ISSN 1045-6333

HARVARD

JOHN M. OLIN CENTER FOR LAW, ECONOMICS, AND BUSINESS

DELAWARE'S COMPETITION

Mark J. Roe

Discussion Paper No. 432

08/2003

Harvard Law School
Cambridge, MA 02138

JEL: K4, H73, G34, G28

Delaware's Competition

forthcoming 117 Harv. L. Rev. (2003)

Mark J. Roe*

ABSTRACT

One of corporate law's enduring issues has been the extent to which state-to-state competitive pressures on Delaware make for a race to the top or the bottom. States, or at least some of them, are said to compete with their corporate law to get corporate tax revenue and ancillary benefits. Delaware has "won" that race, as most large American firms incorporate there. Here I argue that this long-standing debate is misconceived. Delaware's chief competitive pressure comes not from other states but from the federal government. When the issue is big, the federal government takes the issue or threatens to do so, or Delaware players are aware that if they offend the federal authorities, those authorities could take the issue over. Even if Delaware were oblivious to the federal authorities, those authorities can, and do, overturn Delaware law. That which persists in Delaware is that which the federal authorities tolerate. This reconception a) explains corporate law developments and data that neither the race-to-the-top nor the race-to-the-bottom theory have explained well, b) fits several developments in takeover law, going private transactions, and the rhetoric of corporate governance in Delaware, and c) can be detected in corporate law-making in Washington and Wilmington from the "origins" of Delaware's dominance in the early 20th century right up through the passage in the summer of 2002 of the Sarbanes-Oxley corporate governance law in reaction to the corporate governance failures in Enron and WorldCom.

This analysis upsets the long-standing theory of state corporate law competition as a strong race (whether to the top or to the bottom). We cannot tell whether Delaware, if it raced to the top, did so because of the looming federal "threat" or because of state competition. Nor can we tell whether Delaware, if it raced to the bottom, did so because of state competition or because Congress, subject to wider national political pressures than is Delaware, would have taken the issue away had Delaware acted differently. That which persists in Delaware is that which the Federal players approved, or tolerated. And much that is important Delaware never even gets to act upon, as federal authorities can decide without waiting for the states to gear up. This is not to say that what happens at the state level is minor, but that the results are ambiguous in terms of the race debate. If Delaware law is usually efficient, then the federal vertical element could correspond to the strengths of other organizational structures (like separating proposals from ratification in decision-making, or of the checks and balances in the M-form corporation). If Delaware law is usually inefficient, we do not know whether the states, if free to compete without the possibility of a federal "veto", would have raced toward efficiency. Too many of the truly important decisions, the ones affecting capital costs—the mechanism driving the race-to-the-top theory—Delaware and the states do not get to make. And Delaware actors know federal authorities could take away those decisions that remain if they seriously damaged the national economy or riled powerful national interests. When we put this heavy "vertical," federal-state competition structure atop the horizontal state competition theory in corporate law, the state race debate—one that stretched across the 20th century from Brandeis to Cary and beyond—collapses, and is rendered empirically and theoretically indeterminate.

---

* Professor of Law, Harvard Law School. Thanks for support go to the John M. Olin Center for Law, Economics and Business at Harvard Law School.

DELAWARE'S COMPETITION

Table of Contents

Delaware's Competition

Mark J. Roe*

INTRODUCTION

The nature of state competition for corporate charters—is it a race to the top or the bottom?—is one of corporate law's enduring corporate issues, one that dates back to the origins of the modern American corporation at the beginning of the 20th century and that has persisted for a century in policy debates touched off by the SEC, Supreme Court opinions on state authority in corporate law, and continuing academic analysis. Even today, as I write, new data is brought forth to support the proposition that the race is to the top,[1] while other data is assembled to support the idea that the race is to the bottom.[2] The press engages in the debate,[3] and politicians, judges, and commentators wonder whether the crises and scandals at Enron and WorldCom were produced by a race to the bottom, or could now be corrected by a race to the top.

Here I argue that this debate is misconceived, and badly so. Whether or not the states are racing,[4] and whether they are racing to the top[5] or the bottom,[6] we live in a federal system where the federal government can, and often does, take over issues of

---

* Berg Professor of Corporate Law, Harvard Law School. Thanks for comments go to Michal Barzuza, Lucian Bebchuk, John Coates, Einer Elhauge, Allen Ferrell, Jeffrey Gordon, Henry Hansmann, Howell Jackson, Marcel Kahan, Ehud Kamar, Reinier Kraakman, Donald Langevoort, Michael Levine, Mark Ramseyer, Roberta Romano, Hilary Sale, Leo Strine, William Stuntz, Guhan Subramanian, and workshop participants at Harvard and the University of Pennsylvania.

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

[2] Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795 (2001). Cf. Lucian Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law*? 90 CAL. L. REV. 1775 (2002) (no).

[3] Albert Crenshaw, *Delaware, Inc*., WASHINGTON POST, May 7, 2000, at __; Steven Lipin, *Firms Incorporated in Delaware are Valued More By Investors*, WALL ST. J., Feb. 28, 2000, at C21.

[4] Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002) (states do not compete; Delaware has a monopoly); Lucian Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters*, 112 YALE L.J. 553 (2002) (Delaware's powerful incumbency deters active state competition).

[5] Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. (1977); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 21 (1993); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NORTHWESTERN U.L. REV. 913 (1982).

[6] William Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974); Liggett v. Lee, 288 U.S. 517, 558 n.34 (1933) (Brandeis dissenting); Lucian Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437 (1992); ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933). Cf. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporation Law*, 65 TEXAS L. REV. 469 (1987) (Delaware bar as powerful interest group in shaping Delaware corporate law).

national economic importance. The very issues that are most likely to move into the federal arena—securities trading during the Depression, takeovers in the 1980s, corporate governance today after a series of scandals at the beginning of the 21st century—are the issues that could affect firm value so strongly that they would be central to state-to-state competition. Yet, if fundamental issues of corporate governance often move into the federal arena, then Delaware is not deciding all key corporate law matters. And if that risk of Federal action often heavily influences Delaware, then, even when federal authorities do not take the issue away, federal power may make Delaware law.

Even when, as now, the federal government does not threaten to take away Delaware's chartering business in its entirety—something it did seriously threaten to do three times in the 20th century—Delaware players know that the federal government can take away their corporate law-making function in whole or in part, and that it certainly has often enough, on issues big and small. Because Delaware players can never be oblivious to the possibility of being displaced, we have never had, and we never could have had, a true state-to-state race in corporate law.

Delaware has competition, even if it never looks over its shoulder at another state. Indeed, Delaware's competition in making corporate law comes not primarily from other states, but from the Federal government. It comes from Congress and the Securities and Exchange Commission, not California, Nevada, Ohio, or New York. It comes from the Second Circuit Court of Appeals in interpreting the expanse of the securities laws, not a new commercial court in another state.[7] Even if Delaware had all the chartering business, it need not make all (or, at the limit, any) corporate law.

And even if Delaware never acted with the risk of federal intervention in mind, Delaware-made corporate law would *still* effectively have a large federal component. State corporate law that federal authorities dislike, they reverse. State corporate law that they tolerate, they leave standing. State power is to jigger the rules in the middle, to tilt, to get those rules that, even if the federal authorities would not have enacted them, Washington does not gear up to reverse. The point here is surely not that every twitch in Delaware is determined by the prevailing tilt in Washington. Congress moves sporadically, as is well-known; courts need a case or controversy; and the SEC's jurisdiction is incomplete. States often believe they have room to maneuver, and often do. But federal authorities in effect set the broad boundaries—of an uncertain demarcation and width—within which the states can move. These boundaries: a) affect the descriptive nature of who really makes corporate law in the United States, and b) weaken the mechanisms of the state-to-state race.

This federal-state interaction then has deep implications for the race debate: First, there is no certainty to the mechanism that is said to produce a race to the top: Even if empirical evidence showed incontrovertibly that Delaware were racing to the top, we would not know whether state-to-state competition produced the result, or whether the result came from the threat of federal ouster. And, if empirical evidence showed incontrovertibly that Delaware were racing to the bottom, we would not know whether Delaware reluctantly did so because it feared that congressional politics,

[7] And it comes from the New York Stock Exchange, which itself is often prodded to act by the SEC or Congress.

errant judicial decisions, or an out-of-control SEC would have ousted Delaware had it taken the efficient path.

Second, if Delaware law is in fact efficient, what jurisdictional mechanism produced that efficiency? It cannot be pure state-to-state chartering competition, because the potential for federalization influences Delaware. Rather, the structure that has produced American corporate law is often akin to state proposal with the possibility of Federal veto. It resembles the separation of proposal and ratification in management theory (i.e., states act, subject to another authority that could change the result). If state corporate law is efficient, then some variety of a proposal/modification theory would be the basis for a theory of good corporate law-making. More likely, corporate law, like other law, would have to be re-cast as an amalgam of efficiency, trial and error, trying to do the right thing, interest-group pressures, and happenstance. The result may be more ordinary than the racing engines corporate law scholars have designed, but more realistic.

* * *

In Part I, I briefly outline current corporate law competition theory. In Part II, I show the myriad mechanisms by which federal law-makers can, and do, set aside Delaware law. In Part III, I show that federal authority regularly threatens to, and does, displace state corporate law. In Part IV, I address the theoretical implications of federal-state interaction. It undermines key parts of both theories of state competition.

I then conclude. The mechanisms that would make for a pure race are absent in a true federal system such as the United States. The idea here is not just theoretical: hardly a decade has gone by without the federal government considering taking over the major corporate issue of the time, suggesting that Delaware's strongest competitor has been, and probably still is, Washington. This renders the mechanisms of the race impossible or indeterminate. If the issue is important, it becomes a federal issue, not a purely state-law Delaware issue. That result is as one should expect, and the race analysis must yield to a wider perspective on what makes for corporate law.

I. CURRENT THEORY

We have a long, important debate, one that has engaged several of the best minds in corporate scholarship and corporate activism, from Brandeis to Cary, on whether state competition pushes state corporation law to the top (in terms of efficiency for shareholders) or the bottom (in terms of favoring managers over shareholders). A brief review of that debate is in order before we cordon it off.

A. Delaware's Advantages

Delaware is a small state, and its advantages in any race derive largely from its small size. Revenues from the corporate franchise tax are a large fraction of the state's budget, 15-20%, amounting to several hundred million dollars annually, and, because the state's population is small, on a per capita basis those revenues are a noticeable sum of money for each Delaware resident. The corporate bar can influence the legislature (and perhaps the judiciary); corporate bars in larger states seeking such influence would be often ignored. Local interest group pressures from labor unions and local firms are weak relative to their strength in other states. The average citizen in Delaware has a stake in keeping the revenues, and in the rules that produce those revenues, but not much of a stake in what the rules actually are. This makes for something akin to organized private law-making among the corporate players.

