Delaware's Politics

Mark J. Roe

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mroe@law.harvard.edu

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Abstract

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

The interest groups and ideas in play in Delaware are narrow, those in Congress wide. Three key public choice results emanate from that observation. First, interest groups powerful enough to dominate Delaware lawmaking forgo a winner-take-all strategy because state-level losers can call for federal action and either ally there with new interest groups or appeal to ideas not in play in Delaware. Second, the major state-level players usually want to confine federal authority in making corporate law, because a local deal cuts in fewer players; a federal deal splits the pie with outsiders. Third, we can delineate the space in which the states have room to maneuver and where they risk federal action.

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

I then analogize the relationship between Delaware and Congress to that between federal agencies and Congress. Federal agencies have discretion and first-mover advantages, but their independence even when wide is confined, ending when they provoke Congress. So it is with Delaware.

The interstate race is overrated as the chief structural determinant of American corporate law. Without taking account of how Congress and Delaware interact, we cannot see core characteristics of American corporate law. And to understand that federal-state relationship, we must grapple with the how the interest groups and ideas in play in Delaware differ from those in Congress.

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INTRODUCTION

Corporate law analysts have grappled with the nature of interstate competition for corporate charters since the large modern corporation appeared a century ago. Are states racing to the bottom, demeaning the public interest by pandering to firms and their organizers, just to sell corporate charters for a few dollars? Or are they racing to the to, competing to make better corporate law, like businesses struggling to sell a better product? As important as the race might be, I argue that its direction—to the top or the bottom—may well be no more important to the content of American corporate law than the often-overlooked relationship between Delaware and the federal government. it is not as central in determining American corporate law as both sides see it. The less-analyzed structure of the federal-Delaware relationship deeply affects the content of American corporate law. Here, I analyze the public choice structure of that federal-state relationship.

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

Differing private interests and differing conceptions of the public interest are in play at the state and federal levels. How the two levels interact can determine whose interests and which ideas dominate American corporate law. When Delaware fears a federal trump, the interaction can shape what it does. When it acts in a way managers and shareholders both find satisfactory, neither calls on Congress to act and federal policymakers find it hard to put the issue on the congressional agenda. And, when Congress is quiet, broad political concerns stay out of American corporate law.

Delaware's primary interest groups are shareholders and managers. A common view is that managers and insiders have the upper hand. This may be true, but then it begs the question why Delaware doesn't always capitulate to them. The federal overlay helps us to understand why. The state-level losers can appeal; or capitulation may goad federal policymakers to act. Those possibilities push Delaware to arbitrate—often

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via fair-minded judges—between its two main groups, not just because it's plausible policy, but also because it gives a disgruntled loser recourse.

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

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

* * *

We can build this federal-state public choice story up from the ground with Delaware's franchise tax as the foundation. The tax is the prize for winning the interstate race, with many seeing it bonding Delaware to make good corporate law. But bonding isn't the whole story: The tax shapes who counts in making American corporate law. It enhances managers' and shareholders' joint authority—they're the players who can take that $600 million annual pot of gold away from Delaware—while demeaning outsiders' influence. Those outsiders often have a regulatory agenda, and excluding them weakens that agenda, making possible a contractarian model to American corporate law. National ideologies and policy goals of enhancing capital markets and competition (potentially at the expense of managers and shareholders), or of fostering a populist-style leveling of corporate authority, have little weight in Delaware because they don't directly threaten the franchise tax. Congress though is not so limited, and these ideas weigh more in Congress than in Delaware.

Traditional analyses look at who, between managers and shareholders, has more muscle in controlling franchise tax revenues, through their ability to control the reincorporation decision. These inquiries are important, but incomplete. *Both* managers and shareholders—but no one else—must approve reincorporation out of or into Delaware. Thus I reinterpret the franchise tax here in public choice terms: it empowers managers' and shareholders' interests in Delaware, and denigrates everyone else's.[1] It sets, or helps to set, the agenda for making American corporate law. If a rule works for managers and shareholders, it'll fly in Delaware. If a proposed rule offends them both, it won't. And that simple fact may be a central, perhaps even *the* central, determinant of American corporate law.

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

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

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

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

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

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

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

In Part V, I relate this analysis to key theoretical issues. I show how this federal-state structure makes corporate law's contractarian paradigm—that corporate law is, or should be, the contract that investors and managers want—plausible. And the internal

affairs norm—that states should make the rules governing the corporation's internal relationships—is a public-regarding concept that, when respected, pushes the federal interest groups and ideologies away from making American corporate law.

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

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

I. THE RACE

Corporate law, as the longstanding academic tradition has it, is made in a market—one of competing states.

A. States Fight for Chartering Revenues

States, eager in the race-to-the-bottom view to grab the franchise tax from corporations, seek to please the managers of large firms, by making corporate law that maximizes managers' wealth and discretion.[2] In contrast, in the race-to-the-top view, states that burden their firms' operations raise those firms' capital costs, as eventually capital markets see that the firms are weaker and earn less than similar firms from pro-shareholder states. Over the long-run managers realize that they are weakening their firms by reincorporating into that bad-law state, the pot for managers and shareholders to split shrinks, pushing the players to move to states with more efficient corporate law.[3] Bad corporate law might persist in a state, but one way or another the firms incorporated under that bad law would not.

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

[3] Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 21 (1993); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913 (1982). Parallel political science work has powerful political centers damaging markets, while peripheral competing political entities keep them. Barry R. Weingast, *The economic role of political institutions: Market-preserving federalism and economic development*, 11 J.L. ECON. & ORG. 1 (1995).

B. The Federal Trump

But federal authorities can, and do, confine state competition. They have often made rules—such as vast parts of the securities laws—that are functionally part of America's corporate law. They could do more, were they so inclined. In nearly every decade of the twentieth century the decade's major corporate law issue either went federal or federal authorities threatened to take it over—from early 20th century merger policy, to the 1930's securities laws, to the 1950's proxy fights, to the 1960's Williams Act, to the 1970's going private transactions. That history gives Delaware good reason to fear federal preemption on big issues, and it's often shown itself aware that federal authorities might act. Even when it just reacts to national public opinion, it's thereby suppressing its usual contractarian mode for the larger concerns more common on the national level. Elsewhere I analyzed the frequency of federal action, and of Delaware's consciousness that it risks federal action.[4]

C. Delaware as a Quasi-Federal Agency

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

I sketch that picture in the rest of this article. Instead of seeing corporate law as made in state-to-state close combat, imagine—the extreme end of the contrast—that only Delaware and Washington count. Delaware often acts first. Federal lawmakers can then overturn what Delaware does. Usually they don't, but they always could, and that possibility limits state power in making corporate law. Delaware has autonomy, but only if it doesn't goad the federal behemoth. If we can conceptualize the bases for

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[4] Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003). Others pointed to federal authority as tempering the race, although often dismissing its strength and persistence, or limiting its scope to one area of corporate lawmaking. William W. Bratton, *Corporate Law's Race to Nowhere in Particular*, 44 U. TORONTO L.J. 401, 419 (1994); John C. Coffee, Jr., *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 759, 768 (1987); Melvin Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1512 (1989); Arthur Fleischer, Jr., *"Federal Corporation Law": An Assessment*, 78 HARV. L. REV. 1146 (1965) (federal disclosure rules control fiduciary behavior); Mark J. Roe, *Takeover Politics*, in THE DEAL DECADE 321, 340–47 (Margaret Blair ed., 1993) (federal influence on Delaware in making takeover law).

[5] See Mark J. Roe, Delaware's Advantage (working paper in progress, 2005).

when and why federal authorities displace Delaware, we will have gone a long way to understanding the fundamental structure of American corporate law.

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

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

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

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

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

A. In Delaware: The Franchise Tax

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

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

Consider these observations from an astute Delaware player:

> Delaware corporate lawmak[ers] … [are] acutely sensitive to constituency input. [They] amend the corporate law rapidly when there is a demonstrable [corporate] consensus … . [T]his process breaks down when Delaware's corporate constituency is divided … . [Yes,] Delaware responds reflexively to corporate managers, but ... [i]f Delaware law does not … protect[] … investors … it will eventually lose its dominance.
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> … [And i]n areas where a consensus emerges that there is a need for greater clarity or certainty, Delaware's Corporate Law Council will generally draft and obtain swift passage of legislative amendments. When there is no consensus, however, they will not.[6]

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

Why they don't lobby Delaware is worth investigating, although I don't here. They might believe they couldn't outbid a united managerial-investor lobbying group. Or they might believe that no amount of normal lobbying would overcome the Delaware polity's goal of keeping that franchise tax bonanza; since they can't get to the minimum ante—$600 million annually—they might think, why even try to lobby Delaware? Whatever the explanation, we can observe that these groups don't influence Delaware corporate law directly.

General public opinion—important to senators running for re-election—is only a distant, indirect concern for the Delaware chancellor or legislator. National opinion polls might sway a President or Senator worried about his or her overall program, or re-election. But Delaware players can disregard a national opinion poll about, say, executive compensation. When national opinion flares up and does influence the Delaware decisionmakers, we may be seeing indirect federal influence at work, as Delaware suppresses its local contractarian model to avoid offending national opinion that might spur changes from the top.

And public-regarding institutions such as the Federal Reserve, the Council of Economic Advisors, Congress's General Accounting Office, or the SEC are weighty at the federal level; but there's nothing analogous in Delaware. Such public institutions don't influence the Delaware legislature directly; Delaware has built no regulatory agencies that regularize public-regarding inputs. Its mode of regulation—ex post fiduciary duties, not constant oversight—reflects the desires of Delaware's key interest groups. Others might want continuous regulation, but neither populists nor economists count for much in Delaware.

The structure of Delaware corporate lawmaking doesn't bring in other groups. Bar advisory committees do propel the Delaware legislature, but the Delaware bar

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

typically represents managers and investors. Judges need a case or controversy in order to act, and it's the corporate players who have standing to sue, not the broader public. No regulatory agency makes forward-looking rules in Delaware. No Delaware prosecutor scrutinizes corporate America to throw wrongdoers in jail. Delaware could build a prosecutorial office or a regulatory agency to empower other interests or ideas, but it doesn't.

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

B. In Congress

Switch to Washington. In Congress, the range of interests with clout widens beyond just investors and managers. And, for some, public-regarding visions of how to allocate authority inside the corporation would be in play.

