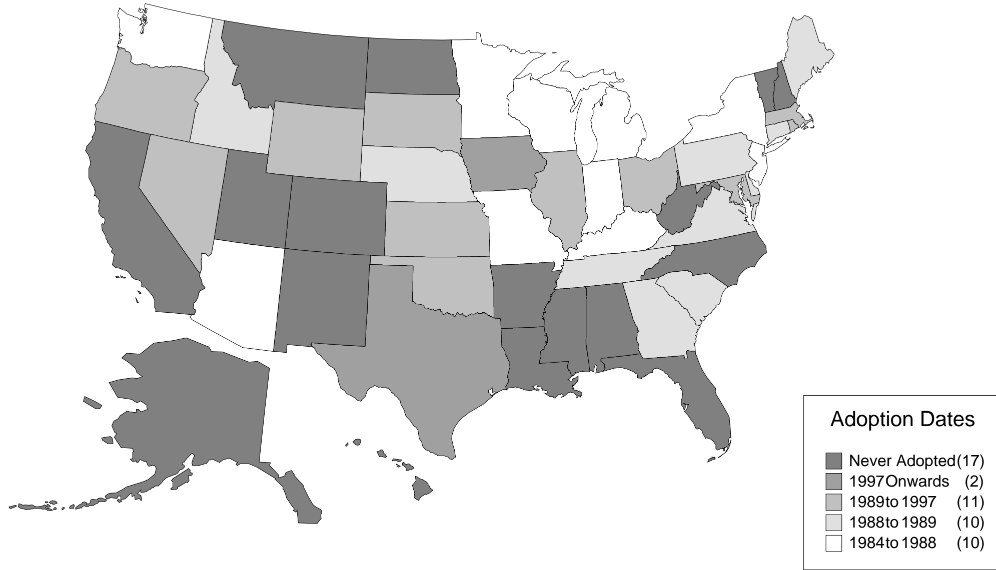
[131] *See, e.g.,* Keith Paul Bishop, *The Delaware of the West: Does Nevada Offer Better Treatment for Directors?*, INSIGHTS, Mar. 1993; Kamar & Kahan, *supra* note 4, at 716 – 20.

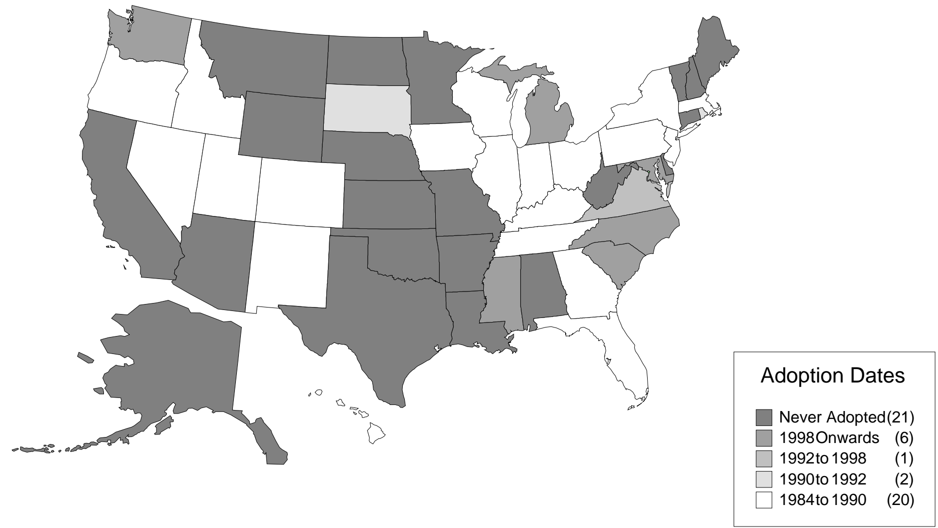
States with Control Share Acquisition Laws

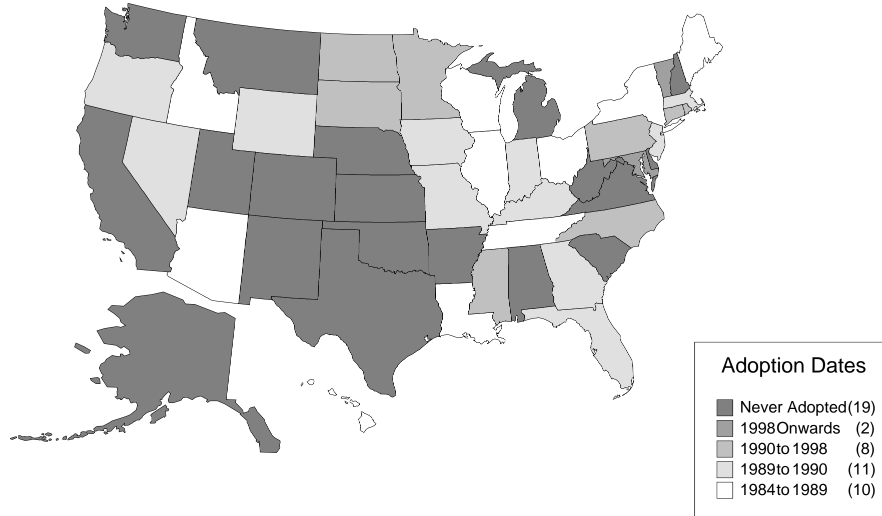


States with Fair Price Laws




States with Freeze-Out Laws
Adoption Dates
Never Adopted(17)
1997 Onwards (2)
1989 to 1997 (11)
1988 to 1989 (10)
1984 to 1988 (10)


States Endorsing Poison Pills
Adoption Dates
Never Adopted(21)
1998 Onwards (6)
1992 to 1998 (1)
1990 to 1992 (2)
1984 to 1990 (20)



4. Determinants of Corporate Law Adoption: Regression Models

The dependent variable in the regression models that follow is the rank with which states adopted each corporate law, following Romano's work.[132] Her methodology is used to ensure that different results are not a product of different methods. The regressions were also repeated with adoption dates as the dependent variable, and results do not change in any substantial way. The independent variables, as described above, are the average rank of neighboring states in adopting the law in question, the percentage of a state's revenue that comes from franchise taxes, the state's unionization rate, legal fees as a percentage of gross state product, firm book value divided by state household income, and a constant.[133] The three measures of interest group strength are positively correlated at levels ranging from 0.4 to 0.5. Because of this, and because of the novel nature of the manager and lawyer strength measures, regressions are run both with

[132] *See* Romano, *Law as a Product*, *supra* note 12. This is also the measure she uses in Romano, *Political Economy*, *supra* note 61. Her most recent paper, Romano, *Laboratory*, *supra* note 78, does not include regressions. As used here, the first state to adopt a law gets a rank of 1, the second state a rank of 2, and so forth.
[133] See *infra* Section II.A.3. for a more complete description of these variables.

all three measures included (Model I), and with unionization alone as a measure of interest group strength (Model II).[134] For convenience, the tables also contain a column indicating the direction in which the relationships should be signed, based on the predictions of the three theories. The key results of these regressions are discussed in the text following the tables.