Delaware also has a specialized, highly regarded judiciary, operating without a jury. The judges take pride in keeping up with business trends, on having good business sense, on knowing their own limits, and on reacting quickly as professionals. The body of judicial precedent and knowledge establishes a network, one that would be costly for a single corporate player to leave.[8]

B. Racing to the Bottom

The race to the bottom was nicely articulated early on by Justice Brandeis in Liggett v. Lee:

> Lesser States, eager for revenue derived from that traffic in charters[,] had removed safeguards from their own incorporation laws…. The race was not one of diligence but of laxity…. [T]he great industrial States yielded in order not to lose wholly the prospect of the revenue and control incident to domestic incorporation.[9]

And in modern times, the perspective was picked up by William Cary, articulating the race-to-the-bottom view he developed while chair of the SEC:

> [T]he first step [for improving corporate law] is to escape from the present predicament *in which a pygmy* among the 50 states prescribes, interprets, and indeed *denigrates national corporate policy* as an incentive to encourage incorporation within its borders. …[10]

Delaware law, the race-to-the-bottom theory runs, panders to managers, often at the expense of shareholders. Shareholders cannot make the reincorporation decision alone, as corporate law requires that they act only after the board—the managers—recommends reincorporation.[11] The first actor in the reincorporation decision is the board, and the states in this view give the managers whatever they want. Shareholders are too dispersed in the public corporation to control the situation, and they usually just rubber-stamp managers' recommendations, if they ever actually get to decide. The standard collective action problem makes it not worthwhile for the shareholders to organize and second-guess managers on reincorporation.

More nuanced analyses see Delaware with a network advantage, which gives shareholders a "plus" that Delaware can then take back via pro-managerial substantive

---

[8] See generally Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting*, 83 VA. L. REV. 713 (1997); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998).

[9] 288 U.S. 517, 557-60 (1932).

[10] Cary, supra note 6, at 701 (emphasis supplied).

[11] E.g., Del. Gen'l Corp. L. §§ 241, 251; Bebchuk, supra note 6.

rules.[12] Or managers ask shareholders to vote to reincorporate by giving them a "good news" package: the firm is expanding and makes a big stock offering or upbeat merger at the time it reincorporates. Shareholders, happy overall, approve the package.[13] Data show that much recent reincorporation is from what are seen as tough pro-shareholder states (like California), into Delaware,[14] and that states with the most anti-takeover, pro-manager rules keep more corporate charters than states with fewer.[15]

C. Racing to the Top

Pandering to managers can go only so far. States that systematically hurt a firm's operations would raise that firm's cost of capital, as eventually capital markets participants understand that the firm is weaker and will earn less than a similar firm from a pro-shareholder state. Over the long run this damage to the firm's capital-raising capacity will take its toll: managers realize that they are weakening the firm by reincorporating in that bad-law state, the pot for all to split (shareholders and managers) shrinks, and that cost pushes the players to reincorporate elsewhere. At the limit the firm could disappear, either in bankruptcy or via a takeover from a stronger firm in a neighboring state with better corporate law.[16] Bad corporate law might persist in a state, but one way or another the firms incorporated under that bad law would not.

A single, isolated corporate rule might not seem to be pro-shareholder—a rule that, say, limits shareholders right to sue. But not all rights and remedies are efficient. Some diminish the capacity of the organization to act and, the theory runs, those that do so tend to be discarded, and those that tend to strengthen the organization for shareholders tend to persist. And so racing theories duel as to the motivations of managers and state law-makers.

---

[12] Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995); Bebchuk, Cohen & Ferrell, supra note 2.

[13] Bebchuk, supra note 6, at 1470-75. Bundling is harder after the 1992 SEC proxy amendments. Note that federal not state authority made issue-bundling harder for managers.

[14] Subramanian, supra note 2. Whether California really is overall pro-shareholder might be debated. It is true though that it's one of the least antitakeover of the states.

[15] Bebchuk, Cohen & Ferrell, supra note 2, although since much of the movement has been from California to Delaware, this conclusion depends on the pro-shareholder quality of California corporate law. In an important recent article, Kahan & Kamar, supra note 4, argue that no other state is racing against Delaware in corporate chartering for franchise revenues. This is a major contribution to seeing the limits to the race. True, even if so, it does not end the race analysis. The race could be one of quasi-contestable markets: if Delaware riles managers (in the bottom view) or hurts firms badly (in the top view), corporate players will rush to Rhode Island or North Dakota to convince them to pass new corporate law. Even if these states are not now racing, corporate players who would benefit from ending Delaware's dominance would show them what to do. This article complements the Kahan & Kamar conclusion: if no state is immediately "racing," then the federal authorities loom, relatively, even larger. It's also complementary in that if Delaware can react to federal power, then it has some packet of market power vis-à-vis other states, who cannot take all of the incorporation business away by undercutting Delaware.

[16] Winter, supra note 5; ROMANO, supra note 5; cf. Daines, supra note 1

II. THE FEDERAL BEHEMOTH: THEORY AND MEANS

That race theory is critically important if both a) all, or most, of American corporate law is really made by the states, and b) state interaction is the primary influence on that law-making. But there obviously is one other big law-maker in the United States, the federal government. What is the traditional division of authority between the federal and state authorities in corporate law? And who makes federal corporate law? The states, it turns out, are not alone.

A. The Internal Affairs Doctrine

If one were only to skim the doctrinal surface, one might think there was a sharp divide between state and federal corporate authority. States govern corporate internal affairs, while the federal authorities, namely the SEC, govern the external trading of the firm's securities. The structure is sometimes stated in federal decisions,[17] and is often proclaimed by Delaware players as proper, traditional, and in need of deep respect. Even the recent Enron debacle, said the Chief Justice of the Delaware Supreme Court early in 2002,[18] would be better dealt with at the state level.

But the internal affairs doctrine is just an understanding, not a crisp constitutional rule allocating corporate regulation. And it's an understanding that is breached more often than Delaware might like. It is breached formally when Federal authorities just go ahead and regulate internal affairs, as they did in Sarbanes-Oxley and related initiatives, mandating board structures and authority. And it is breached informally when federal authorities, under the guise of regulating something else—say, disclosure to securities markets—effectively control the underlying governance structure of the corporation, the very internal affairs that state law is said to govern.

Indeed, all of corporate law could be federal law. This is an obvious point, but one that needs to be explicitly kept in mind here. The interstate commerce authority means that the internal affairs doctrine can be no more than an understanding, not a sharp limit on federal law-making. Indeed, from time to time there is serious talk of federal chartering of firms in interstate commerce, a proposal that, although not realistic today, arose three times in the 20th century (in the 1900s-1910s, the 1930s, and the 1970s) as a serious proposal.[19] In banking, the federal government gave itself chartering authority, and when it wanted state-chartered banks to comply with federal policy, it required them to do so.[20] Congress, were it so inclined, could do the same for America's large firms.

---

[17] CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987).

[18] E. Norman Veasey, The Role of the Delaware Courts in United States Business Litigation, ALI-ABA Advanced Course of Study, April 11, 2002, at 3. E. Norman Veasey is Delaware's Chief Justice.

[19] See infra Part III.B. It continues in diluted form in academic work. Lucian Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999).

[20] Federal Deposit Insurance Act § ___, 12 USC § 1811. This raises a related issue: Bankruptcy and the regulation of capital-providers—banks, insurers, mutual funds, and pension funds—are seen in much of the world as closely-related to corporate law. It's an American conceit

But the issue of full federal incorporation fades, as Congress moves on to other agenda items. As a result, incorporation decisions are left to the states. The last serious effort at federal incorporation was gone by the end of the 1970's. Yet it still is on the minds of Delaware players, who understand the fragility of their franchise and still chafe under the criticisms they endured a quarter-century ago.

The potential for federal impact on state corporate law is noted from time to time in the academic literature. But the usual perspective is that the federal impact is interstitial, weak, temporary, and exceptional. After the isolated impact on this or that issue, the corporate world will get back to normal, with internal affairs a matter for state regulation.[21] I argue here though that the potential, and often the actual, impact of federal law-making in setting boundaries has been more consistent and pervasive. Throughout the 20th century, if the issue was important, it usually attracted Washington's attention, where the rules were often made. Hardly a decade has gone by without significant federal-state interaction.

Full federal incorporation is not the only way Federal authorities can displace state law. Federal authorities can federalize individual items. And, as we shall see in Part IV, federal authorities have regularly done so. When a big issue arises, either the courts (think of the burgeoning fraud liability of 1960s, which turned many state fiduciary duties into federal causes of action), or the SEC (think of proxy fights in the 1950s or the going private activity of the 1960s and 1970s), or Congress (think of the Williams Act in the 1960s or of federal corporate governance mandates via Sarbanes-Oxley) can rule on the issue, going right past the states, or can consider taking it, thereby pushing Delaware into a corner. Federal incorporation would be the clearest ouster of state law, but there are so many other ways by which federal authorities can take the production of corporate law away from the states.

They can, and they often have.

B. Who are the Federal Authorities?

Just to be explicit, we have three fundamental federal authorities, each of which can make and threaten to make corporate law.

1. Congress, of course. Consider corporate voting, perhaps the core "internal affair." Lawyers who work on corporate voting operate primarily not under state law, but under Federal proxy law, section 14 of the 1934 Act, which transformed most voting rules into federal rules. And the SEC could take away the rest from the states were it so inclined. Or governance issues like executive compensation can be

---

that corporate law is the law governing managers and shareholders. In these other domains, uniform laws, the Bankruptcy Code, and financial regulation make American law of the corporation primarily national. But I do not press this point in this article.

[21] I argued a decade ago that Delaware's takeover gyrations were partially explicable by the federal gravitational pull. Mark J. Roe, *Takeover Politics*, in THE DEAL DECADE 321 (Margaret Blair, ed. 1993). For similar notations of federal influence, usually on a particular issue, see Bebchuk & Hamdani, supra note 4 (weak federal constraint); [William W. Bratton, *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, ___ (1989)]; Melvin Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1512 (1989); Gilson & Black, supra note 107 (going private transactions). Even Cary's attack on Delaware could be seen implicitly viewing the Federal government as the only viable constraint on Delaware.

controlled (or so Congress hoped) via tax law. Sarbanes-Oxley shows how Congress, when it so wishes, can micro-manage corporate law. It mandates internal managerial duties and allocates authority inside the firm. And if Congress wishes, it can swoop in and take over any major aspect of corporate law, as it often has, and more often has threatened to.

2. And the SEC. The SEC has broad authority to regulate securities trading. Much securities regulation impinges upon, or overturns, state corporate governance rules. Consider two examples. When Delaware validated a corporate offer to buy back stock from its stockholders (an internal affair, between the firm and shareholders), and excluded one large shareholder—the raider—the SEC responded with its "all holders rule," obliterating the state rule.[22] Or consider who runs the corporation: Delaware says straight out that authority to manage a Delaware corporation is vested in its board of directors. And hence, a proxy proposal that directs the board is impermissible under Delaware law. But now, in a subtle evolution, the SEC is mandating that managers include "precatory" shareholder resolutions on ordinary decisions in the company's annual proxy solicitation. While "voice" is not direction and the structure leaves boards formally empowered to ignore their shareholders, enhanced voice can influence the board, change outcomes, and hence, is a step closer to power. State law's allocation of internal authority is thereby altered.

3. And the courts. Whether or not a shareholder can sue can obviously determine whether corporate law has bite. To a litigator it is perhaps the most basic right of the shareholder. And as is well-known to securities lawyers, the federal courts opened up a huge area of liability under the securities laws in the 1960s and 1970s, implying private rights of action in a way that was substantially turning state fiduciary rules into federal law. Although the Supreme Court cut back on the doctrinal bases for the expansion in the late 1970s, it had constrained state behavior before then and the constraint was not so aberrational that it could not happen again via other means.

4. And the stock exchanges. We also have a fourth, indirect conduit for federal authority. The New York Stock Exchange makes many rules that govern the largest firms, rules that affect internal corporate affairs, the stuff of ordinary state law-making. Stock exchange rules now regulate voting disparities, i.e., whether a one-share, one-vote is required, or whether voting strength is variable. While one might think that the NYSE is a fully private self-regulatory organization, that is not so. It's susceptible to much informal (and formal) influence from the SEC.[23]

[22] Compare Unocal Corp. v. Mesa Petroleum Co., 193 A.2d 946 (Del. 1985), with 1934 Act Rule § 14d-10.