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

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

But in Congress, the players and ideas differ. Managers and employees might ally to confine shareholder power. In a national democratic forum, managers might

[7] More precisely, firms would exit if Delaware offended two groups of managers: those managing firms and those running stockholding institutions. The Delaware deal may not correspond to what ultimate investors would agree to with industrial managers. It is what investors' two types of managers—financial and industrial—want. See Mark J. Roe, Delaware's Advantage (working paper, 2005).

want an ally with many votes.[8] In a small local forum like Delaware that depends on corporate tax revenues, managers don't need those votes and, because employees in Ohio and Pennsylvania don't vote in Delaware, can't get them anyway.[9] Interest groups that can't take the franchise tax away from Delaware still can play a role in Congress. The AFL-CIO comes to mind, as do public interest lobbying groups.[10]

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

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

More goes on in Washington than wider coalition possibilities. Public-regarding policymakers in Washington see themselves as custodians for the overall health of the American economy; they could conclude that tight managerial accountability—beyond that which even interests institutional investors—would be best for the economy. Congress wants strong capital markets and a healthy economy. The White House's Council of Economic Advisors influences the President, the GAO writes reports, and the SEC often proposes rules that managers and institutional investors dislike. Public-regarding views can influence Congress when public servants, like the SEC, the GAO, the Council of Economic Advisors, or the Federal Reserve weigh in. None of these players has the same clout in Delaware.

Public-regarding need not, as I am using it here, be identical to being in the public interest. Congress might react to headlines, might want to be seen as acting on the volatile issues of the day, and might not have long-term national well-being uppermost in mind. Reaching toward the public interest is only a subset of public-regarding actions. Nevertheless, two broad currents of thinking can flood through

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

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

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

[11] [Cf. shareholder access.]

Washington and carry Congress away: populist public opinion and public-interested thinking. Neither is as important in Delaware.[12]

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

III. SEQUENCE

A. Abstractions

1. The narrow result when Delaware acts. Managers and shareholders obviously have much in common. When their interests coincide, they get what they want in Delaware.[13] Presumably they can often succeed in Washington too. Even so, they would be wary of Washington, where they'd have to pay to pacify the national interests who'd want something from the corporation—even if it's only by giving up something elsewhere on their agenda to get the corporate law that they want through the Congressional maze. When the two groups agree, it's easy to see why they prefer Delaware to Washington. I analyze here primarily what happens when they disagree and how the federal presence moderates Delaware.

Suppose Delaware is to decide an issue of managerial autonomy. Figure 1 illustrates a spectrum of autonomy. The right side is profit-oriented, representing only that much autonomy that produces profits; the left side is maximum managerial autonomy. Assume for now that Delaware favors managers, as represented by the point on the left, D. Were the policy arena purely local, managers could take it all and get Delaware's law to reflect managers' preference.[14]

A more realistic illustration would draw in Delaware's corporate industry: the lawyers, government officials, and others who profit from Delaware's corporate

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

[13] Cf. Strine, supra note 6, at 1268-70.

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

business.[15] And it would more realistically recognize that Delaware pays attention to what other states are doing. But we leave these factors out of the picture to begin simply, and then add federal influence. And, yes, it's not just the legislature that makes Delaware law, but also its courts and its bar association committees that recommend results to the legislature. We simplify here too, collapsing all of Delaware's lawmaking institutions into its legislature. Its judges cannot persistently offend the legislature; the legislature appoints the judges, whose propensity to play ball is known when they're appointed. They're vetted by bar association committees and have a prior career. Similarly, the SEC and federal authorities make federal law, but they cannot stray too far from congressional will. We thus simplify lawmaking to two bodies: The Delaware legislature and the United States Congress, each with loosely controlled affiliates.

Figure 1. One Issue in Delaware

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

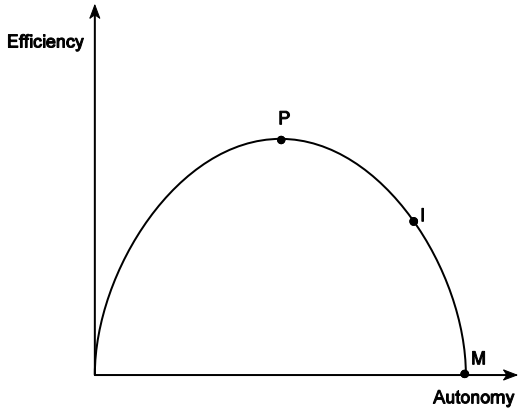

Figure 2. The Trade-off of Autonomy and Efficiency[16]

Begin with public policymakers and, for now, ignore populist interests. Consider Figure 2. Managerial autonomy increases on the x-axis, economic efficiency

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

[16] Managers obviously don't want efficiency at zero. We could have extended the y-axis so that M is at, say, 80% of maximum efficiency, or we could define the origin as starting at 80% of maximum efficiency. I've blanched out much from firms and politics to get us to a two-dimensional graphic. If the graphic doesn't quite seem vivid on the Autonomy dimension, replace it with Executive Pay.

on the y-axis. We start at the origin with satisfactory efficiency, at, say, 80% of what's technically possible. More managerial autonomy initially increases efficiency, because managers need more freedom to maneuver, to decide, and to take risks. But too much autonomy eventually isolates them from outside pressures. Efficiency declines. The curve rises, peaks, and then falls. The space inside the parabola is attainable in the economy; the space outside it cannot be reached. We posit public policymakers, P, who seek to maximize efficiency and do so capably. They prefer the maximum attainable efficiency, at point P. Self-seeking managers seek autonomy, at point M. Investors want profits.

Under the federal policymakers' preferred policy, P, profits might not be as high as at other points on the parabola, and so shareholders would not want exactly what policymakers want. Profits and efficiency are not identical. (Think of cartel arrangements and monopolies, which raise profits but are not necessarily efficient.) Moreover, managers run institutional investors, not the ultimate stockholders. Policymakers might want engaged investors sitting in corporate boardrooms, in the hope that they could increase corporate efficiency.[17] But managers at institutional investors might dislike that burden. While they don't directly value managerial autonomy in their portfolio companies, they know that there's some spillover: tightening the slack in the operating firms induces some tightening of slack in the institutional investors' firms. And even if their engagement initially produced more profit, that profit would in time be competed away, to the benefit of the economy as a whole, not shareholders. Hence, although the investors, I, don't seek to maximize social efficiency, they want profits more than do managers. Their ideal point is at I, between P and M on both axes, a bit closer to P than to M.

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

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

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

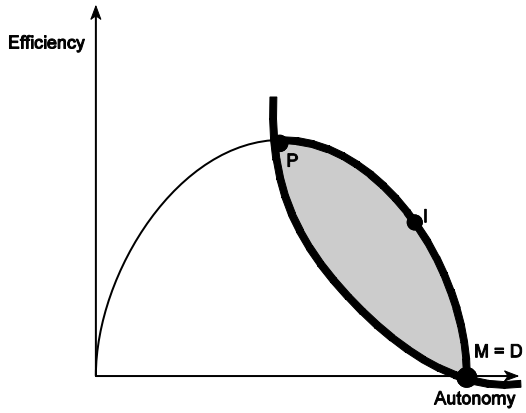

Figure 3. The Ease of a Federal Counter-Coalition if Delaware is Immoderate

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

An M=D result in Delaware is unstable.

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

So, why doesn't Delaware just let the winner take all as in Figure 1? Managers we assume have enough power in Delaware to take all the marbles there, moving its law to the left-hand corner of Figure 1. Shareholders cannot reincorporate out of Delaware without managers' assent; Delaware already has 50 to 60% of the incorporations. And, yes, while there's a stream of future reincorporations that Delaware wants over the long run, politicians are often shortsighted.

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

True, Delaware lawmakers may want to make good policy, and rules in the middle might be good policy. For a California-chartered firm to reincorporate to Delaware, it needs its shareholders' and not just its managers' assent, so Delaware has a long-run reason not to be seen as anti-shareholder. Perhaps these reasons are enough to explain why Delaware does not defer totally to incumbent managers.[19]

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

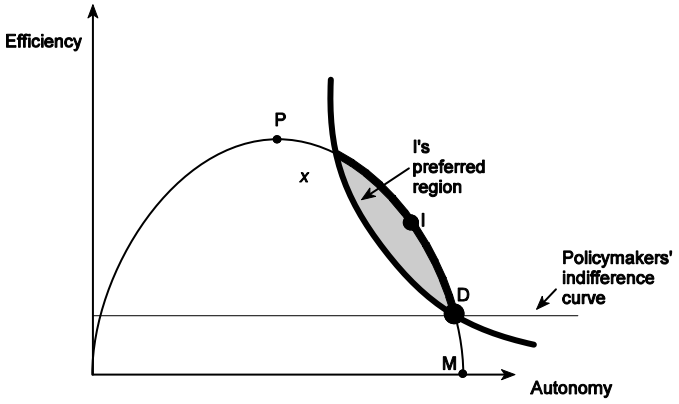

Figure 4. Moderation in Delaware Stymies an Easy Federal Counter-Coalition

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

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

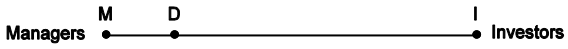

Figure 5: The Delaware Deal in the Federal Shadow

Delaware's moderate takeover law exemplifies how the federal threat tempers its lawmaking. Delaware passed its takeover law in the late 1980s, after most other states had enacted tough antitakeover statutes. Delaware legislators asked why they

[19] ROMANO, supra note 3; Robert Daines, *Does Delaware Incorporation Improve Firm Value?* 62 J. FIN. ECON. 525 (2001) (Delaware law enhances shareholder value by as much as 5%).

shouldn't entirely shut down hostile takeovers for Delaware targets. Managers seemed to have a winning hand in Delaware, yet Delaware passed a moderate law. Consider how the law's primary drafter reacted when confronted with that question:

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

Even when managers had the votes in Delaware, shareholders had clout in Reagan-era Washington, and, on an issue of national importance, shareholders if defeated in Delaware might have appealed to Washington, where the play of interests differed and the outcome was uncertain. At the time, powerful policymakers in Washington favored takeovers. Perhaps the takeover moderates would have lost on the federal level, but the antitakeover forces didn't want to take that chance.