Table 1: Control Share Acquisition Statutes- Ranked Data

		Coefficient (std. err.)	
	Exp. Sign	I (n=48)	II (n=50)
Neighbors' Choices	+	0.97**	0.99**
		(0.43)	(0.40)
Franchise Taxes	-	0.27	0.28
		(1.08)	(0.96)
Unions	-	-0.06	-0.12
		(0.35)	(0.29)
Lawyers	-	-1.27	
		(9.96)	
Managers	-	0.47	
		(5.20)	
Constant		2.39	2.18
		(11.92)	(10.93)

* significant at the 0.90 level ** significant at the 0.95 level *** significant at the 0.99 level

Table 2: Fair Price Laws - Ranked Data

		Coefficient (std. err.)	
	Exp. Sign	I (n=48)	II (n=50)
Neighbors' Choices	+	1.18***	1.21***
		(0.25)	(0.25)
Franchise Taxes	-	2.88***	1.89**
		(0.91)	(0.85)
Unions	-	-0.12	-0.41*
		(0.29)	(0.25)
Lawyers	-	-2.28	
		(7.89)	
Managers	-	-10.78**	
		(4.21)	
Constant		0.92	0.06
		(9.61)	(8.06)

* significant at the 0.90 level ** significant at the 0.95 level *** significant at the 0.99 level

[134] Model I only contains data on 48 states, as the ratio of firm book value to household income was not available for Hawaii and Alaska.

Table 3: Freeze-Out Statutes - Ranked Data

		Coefficient (std. err.)	
	Exp. Sign	I (n=48)	II (n=50)
Neighbors' Choices	+	0.71**	0.95***
		(0.28)	(0.26)
Franchise Taxes	-	1.36	0.73
		(0.96)	(0.89)
Unions	-	-0.68**	-0.60**
		(0.32)	(0.26)
Lawyers	-	7.40	
		(8.44)	
Managers	-	-8.30*	
		(4.52)	
Constant		14.63	11.30
		(11.44)	(9.57)

* significant at the 0.90 level   ** significant at the 0.95 level   *** significant at the 0.99 level

Table 4: Poison Pill Endorsements - Ranked Data

		Coefficient (std. err.)	
	Exp. Sign	I (n=48)	II (n=50)
Neighbors' Choices	+	0.91*	0.89*
		(0.50)	(0.49)
Franchise Taxes	-	0.80	1.01
		(1.10)	(0.95)
Unions	-	-0.29	-0.34
		(0.38)	(0.31)
Lawyers	-	-8.24	
		(9.77)	
Managers	-	2.84	
		(5.27)	
Constant		12.38	7.80
		(17.35)	(15.79)

* significant at the 0.90 level   ** significant at the 0.95 level   *** significant at the 0.99 level

Table 5: Directors' Duties Statutes - Ranked Data

		Coefficient (std. err.)	
	Exp. Sign	I (n=48)	II (n=50)
Neighbors' Choices	+	0.94	0.75
		(0.59)	(0.57)
Franchise Taxes	-	0.24	0.77
		(1.06)	(0.94)
Unions	-	-0.32	-0.51
		(0.37)	(0.30)
Lawyers	-	-16.99*	
		(9.88)	
Managers	-	5.27	
		(5.2)	
Constant		19.64	14.77
		(17.75)	(16.92)

* significant at the 0.90 level ** significant at the 0.95 level *** significant at the 0.99 level

The regressions above indicate strong support for the social learning theory. There is a statistically significant relationship between a state's speed in adopting a law and that of its neighbors in four of the five statute types examined: control share acquisition laws, fair price laws, freeze-out laws, and laws endorsing poison pills.[135] In each case, the coefficient is approximately 1, indicating that a 1 point improvement in a state's neighbors' responsiveness ranking should lead to a 1 point improvement in the state's own ranking.

The regressions show some support for the interest group theory. High unionization rates lead to earlier adoption of freeze-out laws. Every percentage point increase in unionization point leads to a 0.6 decrease in a state's rank.[136] This is a substantial change. For example, if a state moved from the 25th percentile of unionization in 1980, with 12% of its labor force unionized to the 75th percentile of unionization in 1980, with 24% of its labor force unionized, its rank should decrease by 7 positions. Unionization rates are also linked to the earlier adoption of fair price

[135] In the fifth case, directors duties statutes, the coefficient is correctly signed and has the same size as analogous regional variables in the other regressions, but does not reach statistical significance levels.
[136] Throughout, a rank of 1 indicates the first adopter, and higher rank numbers indicate subsequent adopters.

statutes (coefficient significant at the 0.90 level), and are correctly signed (though insignificant) in each of the other cases as well. This indicates that the presence of unions may have facilitated the passage of anti-takeover laws to some extent.

The regressions also show some support for the importance of managerial power, measured by the ratio of firm book value to household income, in the adoption of fair price laws. A a state at the 25th percentile (ratio=0.11) shifting to the to the 75th percentile (ratio=0.57) would decrease its adoption rank by 5 positions. This variable is also linked, at the 0.90 significance level, to freeze-out statute adoption. The measure of lawyer strength is not linked to the adoption of any anti-takeover law at the conventional 0.95 level. These results suggest that states with relatively more firms are more eager to adopt some anti-takeover measures, and that the interest group theory that emphasizes the power of managers should be investigated further.

There is not much support for the competition theory from these models. Franchise taxes are linked in a statistically significant way to the adoption of fair price laws, but the sign of this coefficient is opposite from what the theory predicts. That is, a state that depends heavily on franchise taxes adopts fair price laws later, rather than earlier.[137] Additionally, the coefficient indicates a small effect. That is, a state that moves from the 25th percentile (franchise taxes = 0.14% of state revenue) to the 75th percentile (franchise taxes = 1.01% of state revenue) increases its rank by 2.5 positions. Finally, this result is driven by Delaware, and is not robust to excluding this state from the analysis.