[23] Cf. Exchange Act, §§ 6, 15A(b)(6); 15 U.S.C. § 78f(a), 78o-3(b)(6) (stock exchange rules must address certain issues).

III. DELAWARE'S MAIN COMPETITOR IN MAKING CORPORATE LAW: WASHINGTON, D.C.

A. Can Displace

Notwithstanding the fragile internal affairs doctrine, the Federal government can displace state corporate law, and rather easily. Legislation can preempt state corporate law, and it has. Judicial interpretation of open-ended legislation can leave little or no room for state corporate law, as it has on a few sharp, important occasions. Open-ended delegations to the SEC empower it to muscle aside the states, and it has. And securities law itself can directly pull away corporate law issues from the states, as it has for voting and more. As the leading securities regulation analyst of his time said: "it's not too much to say that [key provisions of the 1934] Exchange Act … [are] at least second cousin, if not first cousin, to federal incorporation in substance, not in form."[24]

1. Displacing state corporate law without federal incorporation. Federal chartering is the most obvious means of preemption. *But even were there no* prospect of Federal chartering—the situation today—federal authorities could still make corporate law. (And in doing so, it deeply affects the state-to-state race: Posit federal authorities determining *all key* issues, but not taking over chartering. If so, state corporate law would be rendered inconsequential, even if it issued the charters.[25] We are not at that end of the spectrum, nor are we at the other end.)

2. Federal corporate law, without Federal-state interaction. Even if Delaware made its rules oblivious to any possible federal trump, the theory would still be in play: The federal players replace state rules that it finds despicable, and modifies those that it dislikes strongly. Sometimes it makes the rules before the state players even act.

Imagine that corporate law consists of four yes-no rules. Delaware decides the four. Two come out (on average) as Federal authorities wanted. One they find repugnant and replace. (Or one is so important that they don't even let the states try.) The fourth state result, the Federal authorities find objectionable but tolerable and leave it in place. What's then left in Delaware is what the Federal authorities tolerate, or like. Even without Delaware reacting strategically to the Federal threat, the totality of Federal-Delaware corporate law is principally what the Federal authorities would want, even though Delaware nominally writes most of the rules. Current thinking looks at the situation I just described and says that corporate law is *75% state-made*, or conceivably 100%, because the federal portion is re-defined out, as an affair external to the corporation, one not considered a vital part of corporate law. Instead, I submit, corporate law in this paragraph can be seen as being as much as *87.5% federal* (or,

[24] Louis Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUSINESS LAWYER 27, 29-30 (1969).

[25] And then there would be no advantage to incorporating in Delaware. The race would then be primarily to provide the lowest tax rate, since states could not vary core corporate law any more than they can now vary securities law. When a corporate issue moves into the federal arena there is that much less for states to race about. Cf. Eisenberg, supra note 21, at 1512.

more accurately, as having a strong federal component). Delaware gets to say some of the words, but only as long as the Federal authorities tolerate their script.[26]

But Delaware-Federal strategic interaction is also in play, further strengthening the thesis here, as Delaware often has the risk of Federal action in mind when it makes its corporate law, as we next see.

B. Can Inspire Fear

Delaware players have reason to fear that if they mis-step, they will lose their law-making business. They know that the federal authorities, even if not breathing down the Delaware corporate necks at every moment, could act if they chose to. If Delaware decides an issue that instigates public policy-makers in Congress or the SEC to act, Delaware will lose the business. If a Delaware action deeply offends an interest group with clout in Congress, Delaware could lose the business. Accordingly, even when the Federal authorities are silent, Delaware has reason to be looking over its shoulder at Washington as much as, or more than, at any other state.

1. Federal incorporation. And Delaware has had reason to fear that everything could be federalized. Not now, in today's environment, but look at the history of federal incorporation, which was on the Washington policy agenda in three decades of the 20th century.[27] In the century's first decade

> [t]he U.S. Industrial Commission [in Washington] lodged a thinly veiled complaint against New Jersey, complaining that [a state's] corporate regulation couldn't stick [if tough] because a tough state would be displaced by another state like New Jersey.[28]

Presidents Roosevelt, Taft, and Wilson each sought mandatory federal incorporation.[29] And the prospect of mandated federal chartering of firms engaged in interstate commerce seriously arose again in the 1930's. The White House,[30] Congress in general,[31] and the head of the Congressional Temporary National Committee in particular, all pushed the idea,[32] and the SEC[33] seriously studied it.

---

[26] True, one might attribute full authority to the states on the issue that the Federal authorities deadlock on, making corporate law not 87.5% federal, but "only" 75% federal.

[27] Note*, Federal Chartering of Corporations: A Proposal*, 61 GEO. L.J. 89 (1972).

[28] Christopher Grandy, *New Jersey Corporate Chartermongering*, *1875-1919*, 49 J. ECON. HIST. 677, 686 (1989).

[29] LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 154 (3d ed. 1989).

[30] Allen D. Boyer, *Federalism and Corporation Law: Drawing the Line in State Takeover Regulation*, 47 OHIO ST. L.J. 1037, 1051 n.69 (1986), citing Letter from the President of the United States to the Chairman of the Senate Banking and Currency Committee (Jan. 25, 1934).

[31] Roper & Dickerson Report, S. Comm. Print, 73d Cong. 2d Sess. 4 (1934), reprinted in 4 LEGISLATIVE HISTORY OF THE SECURITIES EXCHANGE ACT OF 1934, item 16, at 4; Temporary National Economic Committee, *Final Report and Recommendations*, Sen. Doc. No. 35, 77th Cong., 1st Sess. 24 (1941) (the TNEC eventually favored national standards, short of national incorporation).

[32] The head of the Congressional committee, Senator O'Mahoney, describes his efforts through the Depression, World War II, and its aftermath, in an article entitled with his goal. Joseph G. O'Mahoney, *Federal Charters to Save Free Enterprise*, 1949 WISC. L. REV. 407, 415 (1949).

[33] LOSS, supra note 29, at 110 n.17.

Consider this summary of the New Deal view:

> Roosevelt committed himself to the long-held populist and progressive goal of superseding lax state corporation laws with more stringent federal standards. His security policy was an attempt to remedy the weaknesses in the … state and private rules then in effect, which cumulatively failed to minimize fraud or unfairness in the initial sale of corporate securities.
>
> Most fundamental of the rules Roosevelt sought to supersede were the state corporation laws. Originally the state corporate statutes had been restrictive, limiting, among other things, the amount of capital a business firm could raise. But [then the states raced to the bottom with lax corporate law].[34]

So the securities laws were passed, partly in the view that state law failed to handle key corporate problems. And later during the 1930s, Congress's main economic committee during the depression sought to "complet[e] the federalization of business law"[35] that the securities laws had started. Senator O'Mahoney, who chaired the committee, said that '[s]ince … national commerce is carried on by national corporations, it should be the Federal Government and not the State governments which … describe and outline the powers of the corporations … ."[36] The Senator would have had federal rules determine both fiduciary rules and voting rights, regulate how shareholders vote on executive compensation, establish judicial review of stock issuances, and set up alternatives to management-controlled proxy machinery.[37] As if that were not enough to end Delaware's franchise, the bill would have required that the place of incorporation be the company's principal place of business,[38] a requirement that would have ended Delaware's race to anywhere.

Later, in the 1970s, William Cary, by then a former chair of the SEC, brought the issue back, as it turned into an American Bar Association study: Cary said that it was time to end Delaware's influence on corporate law. Either corporate law should be national for firms in interstate commerce, or federal rules should establish a minimal set of standards that would cover all corporations in the United States.

2. Federal minimal standards. William Cary's ultimate proposal side-stepped federal incorporation, advocating, in lieu of a national corporate law, national minimum corporate standards,[39] an idea Congress then picked up with proposals to mandate independent directors, to require key board committees to have a majority of independent directors, and to have shareholders vote on more matters.[40] (These

---

[34] JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 42 (1982).

[35] Boyer, supra note 30, at 1052. See O'Mahoney, supra note 32.

[36] *Hearings on S.10 before the Subcomm. of the Senate Comm. On the Judiciary*, 74th Cong., 1st Sess. 270-71 (1937). And, said the Senator, "if a corporation is engaged in interstate commerce … the representatives of the people of the United States [ought to] defin[e] … its power." Id. at 441.

[37] Boyer, supra note 30, at 1053.

[38] Id. at 1052. This would roughly have mapped onto Europe's "real seat" doctrine.

[39] For the Congressional possibilities, see *Hearings on Corporate Rights and Responsibilities Before the Senate Comm. On Commerce*, 94th Cong., 2d Sess. (1976).

[40] Cf. Fischel, supra note 5, at 916.

proposals, radical at the time, eventually became the norm, either by accretion, practice, stock exchange rules, or SEC action.)

Consider Cary's influential article alone. Little could threaten Delaware more than to read the plan of a then-recent Chair of the SEC for federal standards of corporate action, dealing with Delaware not by praising its expert and savvy judges but by dismissing it as a pygmy.[41] Corporate law must be improved, said Cary, and

> The first step is to escape from the present predicament in which a pygmy among the 50 states prescribes, interprets, and indeed denigrates national corporate policy as an incentive to encourage incorporation within its borders.[42]

These were not the easy-to-dismiss musings of a frustrated SEC commissioner. Nor did they lack real world impact. The American Bar Association quickly studied the proposal from the article—considered to be "the most influential piece ever published by the Yale Law Journal"[43]—to advise Congress whether to federalize corporate law, indicators Delaware players could surely not ignore.[44]

If Cary's proposal for federal minimal standards hit Delaware hard, that would be enough to put down a brick or two in the foundation of the argument I am building—that Delaware's principal competitor is Washington. But there is more. The article still stings Delaware players, 25 years later. One can hear them—in 2002—arguing against Cary's mistakes and how misguided it would have been—and would be today (more of that soon)—to federalize any key part of corporate law.

3. Consciousness. We cannot psychoanalyze the Delaware players to see if they're consciously weighing the risk of federal ouster or otherwise reacting to federal pressure. But we can detect consciousness of the federal threat.

Consider how one critical takeover decision began: This is an issue that "has attracted *national* attention," said the judge first.[45] True, we might see the judges' statement as simple breast-beating. Or it could be Delaware visibly assessing whether it had room to maneuver. Was it constrained by the federal position? With the eyes of the federal authorities upon it, was Delaware really free to maneuver? The latter interpretation is made more plausible by the Court's next stating that an amicus brief "ha[s] been filed in support of appellants by the … SEC," a threat that the court immediately confines by noting: "The SEC split 3-2 on whether to intervene in this case. The two dissenting Commissioners have publicly disagreed with the other three

---

[41] Cary, supra note 6, at 701.

[42] Id. at 696, 700-03.

[43] Ralph K. Winter, *Foreword* to THE GENIUS OF AMERICAN CORPORATE LAW xi (1993).

[44] Richard W. Jennings, *Federalization of Corporate Law: Part Way or All the Way*, 31 BUSINESS LAWYER 991 (1976). Social responsibility activists wanted federalization for other reasons, beyond those that motivated Cary and the ABA study. RALPH NADER ET AL., CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS (1976).

[45] Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (emphasis supplied).

as to the merits … ."[46] With the interested Federal authority divided, Delaware could act more easily than if the federal view were cohesive.