Nor was this interplay on takeovers between Delaware and the federal authorities a single, isolated one: When the SEC disliked state rules on going-private transactions, it announced new rules of its own, took to the bully pulpit, and induced Delaware to change.[21] When it disliked Delaware's validation of a targeted buyback in a takeover, it propounded its all-holder's rule that reversed the Delaware result.[22] As Delaware's Chief Justice said when Congress considered massive corporate legislation in reaction to the Enron scandal (which it eventually enacted): "[if] we [in Delaware] don't fix it, Congress will…."[23] These are some examples; there are more.[24]

4. How Delaware diminishes the congressional deal space. More is going on than just Delaware moderating itself in the shadow of potential federal action. Consider next when and why Congress won't displace some Delaware deals but will displace others. Return to Figure 3, which illustrates a managerial-investor compromise instead of a winner-take-all result. As John Ferejohn and Charles Shipan have said in a parallel context:

> When congress delegates authority to an [administrative] agency, it permits the agency to make the first move: to establish a policy … [that], if it is not preempted by [further] legislation[,] … will be the policy that prevails.
>
> … [T]he key to analyzing [this] type of policy-making is … [to examine its] sequential structure.

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[20] Hearing on H.B. 396 Before the Delaware H.R., 134th Gen. Assembly (Jan. 26, 1988) (testimony of A. Gilchrist Sparks III, chairman of the Delaware Bar Ass'n Corp. Law Council), audiotape, as reported in Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 741 n.230 (2002) (emphasis added).

[21] Roe, supra note 4, at 616-21.

[22] *Proposed Amendment to SEC Tender Offer Rules*, 17 SEC. REG. & L. REP. (BNA) 1320, 1321 & n.5 (1985).

[23] Charles Elson, *What's Wrong with Executive Compensation?* HARV. BUS. REV., Jan. 2003, at 68, 77 (comments of Chief Justice Veasey).

[24] See Roe, supra note 4, at 607-34.

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

Begin with the Delaware compromise in Figure 4 and examine the space above I's indifference arc through P, marked by *x*. The *x*-P region *is no longer attainable in Congress*. Why? If the two big players do their deal in Delaware, they do not want to move to any point further from their indifference limits. *The two can unite to defeat points like x in Figure 6*. The region close to P is out of bounds after Delaware acts.

If policy *x*, or indeed P, reached the national agenda *after* Delaware had acted, one would hear that it wasn't within the SEC's authority, that it would upset the traditional federal-state divide, that it would violate internal affairs norms, that corporate law should be left to the states. Yet had *x* or P come up *before* Delaware acted, it would be a possible outcome in Washington. Washington's slowness and the many veto points that stop it from acting make possible a real federal-state interplay.[26]

When managers and investors set the agenda in Delaware, we get D. If federal policymakers set the initial agenda, we'd be more likely to get corporate rules approximating *x*.

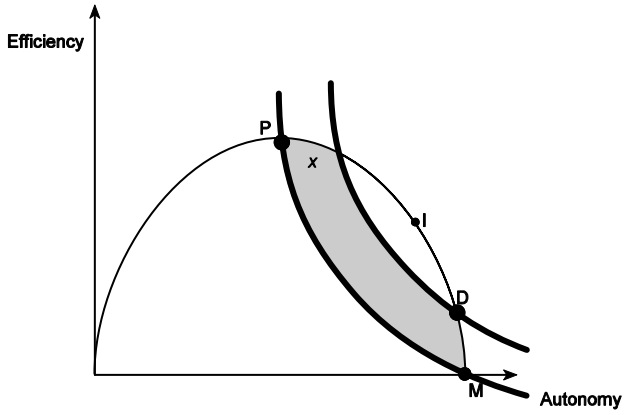

Figure 6. The Constricted Deal Space in Congress After Delaware Acts

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We now have two institutional results. First, Delaware, fearing federal action, won't be extreme. Even if corner results could pass in an isolated Delaware, they won't in a Delaware with its eye on Congress. The looming federal threat puts about half of the Delaware line—that portion which would most offend managers or

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

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

investors—off limits. Second, once Delaware acts, results that would previously have been possible in Congress are also put off-limits, because *both* Delaware incumbents disfavor them. A large fraction of what's possible in Congress—where national interests and ideologies are important—also moves off-limits.

5. Congress: Wide interests, broad ideas. Figures 2, 3, 4, and 6 portray the federal policymakers favorably: They seek the public good and they are competent. But many observers don't think so favorably of them when they make corporate law.[27] Analogous results arise even when federally policymakers make poor law, with Delaware motivated to be moderate its better law, and some space closing off in Washington when Delaware acts first.

So, we could have added other interests and ideologies, such as those of populists who want to level down power inside the corporation and give more incumbent employees. We add the new interests below the perfect policymakers point P at the top of the efficiency curve, in Figure 7 at P_o. The populists don't intrinsically dislike efficiency, but they are maximizing in other dimensions (raising wages, improving environmental quality, flattening corporate hierarchies, increasing affirmative action). These policies, even if they maximize social wealth, often take something away from investors and managers. Investors and managers, if P_o policies win out, have to cut a piece of the corporate pie for others.

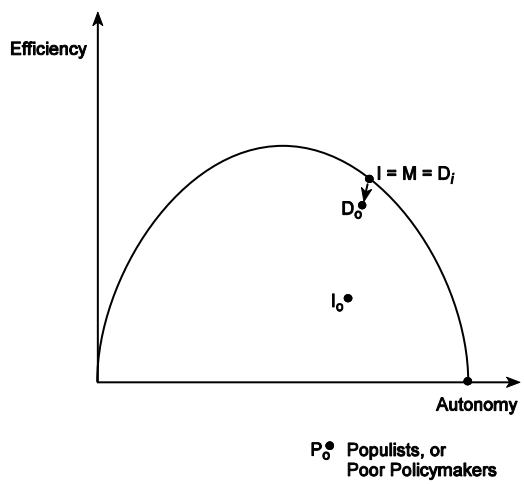

Figure 7. When Federal Policymakers Demean Efficiency

And we posit state law race mechanisms as pushing policy closer in Figure 7 to the optimal rules for the corporate players. Moreover, we align managers with investors sufficiently closely that $I=M=D_i$, which is well above P_o. Delaware is thus more efficient than would be the federal populist policymakers' preference. (We could also posit that investors, or at least some of them—I_o—are inside the efficiency vs. autonomy frontier, either because they are misguided, because they are headline-seekers without efficiency in mind, or because they are captured by other interests who seek to divert corporate value from shareholders and managers. Some say that the

[27] See, e.g., Romano, supra note 3; Winter, supra note 3.

public pension funds and the AFL-CIO funds fit this description.[28]) If managers get their best result in Delaware ($M=D_i$), then P_o and I_o might seek federal action. An uneasy coalition of populists and (activist) investors could displace the $M=D_i$ result. We could reach the same result if we just posited that federal policymakers were more often than not mistaken, thereby demeaning efficiency when they acted. Wrongheaded policymakers at P_o could ally with I_o in Congress to try to overturn an $M=D_i$ Delaware result in Congress. Either way, Delaware and some of its interest groups thus have a reason to move inside the parabola to reduce the intensity of federal opposition. They choose D_o.[29]

6. The tax code and the corporations code. An intuition behind the geometry is at hand. If Congress made most corporate law directly, it would look more like the tax code the current corporate law in terms of the interests in play. Like the tax code, corporations and their governing law affect the broad mass of American citizenry, and Congress legislates public policy through whatever tools it has. It uses the tax code to promote exports, to promote research, to subsidize oil and gas exploration, to promote economic development in depressed areas, to better the environment, to subsidize medical care.[30] A national corporate code would be one more tool.

We need not go far back to find a concrete example: "Responding to widespread anxiety about the movement of American jobs overseas, Senator John Kerry … propose[d] … a sweeping revision of … [the tax code to induce] companies to invest more money in [jobs in] the United States."[31] Tax exemptions, deductions, credits, and rates are a fundamental part of American social policy. If corporate law were made in Congress, it would reflect more general public policy concerns, and broader interest group politics, than it now does.

7. Shareholders' and managers' interest in minimizing federal influence. Another public choice perspective can be seen here. Think of the managers and most shareholders as usually allied on how much corporate law should be made federally

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[28] See the discussion of the shareholder access debate infra note 60 & accompanying text.

[29] Superimposing the divided Washington in the center of Figure 8 onto the earlier diagrams of a moderate Delaware can be reinterpreted in political theory's veto terms: As long as Delaware is moderate, polarized veto players in Washington either veto a major shift from D, or fear a counter-coalition (P vs. P_o and M, say) that would shift the federal result farther from their preferred point. Philip Keefer & David Stasavage, *The Limits of Delegation: Veto Players, Central Bank Independence, and the Credibility of Monetary Policy*, 97 AM. POL. SCI. REV. 407 (2003).

[30] Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison With Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970); STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES (1985); Julie Roin, *Truth in Government: Beyond the Tax Expenditure Budget*, 54 HASTINGS L.J. 603 (2003); CONG. RES. SERV., COMM. ON THE BUDGET, TAX EXPENDITURES COMPENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS, 105th Cong., 2d Sess. (1998). Tax expenditures from the corporate tax are about $100 billion per year. Id. at 7. Since the Treasury gets about $200 billion from the corporate tax, U.S. TREASURY, THE BUDGET FOR FISCAL YEAR 2004, tbl. 2.1, at 29-30 (2004), the expenditure amounts to one-third of the potential total.