[137] The sign of this relationship is not inconsistent with all possible versions of the race theory, but is inconsistent with current writings on the race theory. That is, it is plausible to argue that the true prediction of the pure race-to-the top theory is that states that depend heavily on franchise taxes will adopt all corporate laws quickly, except for anti-takeover laws that reduce shareholder value, which they will adopt more slowly. However, this ad-hoc explanation would fail to explain why high dependence on franchise taxes would delay the adoption of fair price laws, the one anti-takeover statute type that race theorists have defended as consistent with shareholder wealth maximization. For this defense, see Romano, *Political Economy*, supra note 61.

In summary, the above regressions indicate substantial support for the social learning theory; neighbors' choices are significantly and substantially influential in the adoption of control share acquisition, fair price, freeze-out, and poison pill statutes. The evidence also indicates some support for the interest group theory, as unions and managers influenced the adoption of freeze-out and fair price statutes respectively. However, the above evidence does not support the strand of interest group theory that identifies lawyers as the relevant interest group. Finally, the race theory is not supported.

5. Qualitative Evidence of Corporate Law Adoption Patterns

While this study was not designed to collect original case study material, or to survey existing qualitative research, reading the text of the anti-takeover statutes themselves offers some indications on their adoption process. Specifically, dramatic similarities in the texts of these statutes are consistent with a social learning process, while these statutes jurisdictional coverage is more consistent with an interest group theory than with a race theory.

While various statutes could delay takeovers, states have not innovated radically and adopted solutions tailor-made for each jurisdiction, but have instead concentrated on the handful of anti-takeover statutes discussed above. Moreover, as discussed in Part III below in greater detail, the texts of anti-takeover statutes in different states are remarkably similar.[138] This evidence is consistent with the social learning theory, in which legislatures copy from one another. There is little doubt that copying takes place across state legislatures, as typographical errors that survive into subsequent state codes indicate.[139] However, placing great weight on this evidence of copying is not warranted; thus a limited claim is made here that dramatic similarities

[138] *See infra* Section III.A.
[139] *See* Jack L. Walker, *The Diffusion of Innovations Among the American States*, 63 AM. POL. SCI. REV. 880 (1969).

in state statutes are consistent with, rather than indicative of, social learning. This is because copying of statute language could either be a fundamental aspect of policy-making, or an afterthought, whereby policy-makers who have decided on the course to take, perhaps due to interest group pressures, merely use another state's template as a shortcut.

Examining the jurisdictional coverage of state statutes also sheds light on corporate law adoption processes. Since, according to the race theory, states offer good corporate law in exchange for franchise fees, states should not be willing to offer anti-takeover protection for free. Jurisdictional provisions that offer such protections to corporations that may operate in state but may be incorporated out of state are exactly the type of freebies that would undermine a system intended to maximize franchise revenues. And yet, several state anti-takeover laws cover corporations operating in state, but incorporated elsewhere.[140] This remains true despite the Supreme Court's decision in *MITE*, which raised significant doubts about the constitutionality of anti-takeover statutes with broad jurisdictional coverage. Anti-takeover protections for companies that operate in-state but are incorporated elsewhere is much more consistent with an interest group theory, where maintaining corporate production and jobs in-state are the main concerns legislators' have.

B. Extension: Corporate Law Adoption in Transition Countries

This section extends the three theories to the international context. While the theories must be adjusted for international application, and the data is much thinner, the subsequent

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[140] Arizona, Florida, Idaho, Louisiana, North Carolina, Nebraska, Tennessee, Washington all offer anti-takeover protections to corporations with substantial links to the state that are incorporated elsewhere.

discussion indicates that the social learning theory might be helpful in explaining the adoption of corporate law in post-communist transition countries.[141]

In moving from the intra-federal to international stage, one has to adjust each of the theories.[142] Whereas, in the federal context, firms can make independent decisions about where to operate and where to incorporate, this is not generally the case for the international context.[143] Therefore, if nations compete, they compete on the basis of an economic and legal package they offer firms. The stakes of attracting a firm increase dramatically – as the potential benefits of corporate operational activity dwarf those of mere incorporation[144] – but so do the tools available at a jurisdiction's disposition. Whether states will alter the corporate law component of such a package, or, instead increase a subsidy to attract companies, depends on the relative costs and benefits of these choices. Interest groups benefiting from the existing corporate law may raise the cost of altering this part of the package.[145] Conversely, international organization model laws could lower the technical difficulties of improving a corporate code.

The pure interest group model is implausible in the international context of transition countries – no one can sensibly argue that corporate law was a response of domestic firms

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[141] Looking at processes of harmonization within the European Union might be less relevant to the theories presented above, as much of the harmonization is happening through political agreement on directives (i.e. binding laws). However, since the European Court of Justice's decision in *Centros*, discussed *infra* at note 176, the potential for inter-state competition has increased dramatically, permitting a future test of these theories in the EU context.
[142] For a more general discussion of how domestic as opposed to international coordination should be structured, see Albert Breton & Pierre Salmon, *External Effects of Domestic Regulations: Comparing Internal and International Barriers to Trade*, 21 INT'L REV. L. & ECON. 135 (2001).
[143] The option to list on a U.S. stock-market is thought a type of exception to this rule, whereby firms can opt to operate under U.S. securities law while operating elsewhere. *See* Gilson, *infra* note 176, at 151. Again, however, one wonders whether this possibility prompts the US to improve its securities law, or whether the size of its market will continue to attract foreign firms regardless. Also, the *Centros* case discussed *infra* at note 176 may change this point for intra-E.U. competition.
[144] See Kamar & Kahan, *supra* note 4, for a discussion on the various incentives states offer for attracting an automobile plant, as compared to their expected franchise tax revenue.
[145] Hansman and Kraakman accept that companies with inefficient corporate governance practices may survive if they have other advantages or if they are somewhat protected. See Hansman & Kraakman, *supra* note 25, at 450-451. Bebchuk and Roe suggest that state tax and subsidy policies or cheap immobile inputs are especially important advantages in this regard. *See* Bebchuk & Roe, *supra* note 6, at 101.

seeking money from domestic financiers seeking good governance assurances. International capital, and international political advice and pressure clearly altered choices sets dramatically. What one could argue is that interest groups used these international incentives in different ways.