Consider next the view of the prominent Delaware attorney who led the state's powerful Bar Association corporations committee that planned the state's takeover law, on why Delaware had to pass only a moderate antitakeover law in 1988:

> [W]hy … moderate …? Why [not] the most restrictive thing that we can pass? … [T]o the extent that our legislation is viewed either in the short run or the long run as unbalanced and unreasonable, *we all know* that ultimately … we might have to pay the price … of the *federal government coming in and taking … the privilege from us*.[47]

There are revealing speeches. As the 1980s takeover controversy wound down, one Delaware justice commented that Congress was not doing much anymore to control takeovers, implying that the Delaware judiciary had more room to maneuver.[48] And even when Delaware players did not have their eye on what Congress was doing, they knew that media criticism could induce federal action.[49]

More than fear motivates Delaware. Federal authorities deserve respect. As the Delaware Chancery court said recently: "An administrative agency—the Securities and Exchange Commission—has a technical staff, is able to hold public hearings, and can, thus, receive wide and expert input."[50] Either way, Delaware is looking over its shoulder, either at an expert or at a competitor, when it decides.

Consider a recent speech from Delaware's Chief Justice. First off, he sees more clearly than is the norm that the internal affairs doctrine gives Delaware only paper-thin protection. Even where state courts are arguably primary—in internal affairs—"the federal securities regulatory regime is a force in influencing the internal affairs of corporations."[51] And "the New York Stock Exchange … impose[s] … internal standards … [like] minimum standards for audit committees."[52]

But the "internal affairs doctrine" is a long tradition, he pleads, albeit one that federal preemption could end at any time.[53] The Enron debacle and the ensuing corporate governance controversy could precipitously end it, as by then the

---

[46] Id. at 1346 n.1. As I've noted, it's here—where federal authority is uncertain or divided—that the states can race. It's a race confined by federal boundaries: is there a line at which the federal authorities would no longer be divided, and where is that line?

[47] Hearing on H.B. 396 Before the Delaware H.R., 134th Gen. Assembly (Jan. 26, 1988) (testimony of A. Gilchrist Sparks III, chairman of the Delaware Bar Ass'n Corp. Law Council), as reported in Kahan & Kamar, supra note 4, at 741 n.230 (emphasis added).

[48] Justice Andrew G.T. Moore II, *State Competition: Panel Response*, 8 CARDOZO L. REV. 779 (1987).

[49] The Wall Street Journal editorial page, particularly influential during the Reagan-era, lambasted Delaware's validation of the poison pill. See *Review & Outlook: Et Tu, Delaware*?, WALL ST. J., Nov. 21, 1985, at 30, cols. 1-2. They attacked Delaware, but did not propose a federal solution.

[50] Lewis v. Vogelstein, 699 A.2d 327, 332 (Del. Ch. 1997).

[51] Veasey, supra note 18. Veasey's speech was delivered in April 2002, at an American Bar Association function. E. Norman Veasey is the Chief Justice of Delaware.

[52] Id. at 3.

[53] "Absent … Congressional preemption…." Veasey, supra note 18, at 2. He though then concedes that a healthy chunk of securities law effectively regulates internal affairs. Id. at 3.

controversy had already induced Congressional and SEC proposals to deal with internal affairs.[54] But that traditional separation should continue, he says, "selling" the virtues of Delaware over Federal ouster: trustworthy courts with "integrity, expertise, diligence, good faith, independence and professionalism."[55] Although "the Enron foment has provoked debate about the effectiveness of [state-law] standards governing directors[,] … [my] thesis is that the Delaware model works well, over all, … and that one should be cautious in concluding that current events dictate a new … regime of corporate governance."[56] But, says the Chief Justice, *"[i]f we don't fix it [corporate governance], Congress will*, but I hope they've gone as far as they're going to have to go."[57]

Delaware is a major architect of the current regime, he argues further. (A new regime might not have Delaware at its center.) Where might that new regulatory regime come from? "There are competing bills in Congress addressing corporate responsibility."[58] And the SEC might swing into action: "[The then-SEC chair,] Mr. Pitt [says Justice Veasey, quoting the Wall Street Journal,] has … propos[ed] numerous changes to tighten corporate governance, accounting and disclosure standards in recent months, in part to head off … action by Congress."[59] One sees a sense of wistfulness emerging in Delaware: Enron was transforming the corporate arena into one where the SEC jockeyed with Congress, with Delaware on the sidelines.

Three months after the Chief Justice's plea, Congress passed Sarbanes-Oxley, which swept aside key areas of corporate governance and corporate law previously governed by state law.

C. Has Displaced

Having demonstrated that Federal authorities can displace Delaware, that the "internal affairs doctrine" is an understanding that can be, and has been, breached, and that Delaware players understand its vulnerability, I will next demonstrate that federal law deeply affects the corporate internal affairs that Delaware seeks to regulate. First, I

[54] Veasey, supra note 18, at 9. Veasey worried about federal over-reaction. Over-reaction could be detrimental to the corporation; it would also take critical corporate governance elements away from Delaware, vesting them elsewhere. Id. at 10-11. "[W]e do not take for granted our responsibilities or our reputation. … [W]e try harder, because life would be much less interesting without the corporate activity that engenders all this … interesting work." Id., at 33.

[55] Veasey, supra note 18, at 5.

[56] Id. at 4 (emphasis added).

[57] *What's Wrong with Executive Compensation*?, HARV. BUS. REV. 68, 77 (comments of Chief Justice Veasey). Cf. Leo E. Strine, *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAWYER 1371, 1372 (2002): "Hanging in the balance are important issues… . Congress may even … federaliz[e] key elements of corporate law … ." Cf. William B. Chandler III & Leo E. Strine, *The New Federalism of the American Corporate Governance System*, __ U. PA. L. REV. __ (2003): "[P]roblems [occur] if the federal government … [is] not sensitive to the states' primary role in the formulation of substantive corporation law." And: "[T]he 2002 Reforms … generate creative friction with state corporate law … . Delaware … is perhaps slower than ideal in adapting to the new [issues of executive compensation]." Chandler is Delaware's sitting Chancellor; Strine is a Vice Chancellor.

[58] Veasey, supra note 18, at 9.

[59] Id. at 9.

shall show that key matters that conceptually are internal affairs are nonetheless governed by federal law. Second, I shall show instances where states said "yes" to a practice, and the federal authorities came right back and said "no." Sometimes Delaware changed its rule in response to the federal action; sometimes they just watched as the federal authorities took over the law-making. Federal authorities changed the rules governing proxy fights in the 1950s, going private transactions in the 1960s and 1970s, and company self-tender offers in the 1980s. Along the way, federal authorities regulated the leveraged buy-out, and displaced state rules on dual class recapitalizations. For a time, in the early 1980s, takeover law was increasingly becoming federal law. And the early 20th century origin of Delaware came via federalization of the key corporate issues of the time, leaving the states to compete over less important mechanical rules.

1. Delaware's origins in the first federalization. It's not just a modern phenomenon. A hundred years ago, the late 19th- and early 20th-century state-to-state race mixed antitrust and corporate law mandates in a way that would today be odd. Today we keep the antitrust and corporate law categories apart, in differing regulatory domains. The federal government first considered taking everything away from the states via federal incorporation (since the antitrust and corporate issues were mixed), and eventually took away antitrust, severing the two categories.[60]

When the Ohio Attorney-General attacked Standard Oil, he mixed antitrust and corporate policy. Standard Oil had made the oil industry anti-competitive via trust arrangements. The Standard Oil trust in New York held the stock of most of the American oil industry. But, argued the Ohio Attorney-General to the Ohio courts, Standard Oil's entry into the trust arrangements was ultra vires the Ohio corporation. It was ultra vires because such an action—a restraint on trade—was not an act the Ohio legislature authorized Standard Oil to do in its charter, and Standard Oil's authority came solely from its charter. The Ohio Supreme Court agreed and ordered the trust dissolved.[61] Issues of antitrust and corporate authority intersected under state law.

Why had Standard Oil entered into the trust? Its cartel was unstable, for normal cartel reasons. (Members agreed to cut output and raise price, but the high price was attractive, so they increased output. Increased output then forced prices lower, so the cartel unraveled.) Standard Oil wanted to buy the oil companies with which it had the trust deal, but Ohio corporate law barred it from buying the stock of a non-Ohio corporation. Other trusts in other states were formed for the same corporate reasons

[60] As late as 1933, Brandeis still thought the race was an antitrust race. That is, Brandeis' well-known characterization of the states as racing to the bottom, quoted supra in text accompanying note 9, was about *antitrust* considerations, *not* pro-shareholder corporate rules. Brandeis' lead-in sentence was: "The removal by the leading industrial states of *the limitations upon the size and powers of business corporations* appears to have been due, not to their conviction that maintenance of the restrictions was undesirable in itself but to the conviction that it was futile to insist upon them." 288 U.S. at 557-58. Brandeis was speaking of the states' willingness to allow corporate growth, and to give the corporations the means to monopolize, which he opposed. The states were actually providing pro-shareholder rules, by facilitating monopolization. And, hence, the first federalization fits uneasily in the modern framework, which sees state competition mainly in terms of managers vs. shareholders.

[61] State of Ohio v. Standard Oil Co., 49 Ohio St. 137, 30 N.E. 279 (1892). More precisely, it ordered Standard Oil of Ohio—the key player in the trust—to drop out.

and were attacked for the same monopoly-antitrust reasons. The Cotton Oil Trust—a big trust operation at the time—was organized in 1884 to process cottonseed oil.[62] Tennessee and Louisiana attacked it, and their courts sought to shut the trust down.[63] These were corporate issues with national economic consequences.

New Jersey became the mother of trusts, as it was called, largely by authorizing New Jersey corporations to acquire stock in non-New Jersey corporations, thereby facilitating organizing monopolies as holding companies rather than as trusts. This can be properly seen as a state-to-state race at first: states raced to provide flexible terms that would facilitate Standard Oil's monopoly. (Ironically, this was good for its shareholders and, in modern terms, a race to the top, but bad for the public.) New York was approached by the trusts, but refused. New Jersey acceded.[64]

A year after New Jersey's first corporate law liberalization for the monopolizing firms, Congress passed the Sherman Act, formally taking away the authority New Jersey had bestowed on the corporation. New Jersey's corporate law allowed its corporations to enter into one type of combination (the interstate corporate merger) in restraint of trade. If the Federal authorities effectively enforced the Sherman Act, then such a merger would violate the Sherman, and all that would be left to the states would be the (less important) authority to regulate non-monopolizing mergers. Not trivial, but not the core issue of the time.

Then the Delaware-New Jersey race began. Delaware copied New Jersey's mother-of-trust rules, but firms were happy with New Jersey and stayed put. Two decades later though, Woodrow Wilson as New Jersey Governor and presidential contender tried to take away the flexibility. Reformers had excoriated New Jersey's corporate law that had made the state the mother of trusts, and Wilson agreed.[65] He campaigned against monopoly when he ran for governor in 1910, although when elected he did not act. In the 1912 presidential election, Theodore Roosevelt taunted Wilson as being an ersatz reformer, when he, Roosevelt, had busted up trusts. So Wilson implored the state legislature: "The *corporation* laws of the State notoriously stand in need of alteration. *They are manifestly inconsistent with the policy of the Federal government.* … The laws of New Jersey, as they stand, so far from checking monopoly actually encourage it. … We should act upon them at once."[66] The core element was a local antitrust act, but New Jersey also repealed its law authorizing

---

[62] ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 326-27 (1977)

[63] Mallory v. Hanour Oil-Works, 86 Tenn. 598 (1988). See Stephen Marshall, New Jersey and the Trusts, 1888-1896: The Birth of Modern Corporation Law (Dec. 6, 1988 Rutgers working paper).