[31] Edmund L. Andrews & Jodi Wilgoren, *Kerry to Propose Eliminating a Tax Break on U.S. Companies' Overseas Profits*, N.Y. TIMES, Mar. 26, 2004, at 12; Deborah McGregor, *Kerry pledges corporate tax policy reform*, FIN. TIMES, Mar. 26, 2004, at __ ("Mr. Kerry presented his plan … in Michigan, a politically important state where 6.6 per cent of workers are unemployed and many manufacturing jobs have moved abroad.").

and how much by the states. They know that in Delaware they alone split up the corporate pie. Although I analyze here the federal-state interaction primarily when their goals differ, much of the time their interests are the same, and managers and shareholders are more likely to get their preferred results in Delaware's simple interest group environment than in Congress's complex one. True, when they differ, shareholders might conclude that they could do better vis-à-vis managers on a particular issue if it went federal. But they don't try to make a federal case even then, because the price of beating managers once at the federal level could be leakage to other groups absent from Delaware, in a way that would make shareholders' net benefit zero, or even negative.[32]

Figure 8 illustrates. The federal players are two: efficiency-oriented, competent policymakers at the top of the parabola, and populists deep inside the parabola. The policymakers care only about efficiency, so their indifference curve is a horizontal line going through D. They prefer the entire space above that line. The populists have a simple agenda here—they simply wish to reduce corporate power, approximately equivalent to preferring all points to the left of D. Their indifference curve is a vertical line running through D.

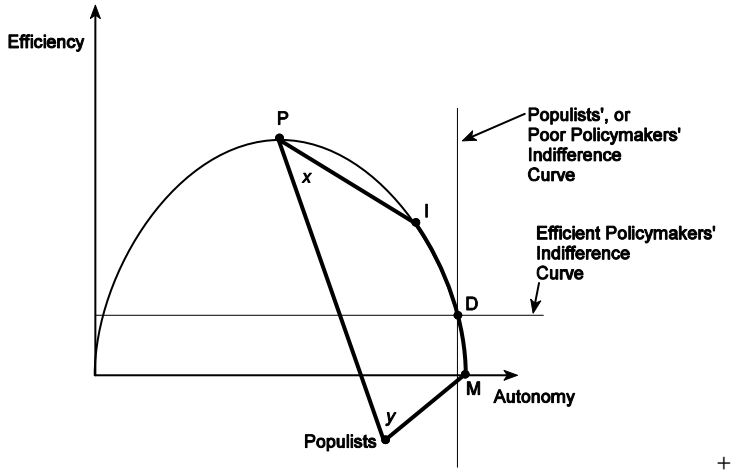

Figure 8. When Entering the Federal Arena Hurts Managers and Shareholders

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

And when managers' and investors' positions are the same, when M=D=I—or close—no federal action is normally possible. Two powerful interest groups can't do better in Washington, so they resist moving the game to Washington. Only when

[32] This could be illustrated with a standard prisoners' dilemma matrix. But I spare the reader—especially those who have worked through the graphics thus far—that matrix here.

overwhelming force—a major scandal or economic reversal—seriously empowers either the policymakers or the populists, or both, can the federal authorities act.

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

* * *

The overall situation militates toward the two primary groups being reticent to invoke federal authorities. Shareholders may on a particular issue conclude that they could do better enough in Congress to pay for the leakage to third parties who are weak in Delaware but strong in Congress. But they still might not go federal, fearing that if more corporate law were federal, more of the corporate pie would go to third parties on other issues. Consider this report of federal activity in an era less conservative than our own: "A *national* coalition of union, consumer, liberal and leftist groups is emerging with the purpose of starting a broad, aggressive attack on what the activists regard as flagrant abuses of corporate power. The activists list several goals, including … *citizen participation in corporate decision making*."[33] And, more recently, William McDonough, chairman of the Public Company Accounting Oversight Board told "a packed Washington ballroom … at the National Association of Corporate Directors' 2003 Annual Corporate Governance Conference" that

> The way democracies work, if the people say they want something, they'll get it. Nobody would have predicted Sarbanes-Oxley would have passed six months before it passed… . The American people are sufficiently angry that if the private sector doesn't get its act together … they're going to get Sarbanes-Oxley No. 2, No. 3, No. 4, and it will curl your hair. I have been asked by many members of Congress if I could figure out a way that they could pass a law controlling compensation.[34]

Free-rider effects might induce any individual Delaware player—an investor here, a manager there—to go federal on an issue especially salient to that player. But interest group associations temper individual action: the Business Roundtable for managers, the Council of Institutional Investors for one large class of stockholders, the Investment Company Institute for another. These associations can overcome free-rider calculations of immediate interest. For shareholders or managers to go federal and be effective, one or the other lobbying organization must swing into action.

8. Delaware's interest in minimizing federal influence. Delaware though—as distinct from its primary interest groups—might not care that Congress federalized some corporate law. So one might think that Delaware wouldn't care whether its law was at M or at D in Figure 4. After all, if Congress federalizes a law, Delaware need

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[33] William Serrin, *Coaltion Forming for a 1980's Drive Against Business*, N.Y. TIMES, Jan. 19, 1980, at 19 (emphasis added). [See Zachary Gubler, Corporate Governance Seminar Paper Outline (Jan. 15, 2005)].

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

not lose tax revenues: no one would flee Delaware because it lost an issue to Washington, because no other state can do better for managers and investors. Delaware loses corporate law, but not charters or taxes. And on some hot issues, Delaware's state apparatus might *prefer* federalization, which would level the state-to-state playing field by reducing other states' opportunities on the contested issue, thereby letting Delaware compete and win where it's stronger.[35]

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

Moreover, Delaware's primary interest groups—managers and investors—usually don't want corporate law to go federal. Nor do its secondary interest groups—its corporate bar and its corporate industry. They can all influence Delaware even without threatening to remove the franchise tax.

9. Efficiency? Efficiency-oriented analysts who think federal action would usually push corporate policy to better, more cost-effective corporate governance, more competition, more rewards to innovation—prefer more federal action.[36] Others fear well intentioned but *in*efficient federal policymakers—or fear interest group gridlock that would cramp corporate agility and prove costly to the economy. Still others would prefer corporations to have a wider conception of the public good—and more interest group input—than Delaware gives them. Views on whether more federal action is wise may depend not only on which outcome the speaker *prefers*, but also on which federal outcome the speaker *anticipates*.

Could the multi-level federal structure improve on single-level governance? If the state-level is defective, a federal overlay can ameliorate that drop to the bottom. If the federal level is defective, a quasi-delegation may narrow the interest group input and cabin federal corporate activity. By separating a proposal from ratification, the

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[35] Roe, supra note 4, at 637. Delaware's lawyers would prefer to keep the lawmaking local; national law tends to be practiced elsewhere.

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

structure could reduce the impact of the defects of each.[37] Congress can't decide everything; Delaware, with money to protect, has reason to avoid losing that money.

Such efficiency theories are plausible but disputable and hard to test. The two-tiered structure might not motivate Delaware toward efficiency. True, if federal actors are usually efficient when they are attentive, then their looming power ought to induce Delaware to be more efficient. But if federal actors aren't focused on efficiency, then Delaware players have reason to deter them on dimensions other than efficiency. If it's the random scandal that induces federal action, then Delaware has reason to market that it can control scandalous corporate matters. Public relations, not efficiency, becomes the issue. Conceivably the recent well-publicized trial on Michael Orvitz's $125 million paycheck from Disney is a Delaware show trial, one that shows that it's getting the corporate scandals—Enron, WorldCom, and executive pay—under control.

B. Examples

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

Here we look for concrete examples that fit these two federal-state public choice interactions. We've seen one already: the wide array of interests and ideas that work their way into the tax code, as would be common if corporate law were made in Congress.[38] There are others: antitrust, foreign corrupt practices, takeovers, state-law constituency statutes, and the incentives and actions of big-state public pension funds each point up how moving a corporate issue from Delaware to the federal arena would change the players and pressures. Some moved, some didn't. And whether they did or didn't move affected who won and who lost. More detail on each follows.

1. Antitrust. During the late 19th and early 20th century corporate law and antitrust issues intertwined, and states decided both. Several industries sought to stabilize shaky cartels with trusts, in which a centralized trustee held the stock of constituent companies and coordinated their production quotas. The trust form arose because states barred their corporations from owning stock of other states' companies. New Jersey, and then Delaware, passed corporate law that helped integrate disparate producers into a single company. This led the antitrust forces to call for a federal incorporation law and for federal antitrust enforcement.

The key state players were insiders and investors. Both wanted corporate law to facilitate monopolization and cartelization. They got favorable organizational law, first via the trusts. The trusts were clumsy, and some states—states like Ohio with players

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

[38] See supra p. 18.

beyond managers and investors, progressive players who preferred public-regarding policies—attacked them. But smaller states, like New Jersey and Delaware, streamlined their holding company rules, thereby allowing holding companies to overcome the trusts' weaknesses. Owners and insiders got what they wanted. On the small-state level, the progressives, public interest advocates, and anti-big-business players (TR, Sherman, and Brandeis) were weaker than they were in bigger states and in Washington.

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

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

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

But that bribery could undermine American foreign policy, so national policymakers might want to stop it for moral or nationalistic reasons. Moving the play from Delaware—silent on the issue—could, and did, change the range of players with power to decide, and preempted the state law result.

The antitrust and corrupt practices examples have a negative connotation for state insulation. In other settings Delaware's first-mover advantage could make for a more efficient corporate law than does federal corporate law. Depending on one's views of the policy matters, some of the following examples might be positive ones.

3. Takeovers? When hostile takeovers were important, managers—via the Business Roundtable and National Association of Manufacturers—opposed moving the decisionmaking to Washington, even when Delaware was not producing strong antitakeover rulings and statutes.[39] Raiders favored preemption, but shareholders generally were silent. And in Delaware, managers argued that Delaware should make moderate takeover law because something strong would risk federal intervention.[40]

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[39] *Witnesses at Takeover Bill Hearing Split on Preemption of State Regulation*, 19 SEC. REG. & L. REP. (BNA) 851, 851 (June 12, 1987).

[40] Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 908 (1990) (describing the merger bar's concerns that "passing this proposal would be the

4. Constituency statutes. Other interests are not always on the periphery of state corporate law, as they are in Delaware.[41] It depends on which state, and what issue. Consider constituency statutes. Many states have them; the statutes bring public forces into corporate governance, although only (as yet) via managerial discretion to consider interests beyond shareholders and managers. True, their effect has largely been to give managers even more discretion than they have had to oppose takeovers. State constituency statutes can thus be seen as managers going up from the baseline of the trapezoid in Figure 8, allying with employee and locality constituencies, to get rules that favor themselves over shareholders.[42] It's the kind of alliance Congress could produce.

For example, the percentage of a state's presidential vote that went Democratic in the 2000 election predicts whether the state will have a constituency statute.[43] Most states' polities resemble the national polity more than they resemble Delaware's; those states produce constituency statutes that give lip service to corporate law as being about more than just managers and shareholders.