The challenge to testing the social learning model is that bodies promulgating particular norms often attach sticks and carrots to such norms. Diffusion scholars develop a continuum from 'voluntary' to 'coercive' transfer to characterize how international organization sticks and carrots shape government behavior.[146] While the OECD corporate governance standards may be purely voluntary, many IMF and EBRD efforts tied loans to the acceptance of advice. The adoption of rules under foreign occupation or colonial status may mark the coercive end of the spectrum. What a social learning theory must show is that receipt of money and advice is different from the receipt of money alone.

Tests analogous to those for the domestic context could also be undertaken for the international context. Under the race theory, what U.S. states gain by changing their corporate law is revenue from franchise taxes. Presumably what foreign states benefit from is investment more generally, as firms incorporated in their jurisdiction must likely operate there as well.

Existing studies of transition economies show that the success of economic reform success is linked to proximity to the West, but surprisingly, not linked to foreign direct investment. Jeffrey Kopstein and David Reilly, for example, examine how proximity to the West shaped the success of political and economic transition from communism.[147] They contrast Slovakia, which chose terrible policies under Meciar, with Kyrgyzstan, which initially chose good policies under Akaev. While the opposition to Meciar was able to successfully mobilize the

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[146] *See, e.g.,* David Dolowitz & David Marsh, *Who Learns What from Whom: A Review of the Policy Transfer Literature,* XLIV POLITICAL STUDIES 343 (1996); Wade Jacoby, *Tutors and Pupils: International Organizations, Central European Elites, and Western Models,* 14 GOVERNANCE 169 (2001).
[147] *See* Jeffrey S. Kopstein & David A. Reilly, *Geographic Diffusion and the Transformation of the Postcommunist World*, 53 WORLD POL. 1 (2000).

prospect of potential integration in the West to undermine Meciar's illiberal choices, political forces in Kyrgyzstan only emphasized how Akaev's initial choices were inappropriate for an Asian state, and thus undermined these.

Steven Fish looks for a relationship between economic liberalization and FDI but does not find one.[148] Saul Estrin and Mike Wright examine who received foreign investment among the former Soviet Union countries, and find it FDI concentrating in two resource rich republics, Azerbaijan and Kazakhstan.[149] On the EBRD index, Kazakhstan has a poor score until 1998, while Azerbaijan continues to be ranked among the transition countries with the worse commercial law. [150] This is an odd result if one believes competition drives lawmaking; if anyone in the region has the potential to attract firms through good law and to profit from this, presumably it is these resource rich republics.

Below is a very rough test of a social learning theory analogizing transition countries to U.S. states. Does proximity to the West improve corporate law? EBRD commercial law indicators are the dependent variables. These measure company law along with pledge law and banking law. The EBRD survey is a good source of information as it has been conducted repeatedly in each of the countries in question, and as it explicitly measures legal extensiveness on the books (as distinct from the implementation of the laws). Distance from the West is measured in two ways– miles from Vienna (logged), and the cost of a phonecall to the US.[151] The graphs below indicate that the closer a country is to the West, the more likely it is to adopt good commercial law; the correlation has the correct sign and is statistically significant. These

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[148] See M. Steven Fish, The Determinants of Economic Reform in the Post-Communist World, 12 East European Politics and Societies 1998 31, 55.

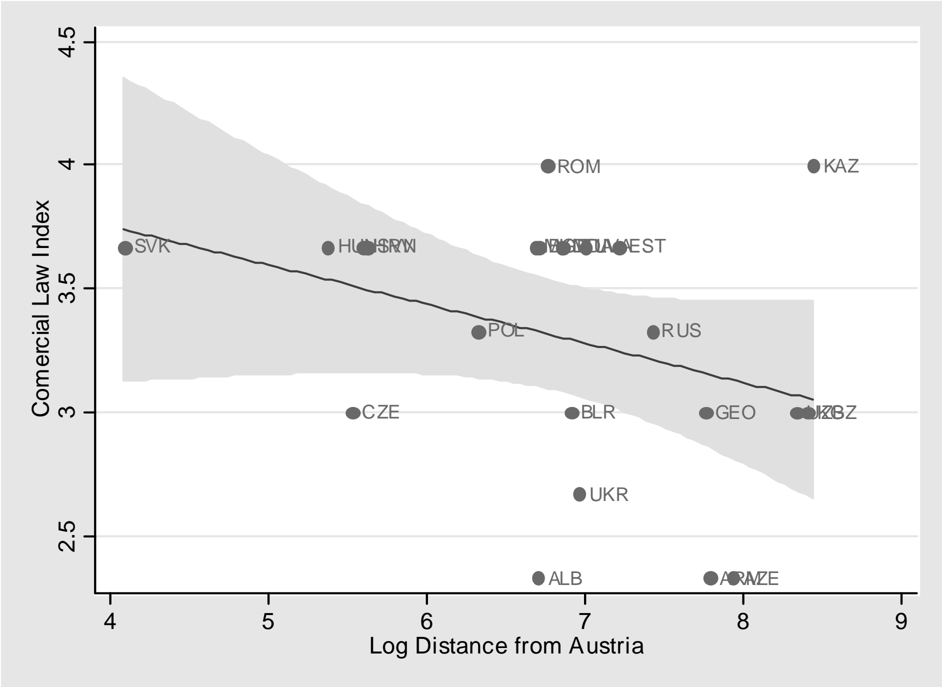
[149] Saul Estrin & Mike Wright, Corporate governance in the former Soviet Union: An overview, 27 J. Comparative Econ. 398 (1999).

[150] *See* EBRD, *supra* note 56.