[64] It passed its first pro-monopoly corporate law in 1889, and continued to make its corporate laws easier for the trusts in the 1890s. Harold W. Stoke, *Economic Influences Upon the Corporation Laws of New Jersey*, 38 J. POL. ECON. 551, 571-74 (1930); Christopher Grandy, *New Jersey Corporate Charter-mongering, 1875-1919*, 49 J. ECON. HIST. 677, 681 (1989).

[65] Lincoln Steffens, *New Jersey: The Traitor State*, MCCLURE'S, May 1905, at 46-47.

[66] Stoke, supra note 64, at 578 (emphasis supplied); William E. Kirk, *Case Study in Legislative Opportunism: How Delaware Used the Federal-State System to Attain Corporate Pre-eminence*, 10 J. CORP. L. 233, 255-56 (1984).

holding companies, the means for monopolization. New Jersey corporations could not buy the stock of competitors.[67]

New Jersey was shutting the antitrust barn doors after their authority had already fled the states for the federal government: By the time Wilson induced the state legislature to act (after the 1911 *Standard Oil* decision meant real Federal antitrust action), the big antitrust authority was federal, and all that was left to the states was corporate flexibility. But presidential debates between Roosevelt and Wilson are not as accurate as we can be on the 1912 efficacy of state corporate law in combating the trusts, and state corporate action followed the then-contemporaneous perception. And then Delaware grabbed the corporate chartering business.

That this was then a mixed issue of antitrust and corporate law was well-understood at the time,[68] although it usually disappears from today's accounts. The federal authorities took the big stuff away—the mechanisms that would strongly affect profits and capital costs—leaving the smaller mechanics for the states.

2. One pervasive incursion: Securities regulation and the SEC. We clearly have two major regulators of the large corporation in the United States: state corporate law and the securities law. Corporate commentators regularly point to the overlapping authority and the conflicts, and the courts try sometimes to separate out the two contesting authorities.

The legislative history of the 1934 Act is instructive. Congress's first report recommended full federal incorporation for firms in interstate commerce, not just a securities statute. While the pure-form of federal incorporation was not taken up, pieces of that plan entered the 1934 Exchange Act. Critics of the 1934 Act said that core provisions *were really federal incorporation rules* that should not be part of the statute.[69] They became part of the 1934 Act anyway, and people just stopped thinking of, say, voting and insider trading as internal affairs, "reconciling" the facts with a new articulation of the lines demarcating corporate internal affairs.

Consider voting. The wide SEC regulation of proxies determines what goes into the proxy request to shareholders, what gets onto the ballot, who gets access to shareholder lists, and how a proxy fight (what could be more basic and internal?) is waged. This is not a small point. Voting is probably the single most important internal corporate affair. It and other key matters that conceptually are internal affairs are governed by federal authority, yet we hardly hear a murmur anymore from internal affairs purists about it.

Or consider the corporation's officers' purchase of stock from the corporation's stockholders on inside information. Such buying and selling of common stock—inside-

---

[67] Stoke, supra note 64, at 578. We could speculate that when the federal government fully federalized antitrust, there was less revenue for New Jersey to extract from the monopolies via the franchise tax, thereby rendering the New Jersey charter less valuable to the large corporation. And hence the chartering business was rendered less valuable for New Jersey, and in turn it could more easily indulge in being public-spirited in denying the then-perceived tools of monopolization.

[68] Note, *Little Delaware Makes Bid for the Organization of Trusts*, 33 AM. L. REV. 418 (1899). Cf. MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1870-1960: THE CRISIS OF LEGAL ORTHODOXY 84-87 (1992).

[69] LOUIS LOSS, SECURITIES REGULATION 109 (superceded 2d ed. 1961).

trading—was validated by the states at common law, and that state result was eventually taken away from the states via the federal securities laws.[70]

(a.) The view in 1933 and 1934—Delaware and the states were seen as not inducing adequate, modern information dissemination from the corporation to its shareholders. Indeed the states generally required no information dissemination, seeing the annual election as sufficient to induce the incumbents to give information sua sponte. Nothing more was needed, although little information was sent out. With states neglecting to compel disclosure, the stock exchanges stepped in early. The first major disclosure effort in the United States came in 1907, not from New Jersey or Delaware, but from the New York Stock Exchange.[71]

Delaware seemed deficient in other areas to Federal players. In the late 1920's Delaware amended its statutes, in a mis-timed act to allow corporations to waive some long-standing protections for shareholders, and to authorize directors to issue "blank" stock whose full terms would be set later by the board.[72] Adolf Berle, an influential commentator of the time, "scathingly" attacked these acts as amounting to the "power of confiscation."[73] The point here is not to assess whether Delaware was racing to the bottom (or to the top), but to see that the Federal authorities reacted. (The Delaware provisions plausibly were sensible, but they riled those who were listened to in Washington, inducing a federal response.)

Disclosure to current shareholders (not just disclosure to external buyers) was federalized in 1934. Indeed, effectively all of corporate accounting has been federalized. It's been done in recent decades by FASB (the Federal Accounting Standards Board), with SEC influence. When accounting controls fail, as they did in Enron and WorldCom, we look to Federal authorities to fix the problem, not to state corporate law.[74]

(b.) Shareholders' vote—Arguably the core of corporate law is the shareholders' vote. The view is now well accepted that the annual proxy solicitation is effectively controlled by SEC regulation, with state law having long faded to a secondary role. Hornbooks tell us that "SEC regulation is in fact so pervasive that … the very structure of the proxy solicitation process is not only informed but dictated by SEC regulation."[75] Or that logically, "[i]n a more perfect world, proxy regulation would be

---

[70] See Goodwin v. Agassiz, 186 N.E. 659 (Mass. 1933) (no privity, therefore no insider trading liability). This was the usual common law rule; it may still be state fiduciary duty today. See Freeman v. Decio, 584 F.2d 186 (7th Cir. 1978) (no fiduciary duty under Indiana law to abstain from insider trading). Nor was this an American common law aberration; British courts reached the same result and left distant shareholders unprotected from insider trades. [Percival v. Wright, 2 Ch. 421 (1902).] Cf. U.S. v. Bryan, 58 F.3d 933, 950 (4th Cir. 1995) (10b-5's insider trading misappropriation theory is "the effective federalization of … relationships historically regulated by the states"). The federal action was choppy: the original bill's explicit rules were dropped and § 16(b) is incomplete. But the general antifraud rules of § 10(b) in time became the federal bar to insider trading.

[71] Paul H. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997).

[72] Seligman, supra note 34, at 43-44.

[73] Id. at 44.

[74] E.g., Daniel Akst, *Why Business Needs a More Powerful S.E.C.*, N.Y. TIMES, Nov. 3, 2002, at C4 ("Corporate America has been rocked by scandal … [It needs] a bigger, better-funded S.E.C.").

[75] ARTHUR M. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 148 (1999).

handled in state corporation statutes."[76] The logic is there, but the reality is that the central act of shareholder control over the board—the annual election of the directors—is overwhelmingly a matter of federal, not state, law.

Why did federal law grab jurisdiction over the core corporate internal act? Probably because states were seen in 1934 as having done "virtually nothing to cope with the problem … of [abuses in] the solicitation of proxies [for management]."[77]

In the 1950s, serious proxy fights emerged and became the major corporate law issue of the time.[78] State decisions came down in favor of insurgents,[79] and the Federal authorities quickly regulated proxy contests with the 1950's SEC proxy rules, rules seen to have been responding to managerial pressure, impeding the insurgents even without state corporate law action on voting and proxy solicitation.[80]

Consider just one mechanical aspect: access to shareholder lists. That access was once considered unsatisfactory at state law.[81] Now SEC Rule 14a-7 requires the company to mail the insurgents' proxy statement for them, or furnish them with a list, a mechanical act that might have been solely regulated at state law. Combine Rule 14a-7 with Regulation 13G, which requires most major shareholders to publicly disclose their holdings, thereby allowing precise assembly of institutional shareholding lists, and we have nearly complete federal displacement of even the most mundane mechanical aspect of state law: insurgents' access to shareholder lists. The SEC in its last early 1990s initiative on shareholder lists was direct, but polite, saying that it promulgated 14a-7 to reverse state law, and end the "*expense and delay requestors typically encounter [under state proceedings] in obtaining a securityholder list.*[82]

Another federal displacement of a mechanical, internal voting rule: state law allowed managers to bundle proposals, putting up a shareholder-friendly proposal

---

[76] LARRY D. SODERQUIST & THERESA A. GABALDON, SECURITIES LAW 116 (1998). Distant viewers see clearly that "[f]ederal securities law has … become an integral part of the law governing corporations *even though the latter is ostensibly* a creature wholly of state-law." JERRY L. MASHAW, RICHARD A. MERRILL & PETER M. SHANE, ADMINISTRATIVE LAW: THE AMERICAN PUBLIC LAW SYSTEM 1126 (4th ed. 1985).

[77] Edward R. Aranow & Herbert A. Einhorn, *Proxy Regulation: Suggested Improvement*, 28 GEO. WASH. L. REV. 306 (1959). Aranow and Einhorn were major securities law commentators of their time.

[78] Willard P. Scott, *Developments in Corporate Law*, BUSINESS LAWYER, July 1955, at 25.

[79] See Wolfson v. Avery (interpreting Illinois constitution as barring a staggered board); Humphrys v. Winons Co. 125 N.E.2d 204 (Ohio 1955); Penn-Texas Corp. v. Niles-Bement-Pond Co. 112 A.2d 302 (N.J. 1955) (barring incumbents in a New Jersey corporation from postponing annual meeting); Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291 (N.Y. 1955) (allowing expenses to insurgents); In re R. Hoe & Co., Inc. 132 N.Y.L.J., No. 86 (N.Y Sup. Ct. Nov. 8, 1954) (allowing insurgents aggressive tactics including "innuendo, misstatement, exaggeration and puffing … as a by-product of a bitter campaign").

[80] John Pound, *Proxy Voting and the SEC*, 29 J. FIN. ECON. 241, 263-67 (1991).

[81] Cf. case-law outlined in the SEC Release, cited in note 82 infra.

[82] Exchange Act Release No. 34-29315, 56 FR 28987-01, at 28,997 (June 1991). Cf. id., at 28,994 n.63 (collecting state cases of lawsuits delaying shareholder access to the companies' lists). One might have thought that this too—a current shareholders' access to the internal corporate list of shareholders—would be an internal corporate affair. But, the SEC redefined this as an external affair. Id. at 29570 n.43 (access to "shareholder lists is not a matter subject to the regulation of the internal affairs of the corporation"). Elastic concept. Moving line.

(special dividend of $X) with a less-friendly one (entrenching managers), which the shareholders had to vote on as a package. The SEC's 1992 proxy amendments, however, now require that the "proxy provide for a separate vote on each matter presented."[83] And similarly, the SEC allowed shareholders to "mix and match" in voting for directors, making it easier for them to elect a minority slate to the board.[84] And even today, the process continues, as the SEC considers instructing firms to give shareholders authority to nominate directors through the company's (historically: management's) own proxy statement.[85] These are all, by any functional view of the term, internal affairs.

(c). Insider trading rules to displace state law—Insider trading was usually legal at common law.[86] The corporation and its officers could disclose or not, according to their pleasure. (Lack of privity meant lack of fiduciary duty.) One might have thought of this as an internal relationship between the firm's manager-controllers and its shareholders. But these common law rules were seen as sub-optimal corporate governance, and the federal authorities took over some regulation of insider trading in 1933 and 1934,[87] and the ambit of that regulation expanded greatly in the 1960s with *Texas Gulf Sulphur*.[88] The rules could have developed out of state agency law's ban on an agent using confidential information to make a profit or out of state fiduciary duty law. They could have, but they did not, and the insider trading rules are federal now.