Delaware has no constituency statute. That's not aberrational. An under-recognized part of Delaware's law is how little it defers to players outside the managerial-shareholder nexus. Said its Chief Justice recently: "Delaware's jurisprudence holds that the interests of stockholders are primary and may *not be trumped by* that of *other constituencies*, although those interests may be considered *if* congruent with the interests of the stockholders."[44] Some analysts, focusing on the "shareholders are primary" phrase, could overlook the important italicized phrase, "*not be trumped by … other constituencies*."[45]

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proverbial camel-back-breaking straw that would force Congress to enact national corporate chartering"). The well-known merger lawyer Joseph Flom as lobbying against an anti-takeover law partly because it could provoke federal preemption. Martin Lipton, the well-known *anti*-takeover lawyer, also lobbied *against* that same anti-takeover law. Id. at 906.

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

[42] Joseph D. Springer, *Annual Survey of American Law*, 1999 ANN. SURV. AM. L. 5 (1999) ("[The] 1989 amendment strengthening [Pennsylvania's constituency] statute was co-sponsored by the local AFL-CIO. …").

[43] Data available from the author. Also, consider two kinds of constituency statutes: one lets boards consider stakeholders during takeovers, another lets them consider stakeholders in every corporate decision. A higher Democratic vote is associated (in data on file with the author) with legislatures letting boards take into account constituencies in any situation but negatively associated with the type that frees the board to consider constituencies in takeover. One could interpret this result as follows: a Democratic state insists on the symbolism of the corporation as always run for constituencies. But in less Democratic states, managers can get a simple transactional constituency statute for takeovers without having to pay with rhetoric that brings in others outside of takeovers. Managers want maximum discretion in takeovers to protect their own jobs, but want minimal legislative intrusion into how they otherwise run the firm.

[44] E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—Or Vice Versa*?, 149 U. PA. L. REV. 2179, 2184 (2001) (emphais added).

[45] Cf. Simon Deakin, *Regulatory Competition versus Harmonization in European Company Law*, in REGULATORY COMPETITION AND ECONOMIC INTEGRATION: COMPARATIVE PERSPECTIVES 190, 214

More generally: Were corporate law usually in the federal arena, the federal authorities could be pressed to allow or to mandate directors to take into account non-shareholder concerns. Many states mirror some of the forces that would be in play in Congress. Forty-one states have constituency statutes,[46] and an active Congress made up of these forces could produce one. California legislators recently rejected—but considered—amending its corporate law to give corporate constituencies a derivative action to sue directors for violating environmental, labor, and affirmative action laws.[47] In contrast, Delaware can often insulate firms—or, more precisely, their managers and shareholders—from such direct pressures.[48]

5. CalPERS. The thesis here is proving a negative. Because corporate law is made in Delaware and Delaware is free from wide interest group pressures, we don't see those pressures on corporate law. But we can look for an institution that's a close cousin to state corporate law and see if it is subject to wider pressures: state pension funds. And there we see those pressures.

California is a big state; its huge public pension plan—one of the biggest stockholders in America—faces the mix of interests that would emerge if American corporate law were made primarily on the national stage instead of in little Delaware. Consider CalPERS' "double bottom line." When managing their stock portfolio, they look first at the return to shareholders. But they also look, says its president, to "producing some other good for the citizens of California."[49] New York's Governor appointed a task force during the takeover-era that endorsed similar policies.[50] Roberta Romano has shown that politically-motivated investment policies fall short of the market rate of return.[51]

Said a recent conservative chair of the SEC, after his tenure was over, state pension fund influence on the American corporation is to be avoided: "I think we will

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(Daniel C. Esty & Damien Geradin 2001) ("The current draft of the [EU's] Thirteenth Directive requires the board of a trarget company to 'act in the interest of all the company, including employment' when responding to a bid…. [Consideration was given to] requir[ing] both the bidder and the target companies to … consult[] with employee representatives during the course of the bid."). Other EU laws require this kind of jaw-boning consultation: "Such information and consultation rights already exist under EU law in respect of decisions for collective redundancies (The Trade Union and Labour Relations (Consolidation) Act 1992; Directive 75/129 on Collective Redundancies) and corporate reorganizations effected through a business transfer (The Transfer of Undertakings (Protection of Employment) Regulations 1981… ." Id.

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

[47] Cal. SB 917 (2004). Although not a real threat today, the point is that it's at the extreme end of what's considered in big states and, from time-to-time in Congress. [Wall St. Journal 1980 editorial.]

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

[49] Simon London, *The Boardroom Burden:Calpers chief relaxes in the eye of the storm*, FIN. TIMES, June 2, 2004, at 8.

[50] GOVERNOR [CUOMO]'S TASK FORCE ON PENSION FUND INVESTMENT, OUR MONEY'S WORTH 45-48 (1989).

[51] Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).

all be better off if we were spared the extension of our flawed political system to our corporate boardrooms[.][52] And more generally, Washington players have "advocated using public pension funds to finance infrastructure projects… ."[53] Such political pressures are weaker in Delaware.

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

> CalPERS currently owns $77,181,120 worth of equity shares in your company. … As a long term investor we believe that fair treatment of employees is a critical element in creating long term value for shareholders. … [Y]our corporation's blatant disregard for [employees' health care] and quality of life issues … is having a significant impact on our investment in your corporation. [W]e urge you in the strongest terms possible, to negotiate in good faith with the UFCW [the United Food and Commercial Workers union] and to provide a benefit package that enhances the productivity of your employees as well as the long term value for shareowners.[54]

CalPERS then sought to block reelection of Safeway's President and CEO to the Safeway board. The press, or at least the conservative press, thought that CalPERS was not acting in its beneficiaries' interest as stockholders, but was motivated by Safeway's labor policy.[55] CalPERS also invests in California's economically depressed areas and promotes environmental and other social issues in its portfolio firms.[56] Conservative legislators, unhappy with CalPERS' activities now seek to allow

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

[53] Romano, supra note 51, at 796.

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

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

[56] Jayne E. Zanglein, *High Performance Investing: Harnessing the Power of Pension Funds to Promote Economic Growth and Workplace Integrity*, 11 LABOR LAW. 59 (1995); Deborah J. Martin, *The Public Piggy Bank Goes to Market: Public Pension Fund Investment in Common Stock and Fund Trustees' Social Agenda*, 29 SAN DIEGO L. REV. 39, 46-47 (1992). See Press Relase, [Cal.] Treasurer Angelides Wins CalPERS Approval of Innovateive "Clean Technologies" Investment Program, A Key Part of His "Green Wave" Environmental Investrment Initiative (2004), at www.treasurer.ca.gov/news/releases 2004/031504_clean.pdf; Marc Lifsher, CalPERS to Start Green Investment Program, L.A. TIMES, Mar. 16, 2004, at C3 (State Treasurer pushes CalPERS board, "convinced that retirees could get a good return … while [both] helping to create more high-tech jobs in California [and in cleaning up the environment]").

California's pensioners to manage their own pension monies, which would erode CalPERS' power.[57]

6. Shareholder access. The SEC proposed recently that shareholders have direct access to public companies' proxy statements to nominate directors, thereby evoking both ends of the federal spectrum. They sought greater managerial accountability, to make American companies better run. Said its SEC champion: the commission's goal here should be to better control "a small minority of lazy, inefficient, grossly overpaid and wrongheaded C.E.O's."[58] Here is the efficiency motivation for federal action.

Managers opposed the SEC. They said that greater shareholder access would play into the hands not of shareholders, but of groups that wanted to influence the corporation. The Business Roundtable—managers' principal lobbying organization—charged that access would empower state and labor union pension funds to advance their collateral agenda, one not tied tightly to corporate profitability.[59] CalPERS' support as stockholder for labor unions in the Safeway strike was cast as a harbinger of what would happen if such shareholders had direct access to corporate America's proxy statements.[60] Here was the populist, new interest group motivation or result perceived to be part of federal action, just as it was part of big state investments.

7. Sarbanes-Oxley. The statute overall illustrates Congress swept by scandal and national opinion into regulating corporate organization in a way it usually leaves to state law. Delaware authorities did seek the chance to remedy the corporate governance debilities that the scandals highlighted,[61] but the state didn't act, perhaps because the concerned officials were judges, who need a case to act, or because Delaware's primary interest groups wouldn't have been able to agree easily on what to do.[62]

Two secondary aspects of Sarbanes-Oxley exemplify the interest group density in the federal forum: It bars executives and directors from trading their companies' stock during blackout periods when their companies' employees could not trade.[63] It also requires executives whose companies later go bankrupt to return any profits made from bailing out of their companies' stock.[64]

Few managers, and probably not too many investors, were interested in either provision. Supporters in Washington, however, included players without much muscle

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[57] [Mary Williams Walsh, *Calpers Ouster Puts Focus on How Funds Wield Power*, N.Y. TIMES, Dec. 2, 2004, at __ (self-managed accounts proposed for new California pensioners).]

[58] Stephen Labaton, *S.E.C. Members Says Agency Has Bowed to Executives*, N.Y. TIMES, Oct. 9, 2004, at B1. The quotation is of Harvey Goldschmid, an SEC Commissioner.

[59] John J. Castellani & Amy Goodman, *The Case Against the SEC Director Election Proposal*, in SHAREHOLDER ACCESS TO THE CORPORATE BALLOT __ (Lucian Bebchuk ed. 2004) (forthcoming) (MS at 9-10, 18-19). John Castellani is the president of the Business Roundatable.

[60] Joann S. Lublin & Jonathan Weil, *Gadfly Activism at CalPERS Leads to Possible Ouster of President*, WALL ST.J., Dec. 1, 2004, at A1.

[61] Elson, supra note 23, at 77 (comments of Delaware Chief Justice Veasey).

[62] See Strine, supra note 6, at 1268-70 (quoted supra on p. 7).

[63] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 306, 116 Stat. 779 (codified at 15 U.S.C. § 7244 (2003).