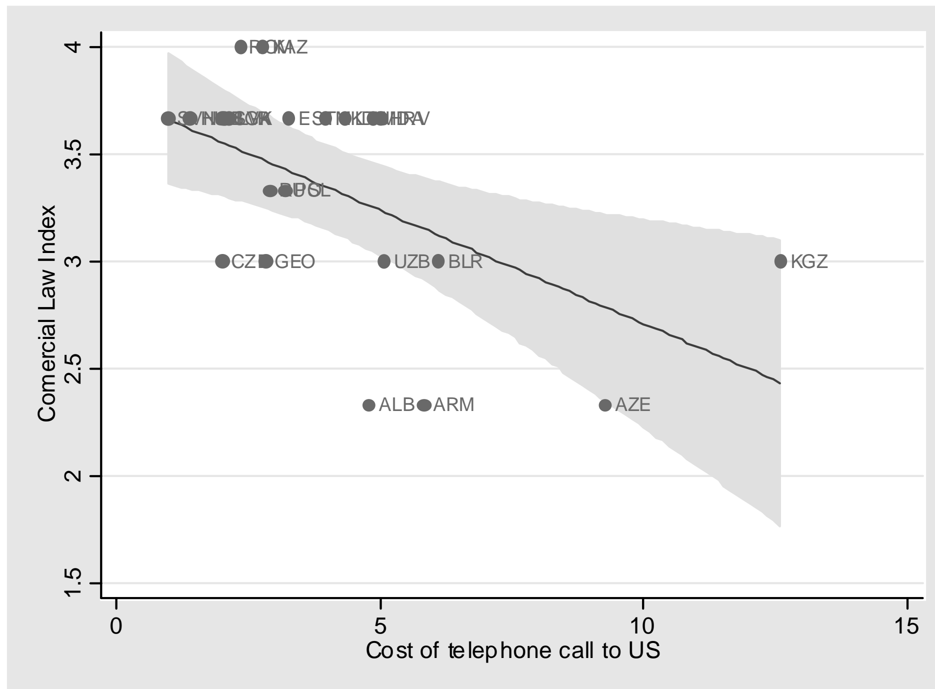
[151] Distance Data comes from http://www.cepii.fr/anglaisgraph/bdd/distances.htm. Data on the cost of phone call to US come from World Bank Development Indicators. Data for Commercial Law Indicators and Financial Regulations Indicators are from EBRD, LAW IN TRANSITION *supra* note 56.

crude first tests suggest that while corporate law has diffused rapidly, it is not necessarily competition, but possibly social learning, that has prompted this development.

Graph 4: Countries Closer to Europe Adopt Better Commercial Laws



Graph 5: Countries More Connected to the US Adopt Better Commercial Laws



The above graphs suggest that proximity to the West correlates with high corporate law quality, as a social learning theory would predict. Combining this tentative data from transition countries with more solid regression evidence that U.S. states imitate their neighbors' corporate law choices increases the plausibility of a social learning theory.

III. NORMATIVE IMPLICATIONS AND IMPLICATIONS FOR POLICY REFORM

The race, interest group, and social learning theories offer very different answers to the question of the appropriateness and desirability of state regulation of corporate law, and offer very different prescriptions for policy reforms. This Part develops the normative and policy implications of the theories, and presents some aggregate evidence that speaks to these questions. First, this Part examines corporate law uniformity. Do we observe convergence, and if so, to a single or to multiple equilibria? Second, this Part turns to corporate law quality. What do the

different theories predict with regard to the quality of corporate law, and the interests that it is likely to favor? What do we observe? Third, this Part turns to policy solutions. While all approaches suggest that legally binding interventions matter, can one improve corporate law through non-binding standards? These questions are not, and cannot be answered conclusively here. However, since this paper gives substantial support to a social learning theory, a policy prescription that warrants further investigation is non-binding standards. According to the social learning theory, these can dramatically alter actor behavior, but need not lead to efficient outcomes. Investing in the development of such standards so that do in fact lead to socially desirable outcomes, and so that they become widely adopted may be an important, if underemphasized, way forward.

Before developing the theories' normative and policy prescriptions, one must examine whether the theories are independent and mutually exclusive. (Such an exercise does not become necessary until this point, because the multivariate regression framework is perfectly consistent with all three theories or some mix of these holding true). Does it make sense to understand competition, interest group pressures and social learning as distinct mechanisms? At the margin, the theories might link up. For example, strong interest groups might spend substantial resources in advertising and lobbying, to make their ideas more legitimate. Or groups that are initially weak, but have legitimate ideas, might attract new members and therefore gain strength. Similarly, states that change their laws to increase franchise taxes may succeed in attracting many corporations, which in turn will attract corporate lawyers, increasing the strength of state corporate bars. While such claims are plausible at the margin, however, the main component of each theory remains independent of the claims of other theories. That is, at least so far, the legitimacy of corporate law paradigms is not shaped primarily by interest group

advertising campaigns. Instead, it depends on a host of other factors, such as fundamental normative principles that structure our legal systems, on moral codes, on the choices other jurisdictions and coordinating bodies make, on the writings of academics and practitioners, on crises that emphasize particular corporate problems at particular times, and so forth. Similarly, the strength of unions, lawyers and managers does not depend heavily on the legitimacy of corporate law or on state success in attracting incorporations. Instead this strength depends on diverse factors such as unemployment levels, labor laws, past labor conflicts and their success rates, etc. Indeed, in the above data, the only independent variables that were correlated to a high degree were the three measures of interest group strength.

Even if the theories are independent, are they mutually exclusive? As empirical descriptors, the theories could be combined. That is, the empirical results could show that states develop corporate law in part due to competitive pressures, in part due to interest group demands, and in part due to social learning mechanisms. This however, is not what the first set of empirical evidence described above illustrates. According to the above data, U.S. state corporate law does not result from mix of the three theories; instead, the data show substantial support for the learning theory, some support for the interest group theory, and almost no support for the race theory. Additionally, very different policy prescriptions and normative implications follow from each theory. Therefore, it becomes important to determine the relative importance of each mechanism, and to analyze the implications of each theory separately.

Table 6 below summarizes the discussion that follows.

Table 6: Normative and Policy Implications: Predictions and Empirical Evidence

	Theoretical Predictions			Empirical Evidence	
	Race Theory	**Interest Group Theory**	**Social Learning Theory**	**U.S. States**	**Transition Countries**
A. Corporate Law Uniformity	Convergence to single optimum	Persistence of divergence	Convergence to single or multiple norms	Convergence to single optimum generally; two models on few issues	Convergence to single model generally; multiple models on several issues
B. Corporate Law Quality	High quality law	Low quality law	High quality law except where efficiency and legitimacy diverge	High quality law, except on takeovers	High quality law
C. Effect of Non-Binding Standards	Ineffective	Ineffective	Effective	Effective	Effective

A. Corporate Law Uniformity

Are corporate laws converging? Or can diversity in corporate law persist? The race theory answers these questions very differently from the interest group theory. The race theory predicts that ultimately, uniformity in corporate law will result, because regulators are thought to be very sensitive to firm incorporations: any jurisdiction offering slightly worse protection than its peers would fear losing incorporations, and would consequently reform its laws to avoid this. The interest group theory generally does not predict uniformity. Instead, the value of the interest group theory is in explaining variation; different corporate laws result from different interest

group combinations in each jurisdiction. Under such a theory, uniformity in outcomes could only result if interests are uniformly strong in particular time periods, which is thought rare. Indeed, Bebchuk and Roe describe particular path dependency mechanisms through which interests that differ at one point in time make divergence persist in later time periods as well.[152] The social learning theory predicts uniformity in corporate law because legislators who lack concrete ideas and guideposts on appropriate behavior pick the standard that is most easily available. However, unlike in the race theory, according to the social learning theory, convergence to multiple models is possible and sustainable, assuming that more than one norms exist and attract different groups. This divergence between groups, however, is less persistent than the divergence the interest group theory predicts. Should an international organization promote a new norm, or should domestic dynamics in a high status jurisdiction change its corporate laws, a new equilibrium could replace the previous one rapidly across a broad set of jurisdictions.