(d). Federal quasi-fiduciary duties—Even general fiduciary duties, perhaps the core of common law regulation of the corporation, suffered federal incursions. In the 1960s and 1970s the explosion of 10b-5 liability was moving common-law-style regulation of all of the then-current corporate transactions into federal courts. The Second Circuit was transforming what had previously had been state fiduciary duty issues into 10b-5 fraud claims.[89] And other circuits were following. As Richard Jennings, a leading authority on securities regulation in the mid-1970s, said: "most of the important litigation relating to corporate mismanagement and shareholder abuse is not conducted in … the Delaware courts [any longer]. … [N]o shareholder in his right mind will litigate a shareholder grievance in a Delaware state court if some other forum is available …."[90]

---

[83] *Regulation of Communications Among Shareholders*, SEC Release No. 34-31326, 52 S.E.C. Docket 2028, Release No. IC-19031 (1992); Rules 14a-4(1) & (b)(1).

[84] Rule 14a-4(b).

[85] SEC, Division of Corp. Fin., Staff Report: Review of the Proxy Process Regarding Nomination and Election of Directors, July 15, 2003, Exchange Act Release No. 34-47778, File No. S7-10-03.

[86] WILLIAM ALLEN & REINIER KRAAKMAN, COMMENTARY AND CASES ON CORPORATE LAW 14.1 (2002) (multilithed draft casebook).

[87] Exchange Act, § 16(b). Wider federal regulation of insider trading was deleted from the first bills, but then interpreted into 10b-5 years later.

[88] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (1968) (en banc), cert. denied 394 U.S. 976 (1969); In re Cady, Roberts & Co., 40 S.E.C. 907 (1961).

[89] Drachma v. Harvey, 453 F.2d 722 (2d Cir. 1972); Poplin v. Bishop, 464 F.2d 714 (2d Cir. 1972); Schoenbaum v. Firstbank, 405 F.2d 215 (2d Cir. 1968); Vine v. Beneficial Finance Co., 374 F.2d 627 (2d Cir. 1967); Levine v. Biddle Sawyer Corp., 383 F. Supp. 618 (S.D.N.Y. 1974)

[90] Jennings, supra note 44, at 997. Accord, Loss, supra note 24, at 34.

Delaware's competition for the issues of the day came from the federal courts—"the flight of shareholder litigants from the state to the federal courts has been … massive" said Jennings[91]—and other commentators thought that 10b-5 would soon govern sales of control, going-private transactions, corporate opportunities (which after all visited a type of fraud on the firm), self-dealing, and so on.[92] They so thought, that is, until the tide crested with *Santa Fe v. Green*.[93] Even though that tide has receded, the landscape did not dry out. Much securities litigation continues today to be corporate governance litigation, and in places has a scope and depth at least that of state litigation.[94] And even when federal authorities do not take over fully, the possibility of their doing so affects Delaware, and often does so more than a state-to-state race.[95]

That influence continues today. To disclose an act is to control that act. Disclosure can charge up fiduciary duties in a way that state law cannot, because potential plaintiffs often cannot discover the fiduciary wrong under state mechanisms. State law might ban self-dealing transactions, but the machinery that sorts out which survive from which fail is made by the SEC, not state corporate law, via disclosure and gate-keeping rules. The SEC rules—defining the materiality standard, finding causation between trading loss and non-disclosure, listing the transactions, and controlling the accountants' interaction and duties—all can, and do, determine which conflicted transactions are effectively regulated, and which are ignored.[96] While the formal division of authority is said to be that the SEC is disclosure-forcing and stock-trade-regulating, while the states handle the internal affairs of shareholder-director relations, savvy lawyers, judges, and analysts know better. Much substantive law can be, and is, made in the name of disclosure. To force disclosure that "This company is run by thieves" usually ends the bad practice, and, hence, ex ante, keeps the thieves out.[97]

---

[91] Id. at 1000.

[92] Stanley A. Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUSINESS LAWYER 883 (1976); Boyer, supra note 30, at 1054.

[93] 430 U.S. 462 (1977). *Santa Fe* ought not though to have relieved the states of fear of federalization, as it invited *Congress* to act: "There may well be a need for uniform federal fiduciary standards to govern mergers," said the Court, "…[b]ut those standards should not be supplied by *judicial* extension of Section 10(b) and Rule 10b-5 to 'cover the corporate universe.'" 430 U.S. at 479-80 (emphasis supplied).

[94] Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, __ VAND. L. REV. __ (2003) ("purchaser-seller connection acts more like the minimalist jurisdictional hook of the interstate commerce requirement rather than a real constraint on the use of securities law to regulate corporate governance") (MS at 5 and MS at 26) ("loyalty-type claim").

[95] Joel Seligman, *The New Corporate Law*, 49 BROOKLYN L. REV. 1 (1993).

[96] See Regulation S-K § 404, which mandates disclosure of a wide class of interested party transactions in the company's annual report and any prospectus used to sell securities to the public.

[97] Cf. Donald C. Langevoort, *Seeking Sunlight in Santa Fe's Shadow: The SEC's Pursuit of Managerial Accountability*, 79 WASH. U.L.Q. 449, 456 (2001) (rarely are all "the relevant facts [of a fiduciary] … breach … set before the shareholders …. The temptation to conceal or 'spin' is too strong. Hence, … [*Santa Fe*] is not a severe restriction …."); Ralph C. Ferrara & Marc I. Steinberg, *A Reappraisal of* Santa Fe*: Rule 10b-5 and the New Federalism*, 129 U. PA. L. REV. 263 (1980).

3. Four sharp federal incursions. For four specific aspects of the firm, federal law directly displaced state corporate law: for going-private transactions, in the all-holders rule, for dual-class recapitalizations, and for institutional investor voting rules.

(a.) Going private and the SEC—In the 1960s and 1970s a common corporate transaction was to "go private." A firm had a controller, with a smattering of public stock. The controller decided to take the firm private, eliminating the public stockholders. Often there were good business reasons: more confidentiality, lower expenses, etc. But whether there were good reasons or not, the price paid and the process used were controversial corporate issues at the time. The SEC wrestled with Delaware. The Delaware cases at first validated going private, holding generally that the dissenting shareholders' only remedy was to get appraisal rights,[98] a remedy that many viewed as inadequate.

The SEC did not hide its disgust with these Delaware cases. SEC Commissioner A.A. Sommer recited the terms of a going private transaction in which the dominant shareholder would gain 400% "without a single dime of additional investment [from] her!" and concluded that "there is something wrong with that."[99] Moreover, the problem is generic, he said: "[f]or some time now there has been widespread criticism of the inadequacies of state corporation law."[100] And, "[t]here are many reasons for [the recent] expansion of federal law. First has been the recognized insufficiency of state laws."[101] Why insufficient? Because "Delaware [is] notorious for the favor its laws show to management, often at the expense of shareholders."[102]

Eventually the SEC promulgated Rule 13e-3: "Going Private Transactions By Certain Issuers …," scorning state law in their release, as had Commissioner Sommer, albeit more politely: "[A]pplicable state law ha[s] not always provided an adequate remedy to the potentially deleterious effects of going private transactions."[103] Delaware shortly afterwards reversed itself.[104] Via its late 1970s decisions, says a critical analyst, "the Delaware Supreme Court … strengthened considerably the power of minority shareholders vis-à-vis management [in going private transactions]."[105]

---

[98] Stauffer v. Standard Brands, Inc., 187 A.2d 78 (Del. 1962); David J. Greene & Co. v. Schenley Indus., 281 A.12d 30 (Del. Ch. 1971); Singer v. Magnavox, 367 A.2d 1349 (Del. Ch. 1976).

[99] See Address by A.A. Sommer, Jr., SEC Commissioner, [1974-75 transfer binder] CCH Fed. Sec. L. Rep. ¶80,010. Cf. Kahn v. United States Sugar Corp., 1985 WL 4440 (Del. Ch. 1985).

[100] AA. Sommer, Jr., *Further Thoughts on "Going Private", Full Text of Commissioner Sommer's Speech on "Going Private"*, SEC. REG. L. REP. (BNA), Mar. 19, 1975, at D-3.

[101] Id. at D-2.

[102] A.A. Sommer, Jr., *"Going Private": A Lesson in Corporate Responsibility, Full Text of Commissioner Sommer's Remarks on "Going Private"*, SEC. REG. L. REP. (BNA), Nov. 20, 1974, at D-1.

[103] Securities Act Release No. 5884, *Going Private Transactions By Certain Issuers and their Affiliates*, Nov. 17, 19779, 42 Fed. Reg. 60,090, 60,091-92 (1977) (proposing SEC Rule 13-e).

[104] On the perceived link between the SEC rule and Delaware reversal, see Fischel, supra note 5, at 915.

[105] Id. at 914. Fischel juxtaposes the Cary initiative and Congressional hearings next to Delaware's strengthening. The SEC's proposed rule sought substantive fairness, deriving its authority to do so from the SEC's powers to deal with "fraudulent, deceptive or manipulative act[s]." The SEC later pulled back from substantive fairness after Delaware required it. See Christopher R. Gannon, *An Evaluation of the SEC's New Going Private Rule*, 7 J. CORP. L. 55, 64 (1981).

Whether Delaware reacted to the SEC chastisement, whether they were embarrassed by the SEC's forced disclosure of pricing information (the SEC-mandated disclosure made Delaware's remedies look frail), or whether they were positioning themselves to deter the sympathetic response in parts of Congress to William Cary's Federal minimal standards proposal is too hard to ever know. But the reaction fits a pattern of awareness, pressure, and reaction. Indeed the courts reversed themselves mid-stream on going private. The *Singer v. Magnavox* case history shows, first, lower court anti-shareholder decisions, punctuated by SEC criticism and action, and finally a Delaware Supreme Court reversal: The Court overturned the lower court's exclusive remedy decision, allowing disgruntled shareholders more remedies than just the weak appraisal remedy and requiring that the defendants satisfy a test of "entire fairness."[106] The leading text on mergers and acquisition law speculates that the Delaware Supreme Court's decision is best explained as one intended to deter turning the talk of more federalization into actual federalization.[107]

If Delaware were reacting to federal pressure to be tougher on controllers, then one would have expected the controllers to complain. And they did. In the early 1980s, Delaware was looked upon suspiciously as a state in which to incorporate: "corporate lawyers [were] recommend[ing] *against* Delaware incorporation … [because] Delaware's judiciary was too 'moralistic.'"[108] (We could speculate that Delaware's final moralizing reaction to Cary and the 1970s federalization debate came in 1985 with *Van Gorkom*—the toughest, most anti-managerial decision to come out of the Delaware courts. That decision put Delaware at risk of losing reincorporation business until it retreated, as its legislature did a year later with § 102(b)(7), effectively over-turning the judges' work in *Van Gorkom*.)

Delaware's early 1980s moralizing is inconsistent with a pure race-to-the-bottom theory. If racing to the bottom, why moralize and thereby induce corporate lawyers to recommend against reincorporating into Delaware? It is, however, consistent with a theory that includes federal pressure as critical in determining Delaware's calculus. Perhaps the judges did not understand that they were supposed to be racing. The report of anti-Delaware reincorporation pressure, anecdotal to be sure, is, moreover, inconsistent with *either* race theory. If "toughness" is racing to the top, Delaware should have garnered charters from those looking for toughness. If "toughness" is racing to the bottom, then Delaware should have garnered charters this way. To take on a policy that loses charters is to give up on the race.