[64] Sarbanes-Oxley Act of 2002, §§ 304, 306.

in Delaware lawmaking: Local 125 of the Internal Brotherhood of Electrical Workers, the Pension Rights Center, the Employee Benefit Research Institute, the American Association of Retired People, the Consumers Union, and the Consumer Federation of America.[65]

8. Europe. Consider this summary of William Carney's precise contrast of American state-based corporate law with European center-based corporate law:

> Carney compared the law of the eight European Directives on company law with the corporate laws in the United States. For that, he … divided [the directives] into 131 provisions, and searched … for similar [U.S.] provisions. The result was that 95 provisions were in effect in no US-state, 14 were in effect in all 50 states, and the remaining 22 provisions were adopted by [some] states. The [95] provisions … in effect in no US-state mainly consisted of protections for creditors, employees and other stakeholders. … Carney concluded that … European harmonization was strongly influenced by [outside] interest groups… .[66]

An American big-state analogue is New York's corporate law, which makes a New York corporation's ten biggest shareholders personally liable for employee wages.[67] The provision has been described as "the single most important reason why New York shareholders decide to incorporate in Delaware."[68] From 1994 until 1997, the New York Senate "approved the bill [to repeal this liability] every year, but it had repeatedly died in the Assembly. Labor blocked the bill because [it would have deleted the shareholder guarantee] … and legislators … did not want to be seen as

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[65] Sen. Comm. on Governmental Affairs, Retirement Insecurity: 401(k) Crisis at Enron (Feb. 5, 2002) (CIS-No: 2002-S401-46); Sen. Comm. on Health, Education, Labor, and Pensions, Protecting the Pensions of Working Americans: Lessons from the Enron Debacle (Feb. 7, 2002) (2002-S431-23); House Comm. On Education and the Workforce: Enron and Beyond: Legislative Solutions (Feb. 27, 2002) (CIS-NO: 2003-H341-13); Sen. Legislative History of Title VIII of HR 2673: The Sarbanes-Oxley Act of 2002 (July 26,2002) (148 Cong Rec S 7418).

[66] Mathias M. Siems, Numerical Comparative Law, at 3 (SSRN working paper, March 2004), summarizing William J. Carney, *The Political Economy of the Competition for Corporate Charters*, 36 J. LEGAL STUD. 303, 318-27 (1997). Cf. Carney, supra note 9, at 718 & n. 7 ("other interest groups [beyond the organized corporate bar] do not play a significant role in influencing corporate law in the United States. … This phenomenon is in distinct contrast to the situation in Europe."); Alan Cowell, *Oslo Journal: Brewmaster Breaks One Tradition but Upholds Another*, N.Y. TIMES, Dec. 24, 2004, at A4 (the slowness of promoting women in "the clubby world of Norwegian business … prompt[ed] the government to tell companies that if women do not constitute at least 40 percent of corporate boards by July 2005, they will be required by law to hire more women as executives."). Norway is not a member of the EU; the nation's central political body is in Oslo.

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

[67] N.Y. BUS. CORP. LAW, § 630 (McKinney 2002). Listed companies are exempt, but companies tend to de-list when they become insolvent. Kahan & Kamar, supra note 20, at 732 n.194.

[68] Frederick Attea, *State Has Hard Time Following a Lead*, BUS. FIRST IN BUFFALO, Apr. 17, 2000, at 30. Cf. Michael M. Membrado & Christopher J. Gulotta, *Navigating the Formation of Start-Up Companies*, N.Y.L.J., Sept. 18, 2000, at S6, S12;. These sources are analyzed in Kahan & Kamar, supra note 20, at 732 & n.195.

catering too much to business interests…. [L]abor groups were adamant about retaining [the liability] and [eventually] corporate attorneys reluctantly acceded."[69]

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

But it hasn't. It acts via ex post judicial review of corporate actions, focusing on the fairness and efficacy of shareholder-board relationships. That's what one would expect if only managers and shareholders' representatives counted.[70] Why regulate if the primary parties can make a deal and the judges can arbitrate?

Federal authorities act at times through similar modes—the Second Circuit's use of the general anti-fraud rule, 10b-5, in the 1970s comes to mind—but they more often act through a regulator, the Securities and Exchange Commission. The SEC lacks full authority over corporate law, but where it can act, it regularly does so prospectively, via regulation, via civil fines, and—with other federal authorities' help—via incarceration. Further, consider Congress's Sarbanes-Oxley corporate governance reforms of 2002. That Act raised the obligations of managers, boards, and institutional investors. Yet, "[it] was viewed as … too prescriptive and harsh to the financial community and corporations."[71] These directly affected groups, who pay the initial costs of these changes, are the very groups that dominate Delaware. Hence, one would not have expected such reforms to come out of Delaware. And they did not.[72]

10. Arbitration vs. prosecution. Would managers and institutional stockholders want their disputes dealt with via criminal prosecution or via arbitration? Presumably the latter. While each side has reason to want to criminalize the other's derelictions, it would be hard to criminalize the other's without criminalizing their own. Both prefer to avoid criminal penalties, and favor having a wise arbitrator—called, say, the

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[69] Dominic Bencivenga, *At Long Last, a Bill*, N.Y.L.J., July 31, 1997, at 5. Cf. Richard Siegler, *Impact of Business Corporation Law Amendments*, N.Y.L.J., Oct. 29, 1997, at 3, 4 (Section 630 not repealed due to "strong opposition from labor unions"). Corporate lawyers said federal bankruptcy law better protected unpaid employees anyway. Bencivenga, supra, at 5.

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

[71] Rabihollah Rezaee & Pankaj K. Jain, The Sarbanes-Oxley Act of 2002 and Securities Market Behavior: Early Evidence 9 (SSRN working paper, Dec. 2003).

[72] Robert Thompson, *Corporate Governance After Enron: The First Year*, 40 HOUSTON L. REV. 99 (2003). Cf. Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595 (1995) (analogous lawmaking results when interest groups dominate American Law Institute or state Uniform Law commissions).

Delaware Chancellor—decide their disputes without criminal sanctions. And that's just about how Delaware law works.

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

IV. POLITICAL THEORY AND THE DELAWARE-FEDERAL RELATIONSHIP

A. Triggering Federal Action

Thus, the two main players in American corporate law generally want the game played in Delaware. What would move the game to Washington? A disgruntled Delaware player's appeal is the main trigger we've thus far examined. (Other states' actions are less likely to goad federal authorities into action, because other states are neither likely to strongly affect the national economy—since they aren't the home to half of corporate America—nor likely to motivate America's managers or its investors to seek federal help.[73])

Outside forces, when powerful enough to temporarily overcome Delaware's agenda-setting power, could also move the game from Delaware to Washington. Sarbanes-Oxley is one example. The public outcry over the Enron and WorldCom scandals disabled managers' ability to oppose federal legislation. In fact, every decade in the twentieth century had a corporate issue of such importance that it moved into the federal arena, or seriously threatened to do so.[74]

Political scientists have sketched the general characteristics of issues that burst onto the congressional agenda. An issue can sit on the policy agenda for years and go nowhere in Congress. Then a focusing event occurs and it moves onto the congressional agenda for action.[75]

1. Scandals, and public-oriented action. Congress sets aside Delaware-based, quasi-private lawmaking when the media show gross corporate wrongdoing or when poor national economic performance is plausibly tied to corporate governance. Congress thus acts sporadically, but sporadic doesn't mean unimportant. As Michael Levine and Jennifer Forrence state, Congress then becomes public-interested.[76] Scandals thus serve as focusing events that motivate national politicians.

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[73] See Roe, Delaware's Advantage, supra note __.

[74] Roe, supra note 4, at 610-34. See supra p. 5.

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

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

Or, in terms of the preference aggregation model from the earlier diagrams, at times a populist or a public-policy idea—or their underlying interests—gets enough power to dominate the congressional agenda, and the forces for managerial autonomy are weaker than usual. The populists or the public-policy people can dominate without allied interest groups from inside the corporation. As Phil Gramm, the conservative anti-regulatory Senator, said when the Enron and WorldCom scandals hit and Sarbanes-Oxley was under discussion: "In the environment we are in, virtually anything can pass. Everybody is trying to outdo everybody else."[77] The Business Roundtable at first opposed the legislation,[78] preferring self-regulation, but joined the bandwagon when legislation seemed inevitable and popular reaction made it too uncomfortable for it to stay opposed. Only later, when the fires subsided, did the Business Roundtable start seeking to roll-back the regulation.[79]

2. Police patrols vs. fire alarms. Matthew McCubbins and Thomas Schwartz identify two main means by which Congress controls federal agencies: police patrols and fire alarms. Congress could continuously keep an eye on what the agency is doing, via regular police patrols. Or it could sit back and do nothing unless constituents scream, fire alarms go off, and the media spots a big issue—again, a focusing event.[80] Congress, I submit, primarily oversees Delaware's corporate law via the second mechanism; the fire alarm is a scandal or bad economic performance. And the SEC serves as Congress's secondary police patrol, keeping an eye on the American corporation via continuous monitoring.

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

The Delaware-federal relationship resembles the Federal Reserve-congressional relationship. The parallel is apt, in that the Federal Reserve is one of the more independent agencies, and Delaware clearly need not jump every time Congress moves. In fact, Delaware is freer than even the Fed. While Congress often structures agencies to respond to congressional will,[81] Congress didn't build Delaware. It isn't in

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[77] Rezaee & Jain, supra note 71, at 7.

[78] Letter, dated May 20, 2002, from John Castellani, President, The Business Roundtable, to Paul S. Sarbanes, Chairman, Sen. Comm. on Banking, Housing and Urban Affiars, Re: Public Company Accounting Reform and Investor Protection Act of 2002 (opposing key provisions of Sarbanes' bill); Arianna Huffington, *Fiscal Reforms? The Fix Is In: Nothing Will Change Without Public Outrage*, L.A. TIMES, July 11, 2002. This process parallels a once-classic view of American political history in which private interests produce wealth, become corrupt or incompetent (or corrupt the State), and then national reformers rebuild the private sector. Jacksonian democracy, the Progressive movement, and the New Deal are said to illustrate. E.g., ARTHUR M. SCHLESINGER, JR., THE AGE OF JACKSON (1945).

[79] Newspaper articles

[80] Matthew D. McCubbins & Thomas Schwartz, *Congressional Oversight Overlooked: Police Patrols versus Fire Alarms*, 28 AM. J. POL. SCI. 167 (1984). Cf. Arthur Lupia & Matthew D. McCubbins, *Learning from Oversight: Fire Alarms and Police Patrols Reconstructed*, 10 J.L. ECON. & ORG. 96 (1994); EPSTEIN & O'HALLORAN, supra note 37, at 25-27.