Do we see uniformity in corporate law? Among U.S. states, uniformity is clearly the norm, although on a small subset of issues jurisdictions separate into two groups. Comparisons of the texts of state corporation codes form the most direct evidence indicating substantial degrees of uniformity. While only four corporation statutes are directly modeled on the Delaware General Corporation Code,[153] the American Bar Association's Model Business Corporation Act has been widely imitated. 24 states have adopted all or substantially all of this Act, while another seven use the model Act's 1969 predecessor.[154] William Carney studied the adoption of particular provisions, and found that 74% of the states had adopted 142 important

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[152] *See* Bebchuk & Roe, *supra* note 6.

[153] These states are Kansas, Oklahoma, Nevada and Puerto Rico. See William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 738 (1998).

[154] *See id.*

Model Act provisions and 87% of states had adopted mandatory Model Act provisions.[155] These percentages increase when the most recent modifications of the Model Act, which may not have had sufficient time to diffuse, are excluded from the tally.[156]

Does convergence to two different texts indicate convergence to two models, or to a single model with small variations? Formally, more than half of America's corporations use variants of the Model Business Corporation Act while the remainder operate under variants of the Delaware Code.[157] Michael Dooley and Michael Goldman's study of the two texts identifies the central difference between the Model Business Corporation Act and the Delaware Corporate Code as the predominance of bright line rules in the former. They also highlight some distinctions in the two texts' provisions regarding capital structure; in the codification of standards of director conduct; in rules governing close corporations; and in procedures for approving fundamental changes.[158] It therefore seems appropriate to characterize the pattern as convergence to a single model on most issues, and convergence to two models on a few important exceptions.

Another way to assess whether U.S. laws are uniform in fact is to turn to firms' perception of these. Romano reports the results of a survey of large non-Delaware companies; she finds 41% responding that the laws of Delaware and their domicile state were similar or no different; 56% stating that they differed somewhat; and 3% stating that these laws differed markedly.[159] This data suggests that firms perceive substantial uniformity in state corporate laws.

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[155] *See id.*
[156] *See id.*
[157] *See id. See also* Michael P. Dooley & Michael D. Goldman, *Some Comparisons Between the Model Business Corporation Act and the Delaware General Corporation Law*, 56 BUS. L. 737 (2001).
[158] *See id.* at 764, 739-756.
[159] *See* Romano, *Law as a Product*, *supra* note 12, at 260-01.

Comparative evidence is also telling. Comparative evidence is helpful in evaluating the concern that uniformity in corporate law be functional: perhaps there is essentially a single correct solution to most corporate law problems. After all, people around the world solve arithmetic problems in identical ways, and this uniformity is not often attributed to competition or norms. In corporate law however, comparative evidence illustrates that U.S. states are very similar to one another, even though other advanced jurisdictions have found very different ways of structuring corporate governance. William Carney codified the European Union directives on corporate governance.[160] He identified 131 independent provisions applicable across European Union countries, and found that 14 were in effect in all 50 states, 95 were in effect in no US jurisdiction, while the remaining 22 were adopted by "what appears to be a random number of states."[161] This bimodal distribution of state adoptions of potential corporate law provisions underscores the uniformity among U.S. states. It of course remains possible that there exists a single correct form of corporate law for the U.S., which is different from the single correct answer for the E.U., because of differences in the degree of ownership concentration, differences in the size and liquidity of financial markets, and other differences between the two jurisdictions.

However, the adoption of "western" corporate law by transition economies is perhaps the strongest evidence that corporate law is not a functional response to underlying economic and societal needs, but is instead heavily influenced by other jurisdictions' choices. There is clearly general convergence of former socialist countries to the corporate laws of modern capitalism. "'Ltd.' in its various linguistic permutations, resonated with connotations of modernity and

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[160] *See* William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303 (1997).
[161] *Id.* at 319-20.

change."[162] EBRD performance surveys score this progress more systematically, and indicate substantial convergence.[163] Whether these countries are converging to one or to multiple models requires a more detailed study, but there is some first evidence that some former communist countries are turning to European models, while others are adopting American ones. New entrants to the European Union had to adapt their laws to EU regulations and directives on a broad set of issues, including company law. However, countries aspiring to E.U. membership, whose prospects of E.U. membership are often very distant, are also reforming their corporate laws in a similar manner. Craig Averch and his collaborators note that in countries where USAID has had an active presence, namely Armenia, Kazakhstan, the Kyrguz Republic, Latvia, Moldova, Russia, Ukraine and Uzbekistan there is a strong resemblance between the laws adopted and their U.S. equivalents.[164] Under a competition model, all transition countries might be expected to be competitors with one another, and thus to be converging to a single equilibrium. How radically different the two models are, and whether material, in addition to ideational factors account for the divergence, requires further study.[165]

What does uniformity indicate about the process of corporate law development? Uniformity in corporate law texts is a clear sign that, at a minimum, the last step of the corporate law making process involved direct copying. Such evidence would be consistent with an interest group theory, only if we believed that different combinations of interest groups in different states agreed on exactly the same substantive corporate law details, and simply borrowed phraseology

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[162] Stephen Petri, *Ten Years of Living Legal Transition: An EBRD Lawyer's Perspective*, in EBRD LAW IN TRANSITION, *supra* note 56, at 33.
[163] David S. Bernstein, *supra* note 56, at 16-17.
[164] Craig Averch, Hsianmin Chen et al., *The EBRD's Legal Reform Work: Contributing to Transition*, *in* EBRD LAW IN TRANSITION, *supra* note 56, at 37.
[165] A large loan conditional on a particular technical reform is the paradigmatic material incentive. Technical assistance alone also costs money, but much less. It should therefore not be counted as a material incentive; theories about material incentives would have to be radically revised if states were thought to reform laws for very small benefits. EU membership is also a large material prize, but is conditional on a host of reforms, and may be a distant prospect for many transition countries.

to express the ideas they agreed on. However, it seems more likely that in borrowing text, jurisdictions also borrow content. Similarly, if there exist a range of possible solutions to corporate law problems, and these solutions are either uniformly accepted or uniformly rejected by the U.S. states, it seems unlikely that this result was the process of independent decisions in the 50 states. Imitation seems more likely. Therefore, uniformity in corporate law is more consistent with the race and the social learning theories, than with the interest group theory.