---

[106] Singer v. Magnavox, 380 A.2d 969, 980 (Del. 1977); see also Roland Int'l Corp. v. Najjar, 407 A.2d 1032 (Del. 1979). Delaware went through a similar reversal on the adequacy of a dominant stockholder's disclosure of pricing information in a merger. Compare Lynch v. Vickers Energy Corp., 351 A.2d 570 (Del. Ch. 1976), rev'd 429 A.2d 497 (Del. 1981) with Lank v. Steiner, 224 A.2d 242 (Del. Ch. 1966) and Poole v. N.V. Deli Maatschappij, 224 A.2d 260 (Del. Ch. 1966). The defendant in *Vickers* would have had to disclose the base-line information under the federal proxy rules, as the Delaware court recognized, 351 A.2d at 572, and one might see this sequence as Delaware finally getting into line with modern federal proxy standards.

[107] RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 1256 & n.40 (2d ed. 1995).

[108] 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) (emphasis supplied).

Only when we see Delaware as seeking to deter further *federal* incursion into corporate law-making, does the Delaware result here become explicable. A policy of toughness is consistent with the view that Delaware corporate players had an eye on Federal authorities, that those authorities more vividly threatened it than its state competitors, and that it felt confined or influenced (psychologically or otherwise) by the Federal authorities, *not* by the competing states.

(b.) The all-holders rule and the SEC—In *Unocal*, the Delaware Supreme Court allowed a takeover target to exclude a bidder from the company's self-tender for its stock. The discriminatory bid would deter the outsider from taking over the company.

True, the rhetoric of the decision was moderate—managers could only use tactics proportional to the threat to the firm and its stockholders. One might consider this issue—a firm excluding a threatening stockholder from the firm's own bid—as an internal affair of the corporation, i.e., a matter of the firm's relationship with its shareholders, akin to a selective dividend going to some but not all shareholders. Such a matter would usually be regulated by the states.

Internal or not, the SEC reaction was simple and swift. With the all-holders rule, Rule 14d-10,[109] the SEC demolished the specifics of state law on a selective buy-back.[110] Nothing was uncertain about it: The SEC said their purpose was to reverse the Delaware tactical result.[111]

(c.) Dual-class recapitalizations and the stock exchanges. In the 1980s, many firms recapitalized with dual class stock, by which insiders got stock rich with votes; and outsiders voting (perhaps under a collective action debility) to give up their vote. Delaware had no problem with dual class recapitalizations.[112] Yet commentators in the main thought mid-stream recapitalizations leaving outside stockholders voteless were deleterious.[113] Again, one might have thought the question of voting and of the firm asking its own shareholders to give up their vote (for, say, a slightly higher dividend) would be a corporate internal affair. But the SEC promulgated Rule 19c-4, which had it survived would have barred all exchange-listed stock from dual class

---

[109] Rule 13e-4, 17 C.F.R. § 240.13e-4; Rule 14d-10, 17 C.F.R. § 240.14d-10. The first regulates self-tenders (the Unocal actual transaction), requiring that offers be made to all stockholders; the second regulates outside offers.

[110] And, less well-known, Congress sought to tax greenmail, a similar transaction, out of existence. IRC § 5881. Federalization proceeded on two fronts: the tax code and the SEC rules.

[111] *Proposed Amendments to SEC Tender Offer Rules*, 17 Sec. Reg. L. Rep. (BNA) 1320, 1321 n.5 (1985).

[112] Providence & Worcester Co. v. Baker, 378 A.2d 121 (Del. 1977) (original charter can allow differential voting rights); Williams v. Geier, 671 A.2d 1368 (Del. 1996) (*Providence* permissiveness not limited to original charter; midstream recapitalizations can change voting allocation). Other states had no trouble with dual-class recapitalizations. Groves v. Rosemound Improvement Ass'n, Inc. 413 So.2d 925 (La. App. 1982); Hampton v. Tri-State Fin. Corp., 495 P.2d 566 (Del. App. 1972); Shapiro v. Tropicana Lanes, Inc. 371 S.W.2d 237 (Mo. 1963); Stroh v. Blackhawk Holding Corp., 272 N.E.2d 1 (Ill. 1971).

[113] Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807 (1987); Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 3 (1988); Louis Lowenstein, *Shareholders Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson*, 89 COLUM. L. REV. 979 (1989). Cf. Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989).

recapitalization. But then the internal affairs doctrine showed itself to have bite. The DC Circuit invalidated Rule 19c-4, holding that 19(c) of the 1934 Act did not empower the SEC to promulgate substantive corporate governance in derogation of state corporate law. These internal affairs are for the states not the SEC.[114]

This seems to have been, and was, a defeated effort at federalization, one that would free Delaware from fear of federalization vis-à-vis dual class recapitalizations. One might have thought that without an act of Congress, Delaware was free. But the SEC has more means to act. By 1994, the stock exchanges, under pressure from the SEC, all put through anti-dual-class rules. In the end, Delaware was effectively preempted again, this time via the exchanges acting under SEC pressure.[115]

(d.) Pensions, proxies, and the Department of Labor. Federalization is not just regulation of the company; it is regulation of its stockholders. Some stockholders are directly told how to act in the corporate governance of their portfolio firms. By telling them how to act, federal authorities take key corporate law decisions away from traditional corporate law-makers.

Pension funds are now told via federal ERISA regulation that they must consider the corporate proxy in the stock they own to be an asset whose use must be actively evaluated. Mutual funds have just been told by federal authorities to announce publicly how they vote on proxy initiatives.[116] These may seem like specialized exceptions to state law-making. But 20% of the stock market is owned by mutual funds, 25% by pension funds.[117] For about half of the American economy, how stockholders act is governed not by Delaware but by federal law.[118]

* * *

These are four sharp examples. There are others, perhaps less sharp and less effective, coming via other federal means. Consider the Internal Revenue Code's efforts on executive compensation and the Federal Reserve's efforts on the leverage in leveraged buyouts.

In the 1980s and 1990s executive compensation became more controversial than it had been. Congress reacted via the tax code. Golden parachutes—by which senior executives were paid handsomely when they unexpectedly left the firm, were taxed to discourage their use.[119] Executive compensation above $1 million was made non-deductible to the corporation unless the compensation was tied to the company's well-being, i.e., tied to the company's earnings or stock price. And tax rules required shareholder approval for the stock options to be tax deductible.[120] More recently,

---

[114] Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

[115] NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 313(A).

[116] Disclosure of Proxy Voting Policies, Securities Act Release No. 33-8188, Exchange Act Release No. 34-47304, Investment Company Act Release No. IC-25922 (Jan. 31, 2003).

[117] Federal Reserve Flow of Funds, Second Quarter 2002, Sept. 16, 2002, at L.213.

[118] And federal authorities regulate the internal workings, boards, and ownership structures of financial institutions such as mutual funds, banks, and ERISA-regulated pension funds. Moreover, one might turn to other federal activities as conditioning corporate action: the corporate tax and the federal chapter 11 of the Bankruptcy Code come to mind.

[119] IRC § 280G.

[120] IRC § 162(m).

boardroom compensation committees came to be regulated. Most importantly, the SEC regularly mandates precise disclosure of executive compensation.

Executive compensation mechanics would seem to be an internal affair. Some firms might wish to keep compensation private, decided by a board committee whose members can tightly tie compensation to performance (however dangerous that kind of confidential structure might be). The internal workings of the firm might militate that compensation be hidden from, say, suppliers and competitors. That's how state law would run. But federal law trumps state law here: the compensation *must* be stated to the shareholders, not just to the compensation committee. And the shareholders now approve (or vote against) that compensation, and the composition of the board's compensation committee is determined not under state law, but elsewhere.

In the 1970s and 1980s leveraged buyouts became common. A cousin to going-private transactions, they begin with a controller, either inside managers or an outside buyout firm with a thin equity investment, using the buy-out company's assets to borrow heavily. These were perceived by many as "going too far," by adding too much debt to corporate balance sheets, as financially destabilizing the firm and making it more brittle. (To be sure, much evidence, maybe the weight of the evidence, was that the LBOs induced more efficient management.[121] But that's not the race point here: the point is that when it is important, the transaction attracts federal attention, whether that attention is wise or not.)

LBOs might have been regulated via corporate law. In fact, an adjunct to corporate law, fraudulent conveyance law, did come into play.[122] But federal authorities reacted as well, via the Federal Reserve's re-regulation of borrowing for corporate acquisitions.[123] The regulation had some bite, and it was seen as a "shot across the bow" for leveraging transactions: that if they went further, the Federal Reserve would react further.

* * *

These two subtle incursions and the four sharp federal incursions regulating going private transactions, mandating an all-holders rule, barring dual-class recapitalizations, and mandating how half of the country's shareholders treat their votes are enough to show federal law displacing state corporate law. But there's more. First, one can see the SEC subtly amplifying shareholder voice in the 1990s via nudges and shifts. Next, we see that federal-state interaction helps to explain takeover laws that state competition explains less well. And, we see Congress taking central aspects of corporate governance away from the states via Sarbanes-Oxley in 2002.

---

[121] Steven Kaplan, *Federated's Acquisition and Bankruptcy: Lessons and Implications*, 72 WASH. U.L.Q. 1104 (1994); Steven Kaplan, *Management Buyouts: Evidence on Taxes as a Source of Value*, 44 J. FIN. 611 (1989).

[122] United States v. Tabor Court Realty Corp, 803 F.2d 1288 (3d Cir. 1986); Wieboldt Stores, Inc. v. Schottenstein, 94 Bankr. 488 (Bankr. N.D. Ill. 1988).

[123] See, e.g., Board of Governors of the Federal Reserve System, *Securities Credit by Persons Other than Banks, Brokers, or Dealers; Purchase of Debt Securities to Finance Corporate Takeovers*, 12 C.F.R. Part 207; Regulation G, Docket No. R-0562; *Purchase of Debt Securities to Finance Corporate Takeovers*, Regulation U, 12 C.F.R. § 221.124.

4. Four subtle shifts via federal rules. Even before Sarbanes-Oxley, one could detect shifts of authority in the corporation, shifts induced by federal rules.

(a.) Amplifying shareholder voice. A core state law concept is that a corporation's board manages the business; corporate lawyers just refer to this as Delaware § 141.[124] Shareholders cannot direct the board on business strategy and plans. The board is primary.

But consider the evolution of the SEC's Rule 14a-8, under which the SEC allows shareholders access to company's proxy solicitation. The SEC's own exclusions were historically so large that the rule was for decades not a governance tool, but a means of social protest.[125] Proposals on corporate structure or the allocation of authority between directors and shareholders were excluded. Nothing could get onto the company's proxy solicitation that dealt with ordinary management.[126] Nothing could get in that was improper under state law. The SEC respected Delaware § 141—that the business of the corporation is to be managed by the board.[127]

But in a subtle shift in the 1990s, the SEC forced managers to give access to their proxy statement to shareholders' "precatory" proposals on corporate governance. In its *Waste Management* decision, the SEC forced management to accept a proposal on increasing the independent directors on the board, and there since have been a slew of anti-poison pill measures and anti-staggered board precatory votes.[128]

One might cynically think this just lets off shareholder steam, since boards can formally ignore their shareholders' "precatory" vote, as some have. But the SEC seems here to be pressing into the territory once governed exclusively by Delaware § 141. Boards should be wary of ignoring a proposal shareholders approved. Voice is not direction, but it is a means to power; and the SEC is subtly re-drawing the sharp lines in the shareholder-board balance otherwise delineated by Delaware § 141. And it now is considering whether to go beyond voice, in allowing shareholders partial access to the company's proxy statement.[129]

(b.) Institutional investor voice. As takeovers subsided at the end of the 1990s, reformers and investors looked to institutional investors as a counter-weight to managerial control of the large public firm. Much of the activity did not have law as its

---

[124] Del. Gen'l Corp. L. § 141.