[81] Matthew D. McCubbins, Roger Noll & Barry R. Weingast, *Administrative Procedures as Instruments of Political Control*, 3 J.L. ECON. & ORG. 243 (1987); Matthew D. McCubbins, Roger Noll & Barry R. Weingast, *Structure and Process, Politics and Policy: Administrative Arrangements and the*

the loop in appointing Delaware officials, as it is for federal agencies. Congress often calls in agency personnel to testify, and thereby influences agency preferences and actions; federal players do communicate with Delaware players, but without the intensity of regular congressional hearings. Congress determines agency budgets, but it doesn't regulate Delaware's franchise fees.

1. In Delaware's insulation. Analysts often want to insulate monetary policy from current political demands. The polity prefers short-term monetary laxity, the usual story goes, and politicians facing an election in a few months would give voters that shortsighted policy at the expense of long-term growth.[82] This view puts a positive spin on insulating the Federal Reserve from day-to-day political pressure.

Central bank independence, even if short of total independence, is seen as critical to implementing that policy. The public wants immediate popular economic gain, such as the highest possible immediate employment. Alan Blinder, a former vice-chair of the Federal Reserve, argues that a key reason for independence is that "monetary policy, by its very nature, requires a long time horizon."[83] Presumably he means very long compared to the elected political institutions' and the public's usual short horizon:

> So, if politicians made monetary policy … day-to-day … , the temptation to reach for short-term gains at the expense of the future (that is, to inflate too much) would be hard to resist. Knowing this, many governments wisely try to depoliticize monetary policy by … putting it in the hands of unelected technocrats with long terms of office and insulation from the hurly-burly of politics.[84]

Ensuing analyses look at how much the Federal Reserve still defers on big issues to the elected branches' wishes.[85] Some political scientists see the issue as even more basic:

> The main mechanism by which democracy is thought to hinder growth [is] pressure[] for immediate consumption, which reduce[s] investment.

Political Control of Agencies, 75 VA. L. REV. 431 (1989). Cf. Barry R. Weingast & Mark J. Moran, *Bureaucratic Discretion or Congressional Control: Regulatory Policy-making by the FTC*, 91 J. POL. ECON. 765 (1983).

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

[83] ALAN BLINDER, CENTRAL BANKING IN THEORY AND PRACTICE 55 (1998); see sources cited in Drazen, supra note 82, at 142 n.19, 143.

[84] BLINDER, supra note 83, at 56-57.

[85] E.g., for indicators of deference, see Thomas Havrilesky, *Monetary Policy Signaling from the Administration to the Federal Reserve*, 20 J. MONEY, CREDIT & BANKING 83, 84, 86 (1985), and sources cited therein; Nathaniel Beck, *Elections and the Fed: Is There a Political Monetary Cycle?*, 31 AM. J. POL. SCI. 194, 194 (1987) ("the Fed … accommodates fiscally induced political monetary cycles, but does not actively cause [them]. This is explained by the relative power of the president and the Fed"); John T. Williams, *The Political Manipulation of Macroeconomic Policy*, 84 AM. POL. SCI. REV. 767 (1990). For analysis that the Federal Reserve chairs "have a greater impact than external authorities … because of the high levels of institutional expertise, leadership, cohesion, loyalty and the socialization process … within the bureaucratic agency," see George A. Krause, *Federal Reserve Policy Decision Making: Political and Bureaucratic Influences*, 38 AM. J. POL. SCI. 124, 124 (1994).

> Only [governments] that are institutionally insulated from such pressures can resist them, and democratic states are not.
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> The heart of the neo-liberal research program is to find institutions that enable the state to do what it should but disable it from doing what it should not.[86]

Similarly:

> Congress [sometimes wants] a policy that would not get majority support. The classic example is this: Congress [wants] a low-inflation monetary policy, knowing that it will have an incentive to renege. … {So] Congress delegates authority over monetary policy to a conservative agency … that provides political shelter … .[87]

The analogy to Delaware corporate lawmaking needs little stretching. When Delaware, like the Federal Reserve, decides first, Congress often acquiesces. American corporate law, by usually giving Delaware first crack at making the rules, reduces political pressure on corporate lawmakers. Unelected Delaware chancellors with long tenure, who are structurally insulated from hurly-burly of national politics, typically first make corporate rules. The Delaware legislature acts next. It listens to a corporate bar committee, which is just about as insulated from national politics as are the Delaware courts: the bar committee represents managers and shareholders, and the Delaware legislature is less worried about, say, general environmental policy or labor relations than Congress might be, and more concerned about that franchise tax.

2. In its porosity. In most democratic polities the central banker can be dismissed, much as the federal authorities can oust Delaware:

> Lohmann (1992) suggest[s] appoint[ing] a conservative central banker, but [keeping] the option to dismiss him at a cost. Her argument is that the high variance of unemployment with … [a] conservative central banker reflects a 'distorted' response to output shocks, since the deadweight loss is larger for extreme shocks. The option to dismiss a conservative central banker will lead him to accommodate large shocks. This solution is much like using a rule with an escape clause [for extreme circumstances]….[88]

The Federal Reserve watches and reacts to election returns, and can thereby falter in making good long-term monetary policy;[89] thus the independent agency's insulation can dampen, but not eliminate, politics' short-term influence. Delaware is similar: Federal authorities sometimes take corporate lawmaking power away from Delaware. Delaware, seeking to stymie federal action so that the state maintains its authority, sometimes goes just far enough to deter the federal authorities from acting.[90]

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[86] Adam Przeworski & Fernando Limongi, *Political Regimes and Economic Growth*, 7 J. ECON. PERS. 51, 51, 65 (1993) (but "[i]n our view there are no such institutions to be found").

[87] Ferejohn & Shipan, supra note 25, at 9.

[88] DRAZEN, supra note 82, at 145. See also GØSTA ESPING-ANDERSON, THREE WORLDS OF WELFARE CAPITALISM 14-15 (1990).

[89] Cf. Mark Toma, *Inflationary bias of the Federal Reserve System: A bureaucratic perspective*, 10 J. MONETARY ECON. 163 (1982).

[90] See examples and structure discussed in Roe, *Delaware's Competition*, supra note 4.

It considers general public opinion, which could influence elected federal lawmakers. Both results resemble the monopolist's limit pricing: not so high as to attract entry.[91]

Delaware, like the Federal Reserve, is autonomous, but not fully so. It cannot get too far out from political currents, because if it does, federal authorities can, and do, intervene. The President appoints the chair of the Federal Reserve every four years and appoints a few Fed governors every few years. The Federal Reserve normally buffers policy from the general polity, but it cannot readily defeat a determined polity.[92]

Moreover, just as the Federal Reserve enhances its independence by linking itself to "a supportive constituency in the financial services industry,"[93] Delaware can keep some autonomy from Congress by linking itself to managers. This sometimes subjects both entities to interest group distortions: Bankers, to the detriment of others in the polity, could overly influence the Fed. And, although Delaware's insulation usually lets managers and investors work out a contractarian result by themselves, there are times and issues when the contractarian result isn't in the public interest.

Besides, the state, like the Fed, often serves Congress's interest by taking primary responsibility for corporate regulation—and the heat that comes with it—off Congress. Congress doesn't have to send out surveillance patrols. If something goes wrong, Congress isn't the first to be blamed.[94]

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

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[91] And one reason Delaware fuzzes what they're doing could be to raise the costs of federal action and of interest groups' lobbying at the national level. Similarly, the Federal Reserve chair's pronouncements may be Delphic, partly to best manage his job, but also to deter congressional pressure.

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

[93] Havrilesky, supra note 85, at 84-85.

[94] Cf. Jonathan R. Macey, *Regulatory Competition in the US Federal System: Banking and Financial Services*, in REGULATORY COMPETITION AND ECONOMIC INTEGRATION: COMPARATIVE PERSPECTIVES 95, 98-99 (Daniel C. Esty & Damien Geradin eds. 2001) ("where Congress can avoid potentially damaging political opposition from special-interest groups by allocating the responsibility for a particularly controversial issue to state and local governments (as is the case with the issue of abortion)").

This observation does not make the Delaware-federal institutional divide irrelevant. For Congress to shield the corporation from the swarming interest groups, it needed institutional ballast. Creating the SEC was one way; tolerating Delaware another. Or, perhaps better: had Delaware not evolved as it has, Congress might have built a federal agency like the Fed to insulate corporate lawmaking from the hurly-burly of national politics. With Delaware available, Congress was able to use it as a quasi-federal agency.

4. In reducing the time inconsistency problem. A reason for Federal Reserve autonomy is the need to maintain a consistent economic policy over time without succumbing to short-term political payoffs. A legislature can't, say, easily stick to a low-inflation policy, if political pressures develop in an election year favoring an inflationary policy.[95] Corporate policy could be similar. Over the long run a business-oriented policy could produce more investment, more growth, and better economic performance. But in the future political pressures might generate pressures to go anti-shareholder. A polity where the initial corporate decisions are made by a state dependent on shareholders and managers for tax revenues reduces this prospect.

5. In processing information. The federal-Delaware institutional structure affects legal outcomes, because some interest groups have more muscle in Delaware than they have in Congress. But there's more just interest group differences in the two lawmaking levels. "[I]nstitutional arrangements may reflect the need to acquire and disseminate information in addition to (or instead of) the need to solve distributional issues. Committees may be powerful in a legislature not (only) because they monopolize agenda power but (also) because they monopolize information and expertise."[96] This new political science view corresponds to an older view in the legal academy about administrative expertise.[97] Congress may tolerate Delaware because it specializes in corporate law issues, similar to how a federal agency specializes and becomes expert. Had Delaware not emerged as the de facto maker of American state corporate law, Congress could have created an expert administrative agency, like the Fed or the SEC, or expanded the powers of one already in place. In this view of the current structure, Delaware still creates the corporate law that Congress wants, or tolerates, just like an administrative agency rules within the ambit of Congress's parameters. It's the accidental agency.