B. Corporate Law Quality

What implications do the race, interest group and social learning theories have for the quality of corporate law? When does good corporate law result, that is, law properly aligning actor incentives to maximize company value? And when does law favoring some interest group result, at a net cost to society at large?[166] Race-to-the top theorists predict good law across all issues. Social learning theorists are somewhat optimistic on this front – the correlation between legitimacy and efficiency determines how good the quality of corporate law will be, and it is likely that this correlation is positive. Interest group theorists are the least optimistic – interest groups lobby to gain special legal privileges at the expense of other constituencies, and this can often lead to bad law. In this account, good law will only on issues where public and interest group interests do not conflict.

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[166] The shorthand used here is that good corporate law is law that helps corporations run efficiently, and bad corporate law is law that contributes to inefficiency, often by granting particular groups benefits than on net cost the corporation more than they are worth. This definition does not imply that good corporate law leads to good or fair distributional outcomes; indeed, the reverse seems more likely. If the race theories are correct, the distributional consequences of corporate law development in a competitive system are problematic, in that firms' power over legislatures may be far greater than the influence less mobile social interests wield. The interest group theory where managers and lawyers are the relevant pressure groups gives no greater reason for optimism about distributional equity. Indeed, bad corporate law that grants disproportional benefits to workers might do the most to redistribute resources from riche to poor.

How would we know who is right? Direct examination of the process of corporate decision-making through the empirical analysis in Part II is one way of testing the plausibility of each of the three theories of corporate law development. Examining whether predictions of these theories that concern corporate law quality prove correct, is an additional way to test and develop the theories. Academics sometimes judge existing corporate law against normative ideals. While US academics are divided on many questions, it seems fair to say that corporate law works fine, except for some provisions that protect managers too much.[167] Indeed, very diverse comparisons in comparative corporate law systematically list the U.S. among countries with good corporate law.[168] Comparative corporate law scholars often ask not whether the U.S. model is a good model, but whether the U.S. model is the only good model, or whether other models could also succeed.[169]

How might each theory account for the relative success of U.S. corporate law? If the race-to-the-top theorists are right, the federal structure is key to U.S. success in the corporate law field. Therefore, we should expect to see worse corporate law in unitary rather than in federal systems, at least in federal systems that delegate substantial corporate law competence to their sub-units. If the interest group theorists are right, we should see worse corporate law where lawyers, workers, and managers are stronger. Mark Roe's comparative historical work indicates that strong labor, in combination with social democratic governments, accounts for ownership

[167] For some of the clearest voices in support of the US corporate law system, see Winter *supra* note 1, ROMANO, GENIUS, *supra* note 1, Hansman & Kraakman, *supra* note 1.

[168] For a discussion of various taxonomies of good and bad corporate law, and for a new proposal, see Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, HARVARD L. REV. (forthcoming 2006). For an empirical study examining corporate law quality in 49 countries, where good corporate law is defined as law that offers high degrees of investor protection, see Rafael La Porta, Florencio Lopez de Silanes, Andrei Shleifer and Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

[169] For different answers to this question, see Hansman & Kraakman, *supra* note 1, (arguing for the superiority of the Anglo-American model) and Gilson, *Controlling Shareholders*, *supra* note 168 (recognizing diverse corporate law models as successful). For a more general discussion of this question, see PETER HALL & DAVID SOSKICE, VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE (2001) (arguing that different varieties of capitalism are sustainable, because of complementarities between institutions in Liberal Market Economies and Coordinated Market Economies, respectively).

concentration in several European countries.[170] This research suggests that organized labor is indeed is a powerful shaper of corporate law. However, while U.S. workers are weaker than workers in many developed countries, U.S. managers are often considered stronger than managers elsewhere. Pay is one measure of the interest group strength, and as Michael Jensen, Kevin Murphy and Eric Wruck assert "the US is the undisputed trendsetter in executive compensation practices."[171] Additionally, the systemic position of managers in the U.S. is very strong. As Lucian Bebchuk and Mark Roe explain, diffuse ownership makes managers much more powerful in the U.S. than elsewhere.[172] This strong position of managers could count as evidence against an interest group theory of corporate law, as U.S. corporate law seems to have developed well despite the comparative strength of this interest group.[173]

If the social learning theorists are right, we should see better corporate law in jurisdictions that are most integrated in the system of social norms (assuming that efficient, rather than inefficient corporate law norms have become legitimate). The evidence that countries more integrated in the international system have better corporate law is overwhelming, but many other factors could lead to this correlation – developed countries outperform others on almost any indicator. The eagerness of former communist countries to join the international community and adopt its models of comprehensive corporate laws, containing provisions for corporate governance and shareholder rights, and defining director and officer duties, provides some modest support that integration in a community and acceptance of its very specific norms about corporate governance go hand in hand.[174]

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[170] *See generally* Mark Roe, POLITICAL DETERMINANTS, *supra* note 30.
[171] *See, e.g.,* Jensen, Murphy & Wruck, *supra* note 67, at 2.
[172] *See* Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Law and Governance*, *in* CONVERGENCE AND PERSISTENCE 98-99 (Jeffrey N. Gordon & Mark J. Roe, eds., 2004).
[173] For a more elaborate discussion of the strength and relevance of labor as an interest group, *see infra* TAN.
[174] *See* EBRD, *supra* note 56, and Graphs 4 &5 in Section II.B.

In summary, direct evidence on which theory correctly predicts the observed quality of corporate law is not conclusive. Below are a few more tests that might help to investigate this question further.

Europe might be the next testing ground for theories of corporate law development. Examining how European countries' laws on issues covered by directives and on issues not covered by directives compare. While the competition theory would predict that the latter set of issues would see better law on average, the norms theory might predict the reverse.[175] What happens in the Europe Union after the European Court of Justice's *Centros* decision should also be helpful – if the race theorists are right, a race changing corporate law dramatically should result.[176] If the social learning theorists are right, *Centros* need not trigger any changes.

Finally, we might want to compare corporate law quality to other costs and benefits jurisdictions impose on firms. If the race theory is correct, we should expect a positive relationship between corporate law quality and corporate franchise tax rates, ceteris paribus. As discussed above, the race theory predicts that governments should be able to extract a premium for providing this higher quality law. If an interest group theory is correct, we should expect a negative correlation between corporate law quality and corporate franchise and income tax rates – countries that favor corporations over other societal interests should do so using various tools at their disposal, including their ability to lower tax rates. Similarly, a norm theory might predict

[175] Analogous tests are of course possible for the U.S., where the quality of state corporate law and quality of federal law that regulates corporations are often juxtaposed. If however U.S. states are operating more and more in the shadow of federal intervention, as Mark Roe has argued, see Roe, *supra* note 5, whereas E.U. states retain more substantial decision-making autonomy, the E.U. becomes a better testing ground for theories of state competition, politics and learning.

[176] The European Court of Justice *Centros* decision unleashed the possibility of sharp competition between E.U. member states, on aspects of corporate law where E.U. legislation did not offer harmonizing principles, and thus made the study of how firms and states respond to such a situation worthwhile. *See* Centros Ltd. v. Erhverus-og Selskabssysstyrelesen, case no. C. 21/297, March 9, 1999 2 CMLR 551. *See also* Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, in CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE 151-57 (Jeffrey N. Gordon ed. 2003) (discussing *Centros* and its implications).

such a negative correlation, splitting jurisdictions into two groups: jurisdictions that accept corporate friendly norms, and combine high quality corporate law with low taxes, and jurisdictions that have anti-corporation norms, and combine low quality corporate law with high taxes.

C. Effectiveness of Non-binding Standards

What role do binding and non-binding external standards play in the various theories? This question is critical to reformers interested not merely in observing corporate governance, but in effectuating change. Binding standards might take the form of federal regulation or international treaties; non-binding standards take the form of recommendations by professional associations or international bodies. In the race theory, binding standards matter; non-binding ones do not. Binding standards can stop the race, while actors retain every incentive to "cheat" and outperform competitors who have adopted the non-binding standard. Similarly, in the interest group theory, binding standards can change actor incentives; non-binding ones at best modify superficial rhetoric. In the social learning theory, both binding and non-binding standards shape behavior; indeed, binding standards draw some of their power from the aspirational goals they enunciate. The comparison of the theories must concentrate on the non-binding standards, because it is here that the major differences in their predictions lie. In the U.S. context, examining non-binding standards also offers a possible way out of the fierce debates between those who advocate state determination of corporate law issues as opposed to federal intervention.

The success of the model code in the US is evidence of the importance of non-binding standards. As discussed above, it has been widely adopted across U.S. states.[177] It is hard to explain the widespread adoption of its provisions through a classic interest group model. One would have to assume a very high degree of uniformity among interest groups in different U.S. states, to argue that almost identical groups pushed for almost identical laws.[178] It is possible to do so under a race-to-the-top model, but here we should witness an unstable equilibrium, whereby competitors settle on this code for a while but then seek to gain advantages by improving on the standard. We would see constant change, rather than big shifts when the code changes followed by stability. It would also be difficult to square the dominance of the model code with the argument that other states are competing with Delaware – presumably if this were the case, they would copy Delaware law.

International organizations have been dispensing advice on corporate law issues for quite a while. While the EBRD was established in 1991 with a mandate that included assistance with legal reform in transition countries,[179] at least as of 1997-98, the IMF and the World Bank also began demanding good corporate governance.[180] There is ample evidence that these countries are indeed following international organization proposals in developing their corporate laws.[181] The strongest argument that could be made for the competition thesis is that they are actually doing so to attract foreign investment. As discussed in Section II.B. above, this is not necessarily consistent with comparative evidence that FDI and corporate law improvements do not correlate positively.

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[177] *See supra* Section III.A..
[178] The data used for the regressions above belie this assumption, and indicate, for example, that unionization rates vary dramatically across U.S. states.
[179] *See* Hans Corell, *Celebrating Ten Years* of Law in Transition, in LAW IN TRANSITION, *supra* note 56, at 1 (2002).
[180] *See* Gilson, *supra* note 176, at 131.
[181] *See generally*, EBRD, LAW IN TRANSITION, *supra* note 56.

In summary, non-binding standards seem to work, as the social learning theory predicts, and contrary to the predictions of other theories.

IV. CONCLUSIONS

This paper proposes a new social learning theory of corporate law development, and presents substantial evidence that it more correctly explains corporate law adoption among U.S. states than the alternative race and interest group models. Sociological studies whereby corporate managers adopt anti-takeover tools only when these have been legitimated, similarities among state anti-takeover statutes, and the S-shaped pattern of cumulative adoptions of state anti-takeover laws establish the plausibility of the social learning model. Multivariate regressions in which neighboring states are shown to have significant and large effects on one another's choices further support the social learning model. Preliminary support for the social learning model in explaining the adoption of corporate laws in post-communist countries comes from data correlating corporate law quality to distance from the West.

Support for an interest group model is mixed: manager strength and union strength are linked to early adoption of some, but not most, of the anti-takeover statutes examined, while lawyer strength never seems to matter. This paper's evidence does not support the race model. While anti-takeover laws are probably the most challenging cases for theories of inter-state competition, the race model's assumptions and evidence have been challenged in this and other papers at many additional levels.

The stakes for identifying a persuasive explanation for corporate law development are high. Such investigations further the academic debate, where the dominant race theory has been severely questioned but no coherent alternative has been developed in its place. Politically, the

social learning theory implies a different solution to the debate on whether corporate law should be formulated at the federal or the state level. Non-binding standards might have the power to change the nature of state behavior without the high political and self-determination costs that federal involvement in corporate law would entail. At the same time, while corporate laws can diffuse rapidly across states, there is no guarantee that this will lead to efficiency gains. If social learning also influences the international diffusion of corporate law, then the strategies of international organizations can shift from costly sticks and carrots to softer measures of knowledge transfer and technical assistance.