* * *

The analogy to the Fed is good but imperfect. Some American political players are more attached to federalism and state power as vital to American democracy than they are to the autonomy of federal agencies. Similarly, Senators at times get their peers' deference on matters of local significance, but Senators will not accord the same deference to policy matters in the agencies. As a result Delaware's Senators may at

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[95] BLINDER, supra note 83, at 55-56.

[96] [KEITH KREHBIEL, INFORMATION AND LEGISLATIVE ORGANIZATION (1991);] KENNETH A. SHEPSLE & BARRY R. WEINGAST, POSITIVE THEORIES OF CONGRESSIONAL INSTITUTIONS 5, 15-16 (1995).

[97] JAMES LANDIS, THE ADMINISTRATIVE PROCESS 1 (1938); Richard B. Stewart, *Administrative Law in the Twenty-First Century*, 78 N.Y.U. L. REV. 437, 440-41 (2003).

times seek to deter federal action and other Senators feel federalist comity compels deference.

Both Delaware and the Fed seek that the public defer to their nonpartisan expertise, although the Fed is more successful. And whereas the Fed's buffering is temporal; Delaware aims to narrow policy breadth: even if everyone wants the Fed's policy when we're planning the long future, when that future time finally arrives, short-term interests would dominate if the buffer did not slow down the political juggernaut. For Delaware, the interests outside the core corporate law players—the public interest groups, public-policy-makers, and employees—have a public interest vision, but theirs differs from that held by the corporate players. Although the particulars and degree differ, the institutional role—the Fed and Delaware as buffers—is still there.

C. And How Delaware Affects Congress

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

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

Moreover, those in Congress who get support from Delaware's primary interest groups don't need to pass laws favoring them to get their clients' support. As Jonathan Macey points out in analogous circumstances, all that the clients need to know is that their patrons successfully blocked federal action.[98]

3. In giving Congress cover and deniability. If something goes wrong, Congress need not take responsibility. It doesn't need even to point a finger. Everyone knows states make corporate law. If there's a scandal, or a failure, the states have failed, and the U.S. Congress can ride in to the rescue.[99]

V. CORPORATE THEORY MEETS POLITICAL THEORY

A. The Contractarian Paradigm

1. What is it? A standard view is that corporate law should be contractarian, reflecting the terms shareholders and managers would have adapted had they built the corporation up from basic contract law. Those terms should be default rules, malleable for those shareholders and managers that want differing relationships. Mandatory

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

[99] See MORRIS FIORINA, CONGRESS: KEYSTONE OF THE WASHINGTON ESTABLISHMENT 48 (1977).

terms should be few. Analysts argue that Delaware corporate law comes close to reflecting the contractarian agenda.[100]

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

Mandatory terms would be the kind that third parties might prefer. That is, mandatory terms might be put in play if the lawmakers did not think that the investor-manager deal would reflect the legitimate interests of third parties, such as creditors (via minimum capital rules), employees, or other interests groups. Or to heighten the relative power of other groups, corporate law might diminish the power of the two Delaware players.[101] Day-to-day American corporate law doesn't do heighten those other groups' power.[102]

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

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

Similarly, when populist and progressive forces wanted to cut the power of financial institutions, they turned to federal authorities to keep financial institutions small and weak.[103] Once financial power—symbolized by J.P. Morgan's interests—was cut, first rhetorically with the Pujo investigation in 1913 and then more vigorously with the Glass-Steagall Act in the 1930s, policymakers then deferred to state-law

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[100] EASTERBROOK & FISCHEL, supra note 70, at 4.

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

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

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

corporate contracts. Populists and progressives altered corporate structure, but primarily at the federal level, not via New Jersey's and Delaware's corporate law.[104]

B. The Internal Affairs Norm

1. What is it? The relationships among shareholders, and between shareholders and managers, are seen as internal to an entity sitting within a single state, and therefore are properly matters for state regulation. External buying and selling of securities across state lines is for the SEC and the securities laws to regulate. The line between internal and external is clearly not bright, but the distinction has been important in defining the national and state spheres of corporate lawmaking.[105] The formal doctrine originates with choice of law rules in which states defer to the incorporating state's rules for the firm's internal affairs; but the internal-external line has come to roughly mark the traditional boundary between the state and federal domains. And some courts say that the SEC cannot move into state internal affairs without clear congressional authorization, but can go beyond the precise terms of the statute to define ambiguous grants to regulate securities trading.[106] The internal/external distinction is part of the debate over who should make American corporate law.[107]

2. The internal affairs doctrine as crude interest group public choice. Surely the doctrine has a life apart from the interests that benefit from its use. But behind the internal affairs standard is the *realpolitik* that deferring to states on internal affairs is equivalent to deferring to manager-shareholder interests. For some players the ideology may only thinly mask self-interest. As Gordon Tullock remarked, most citizens "realize that the government can be expected to do things in their personal

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

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

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

[107] See, e.g., TASK FORCE ON SHAREHOLDERS PROPOSALS OF THE COMM. ON FEDERAL REGULATION OF SECURITIES, SECTION OF BUS. LAW OF THE AMERICAN BAR ASS'N, REPORT ON PROPOSED CHANGES IN PROXY RULES AND REGULATIONS REGARDING PROCEDURES FOR THE ELECTION OF CORPORATE DIRECTORS 19, 23, 25 (2004). The task force, chaired by two respected lawyers who often represent managers, said that the SEC shareholder access proposals, see supra p. 27, "raise[d] significant … federalism concerns … ." And "federal regulation of … proxies may impinge on state substantive law and raise federalism issues… . Exactly where that line exists has not been clearly delineated … ."

interest only if it at least superficially fits the public image."[108] Many are surely sincere in their ideology, which matches their self-interest.

The ideology is stated, sometimes grudgingly, by SEC commissioners, by Congress, by the courts,[109] and, more relevantly and with more respect, by corporate players. Bruce Atwater, a big-company CEO and major corporate spokesman in the 1980s, opposed federal preemption of state takeover law and when doing so invoked the tradition that states define and create the corporation.[110] The norm's effect is to restrain the federal authorities. When it's successfully invoked, it impedes federal action. It weakens the players stronger on the federal level, and boosts those stronger at the state level. It strengthens the contractarian paradigm, because the two primary contracting players are strongest at the state level.

VI. IS DELAWARE CAUSE OR EFFECT?

A. Means and Ends

1. The median voter and the institutional structure. Two views dominate modern political science. In one, a democratic polity does what the median voter wants.[111] In another, agenda setting is key because coalitions are many, politics is arrayed in too many dimensions for there to be a median voter, and, as Kenneth Shepsle and Barry Weingast showed, institutional structure determines the agenda, which determines the outcome.[112] I next integrate both views into the public choice foundation to American corporate lawmaking.

2. Does the American voter want conservative corporate law? Are broad political concerns kept out of American corporate law because of the institutional structure that has Delaware setting the agenda, with the federal authorities thereafter deciding whether to displace the Delaware decision? Or are such broad political

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

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

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

[111] DUNCAN BLACK, THE THEORY OF COMMITTEES AND ELECTIONS (1958); cf. ANTHONY DOWNS, AN ECONOMIC THEORY OF DEMOCRACY 115-18 (1957).

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

concerns kept out because the American polity doesn't give much weight to them and thus tolerates Delaware's excluding them? Would substantive results be the same, even if all corporate law were made at the national level?

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

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

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

I have argued that Delaware's franchise tax defines its interest groups—as shareholders and managers. And I have argued that Congress is not so limited, with other interest groups in play and interested in what happens inside the American corporation. Groups like environmentalists, employees, labor unions, economic policymakers, and so on would have a say in Congress.

And those groups do have a say in Congress. Congress has given those groups an Environmental Protection Agency, an Occupational Safety and Health Administration, a National Labor Relations Board, a Council of Economic Advisors, and other agencies to constrain the corporation.

So, one might argue, the law does confine corporations and their managers, but the confining rules just come in a form other than the internal mechanisms of corporate law, such as boardroom representation of third party interests, or wide duties that extend beyond shareholder primacy or, as it really is, managerial discretion.

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

CONCLUSION

The standard story is that states make corporate law, with state competition critically determining its content. This may be so, but perhaps the relationship between the states and Washington is just as determinative, because federal authorities can displace the states, and often do so on big issues. Corporate law issues can always go federal or attract federal attention. The SEC is always on stand-by, and Congress takes up issues that deeply affect the economy or the opinion polls. These possibilities confine the range of state lawmaking and, on occasion, condition it.

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

Sometimes, despite local compromise, the issue is so big—one evoking headlines in the media and fears for the economy—that it attracts federal attention. Different coalitions can, and do, emerge at the federal level. Sometimes the managers or the investors find new coalition partners on the federal level and thereby break the Delaware deal. Delaware limits the first decisionmaking arena by keeping corporate outsiders and public policymakers out. Sometimes managers and investors can make their deal there and then unite at the federal level to fight off other forces. But sometimes Delaware loses control of the agenda. It loses control when the public is sufficiently motivated that Congress acts because the economy is weak or because scandals dominate the media. Congress ousted Delaware most recently with Sarbanes-Oxley after the Enron and WorldCom scandals hit the headlines.

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

By thus viewing Delaware, we have uncovered rich public choice explanations for the core nature of Delaware and American corporate law, without needing a state-to-state race. These public choice explanations don't let us to precisely explain statute after statute or exact judicial holdings, but they mark off the broad boundaries of corporate lawmaking. We have explained Delaware's moderation, Delaware's dominance, and the conservative, boardroom-centered nature of American corporate law without relying on the state-to-state race for franchise tax revenues, just on the federal-state interaction. We've reinterpreted the state corporate franchise tax as

excluding many players from making corporate law. We've shown how Delaware's structural differences with Congress are not just state-to-state competition vs. a congressional monopoly, but the differing interest groups and ideologies that affect each. The interest groups would differ *even if both* Delaware and Congress were monopoly lawmakers. We've seen how the internal affairs doctrine reflects deference to some interest groups and not others. And we've seen how the Delaware-federal sequence is an agenda-setting structure.

The interaction between federal power and Delaware interests explains much of American corporate law, maybe as much as, or even more than, does interstate competition or a Delaware monopoly. We have here gone a long way, I believe, to explaining American corporate law, with only passing reference to the interstate debate, by using basic public choice analysis to scrutinize Delaware and the federal authorities.