[125] Medical Comm. for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970) (Dow Chemical and napalm), vacated for mootness, 404 U.S. 403 (1972); Roosevelt v. E.I. Du Pont de Nemours & Co., 958 F.2d 416 (D.C. Cir. 1992); NYC Emp. Retirement System v. SEC, 843 F. Supp. 858 (S.D.N.Y. 1994) (Cracker Barrel discrimination); Nike Inc. SEC No Action Letter, 1997 WL 384740 (July 10, 1997).

[126] Exchange Act Rule 14a-8(i)(7).

[127] Exchange Act Rule 14a-8(i)(1).

[128] SEC Letter to Waste Management, 1991 WL 178585 (Mar. 8, 1991) (staff refuses no-action letter when Waste Management seeks to exclude shareholder proposal on independent directors); Int'l Brotherhood of Teamsters Gen'l Fund v. Fleming Cos, 1997 U.S. Dist. LEXIS 2980 (W.D. Okla. Jan.24, 1997) (poison pill shareholders' proposal properly included in the proxy statement); ALLEN & KRAAKMAN, supra note 86, at 7-54 to 58; Claudia H. Deutsch, *Revolt of the Shareholders*, N.Y. TIMES, Feb. 23, 2003, § 3, at 1, 12 ("It's going to be a raucous few months. … Angry investors have already filed a record number of resolutions… .").

[129] SEC Division of Corp. Fin., supra note 85; Deborah Solomon, *SEC Proposes Giving Holders More Clout in Picking Directors*, WALL ST. J., July 16, 2003, at C5.

center, but involved organization (e.g., the Council of Institutional Investors), the media, and individual institutional action (e.g., CalPERS' pressure on individual companies). Law-making occurred, but on the federal not state level, as institutional investors pressed the SEC for more authority to act in concert. The SEC partially acceded, via the 1992 amendment to the proxy rules. The rules eased stockholder coordination in proxy contests, and were seen to counter-balance state antitakeover legislation, moving some authority back to shareholders.[130]

(c.) Gate-keeping and whistle-blowing as federal corporate governance. Corporate governance is often about gate-keeping: Before the corporation acts, must it get a certification from an outside professional whose reputation (and liability) is on the line? Gate-keepers include the company's attorneys, its accountants, and its underwriters.[131] The SEC regulates gate-keeping and gate-keepers closely. The detail is best left out here, but each gate-keeper needs to be conscious of its responsibilities under federal law, and maybe less so under state law.[132] To impose a duty on lawyers or accountants to bring the perceived wrong-doing up the corporate chain of command is to control the substantive act. By defining issues of professional responsibility—when the company's lawyers must go to the board or blow the whistle; how public an accountant's resignation must be, whether the accountants' ancillary business with the audited firm must be disclosed—the SEC is effectively allocating authority inside the firm. It is internal corporate governance. And it is Federal law, not state corporate law.

Consider one prong in the federal response to the Enron and WorldCom scandals. The Sarbanes-Oxley Act of 2002 calls for the SEC to require attorneys representing securities issuers to report evidence of material securities law violations up the corporate chain, ultimately to its chief executive officer. And if the CEO "does not appropriately respond ([by] adopting … remedial measures or sanctions …)," then the lawyer must go to the board's independent directors, the board's audit committee (which must be independent under a separate rule) or the entire board.[133] The violations for which the lawyer now becomes a serious gate-keeper are not just securities law violations, but *any* "breach of fiduciary duty or similar violation."[134] These are internal affairs, and this is a federalization of the corporate control of state fiduciary duties. Auditors are under stronger duties: to report violations of law first to

---

[130] SEC, *Regulation of Communications Among Shareholders*, SEC Release No. 34-31326, 52 S.E.C. Docket 2028, Release No. IC-19031 (1992), 57 Fed. Reg. 48276 (1992). See [Norma M. Sharara & Anne E. Hoke-Witherspoon, *The Evolution of the 1992 Shareholder Communication Proxy Rules and their Impact on Corporate Governance*, 49 BUS. LAW. 327, 331 (1993).]

[131] Reinier Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1986); Reinier Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857 (1984).

[132] See SEC v. National Student Marketing Corp., 457 F. Supp. 682 (D.D.C. 1978); In re Carter, Exchange Act Release No. 17,597 (Feb. 28, 1981).

[133] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745 (2002).

[134] Sarbanes-Oxley, § 307. And the Act bars firms from retaliating against employees who help outside investigations. Sarbanes-Oxley, § 806.

senior managers, and if they fail to respond, to go to the board and the SEC.[135] And internal control systems (what could be more internal?) are also being federalized.[136]

(d.) Creeping preemption. And in the 1990s, we see a shift little-noticed[137] but surely vivid in Delaware: Most federal securities laws have savings clauses, affirmatively saving supplementary state rules and remedies. But in the late 1990s Congress in rapid-fire succession passed the National Securities Markets Improvement Act of 1996 and the Securities Litigation Uniform Standards Act of 1998,[138] laws that not only reject traditional savings clauses but eradicate contrary state law:

> [N]o law, rule, regulation, or order, or other administrative action of any State, or any political subdivision thereof … shall directly or indirectly apply to … a covered security.[139]

Congress explicitly understood the race, and squelched it:

> Without a national standard … the potential threat is always there that one [s]tate will change its laws in such a way as to become the haven for [such] litigation. This almost happened in California last year …."[140]

---

[135] Private Securities Litigation Reform Act of 1995, Exchange Act § 10A.

[136] Delaware's Chancellor Allen recognized that, starting with the Federal sentencing guidelines from 1991, power over internal controls had changed: The guidelines give a big break to corporations with good compliance programs. So, in *Caremark*, Allen found the potential fiduciary duty breach in the defendant company not having a program in place, effectively overturning earlier Delaware authority, *Allis-Chalmers*. Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963). The Delaware court became a "conduit" for the federal sentencing guidelines, making corporate law serve a purpose other than that of shareholders or managers, strengthening enforcement of non-corporate law. And in 2002 the rules on internal control systems were made explicit, not just piggy-backed: Sarbanes-Oxley makes management assess the control systems and represent their adequacy.

[137] But see Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Su*e, 62 LAW & CONTEMP. PROBS. 215 (1999), for a nice analysis cognizant of the sharp federalization entailed by these acts, which "reversed six decades of legislative policy [of deference to the states]. … [There had been a] longstanding [federal] tolerance for parallel state law… . [State securities protections] provoked [no federal response until] Congress in 1996 and 1998 … preempted [those] states law[s]." Id. at 229. The "division between corporate governance and regulation of [securities] market transactions has blurred [and] … seems difficult to preserve." Id. at 221-22. By undermining the "division between federal and state regulation[,] … [Congress,] … [via] the 1998 Act … prevent[ed] any … state rule more favorable to shareholders … [, taking] another large step toward a federal corporations law." Id. at 242.

[138] Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C. §§ 77-78).

[139] 11 U.S.C.A. § 77r (West Supp. 1999). The drafters knew exactly what they were doing, as they replaced the contrary understanding, deleting from the statute:

> Nothing in this subchapter shall affect the jurisdiction of the securities commission … of any State … over any security or person.

15 U.S.C. § 77r (1994 (repealed 1996). Congress with these two laws sought to cutback state remedies for losses in sales of corporate securities.

[140] *Securities Litigation Uniform Standard Act of 1997: Hearings on S. 160 Before the Subcomm. On Sec. Of the Sen. Comm. On Banking, Housing, and Urban Affairs*, 105th Cong., 2d Sess. 150 (1998) (statement of Sen. Dodd), as analyzed in Thompson, supra note 137. The defendants in securities litigation, people with clout in Congress, wanted a single national standard: "today's capital markets are global, not national … definitely not local. While we take states' rights seriously, we also have to recognize the realities of today's marketplace. Software companies compete around

Congress was seeking not to end state-to-state confusion but to preempt particular state law.[141] The point again is not that federal law is surely improving upon state law-making that had raced to the bottom, but that states in general, and Delaware in particular, cannot just look to other states as their competition. Federal authorities can trump the state race, and they do. The 1990s preemptions did.

5. Takeovers in the early 1980s. And now takeovers. One might criticize the thesis here by saying that takeovers are the central modern issue of corporate law, and takeover law is largely state law. And, one might argue, the story of Delaware's competition as largely federal, does not apply. Hence, I here confront what for my thesis is probably the hardest case. For takeovers though, the critic must recognize that for a key time, takeover law *was* substantially federal, that it almost became locked in as federal, and that Delaware's movement cannot be well-explained without referring to federal takeover actions.

* * *

In the 1960s takeovers emerged in the states, perhaps because proxy fights had become hard. Tough offeror tactics (like the quick-attack, "Saturday night special") usually succeeded; targets succumbed.[142] Congress in response passed the Williams Act in 1968, to slow the quick tactics down. The Williams Act not only illustrates the constant federal-state interaction, but its open-ended terms provided part of the takeover battleground of the 1980s, not just between offerors and targets, but also between federal and state authorities.

Today takeover law is perhaps the states' last major remaining region where they exercise nearly full authority. But it almost did not turn out that way. Delaware, we shall see, almost lost its authority over takeovers on three Federal fronts in the 1980s: in the SEC, in the courts, and in Congress.

Moreover, Delaware's takeover positions in the 1980s are hard to explain via either race theory. While other states were producing one antitakeover law after another, watching them get knocked down at the Federal level, as preempted by the Williams Act or the interstate commerce clause, Delaware waited and then passed only a mild anti-takeover law late in the decade. And its court decisions consciously sought to be "proportional" for most of the 1980s. Yet, by the end of the decade, with the 1989 *Time-Warner* decision, Delaware turned antitakeover.

If Delaware was racing to the top in providing pro-shareholder takeover law in the 1980s, why did it stop racing by 1990? And if Delaware usually races to the bottom, pandering to managers, why did it take so long for it to get there? The issues in takeovers were not subtle, and the interstate pressures on Delaware were powerful: The other states were passing powerful antitakeover laws. Managers were pressing Delaware to go fully antitakeover. Their lawyers, evidenced by Martin Lipton's

---

the globe not only for market share, but for capital." Statement of Daniel Cooperman, Senior V.P., Gen'l Counsel, Oracle Corp., on behalf of the Software Publishers Ass'n, in *Hearings*, supra, at ¶4.

[141] Thompson, supra note 137, at 232. Congress sought to oust California here, not Delaware.

[142] See Bratton, supra note 21, at 1519 (citing data sources such as Douglas V. Austin, *Tender Offers Revisited: 1968-1972, Comparisons with the Past and Future Trends*, 8 MERGERS & ACQUISITIONS, Fall 1973, at 16).

famous public proposal for reincorporation out of Delaware, wanted antitakeover law. The demands of the race were as plain as could be for Delaware. Lipton said:

> The *Interco* case and the failure of Delaware to enact an effective takeover statute, raise a very serious question as to Delaware incorporation. New Jersey, Ohio and Pennsylvania, among others, are far more desirable states for incorporation than Delaware in this takeover era. Perhaps it is time to migrate out of Delaware.[143]

Yet Delaware's mid-1980s decisions zig-zagged through takeover doctrine: *Revlon* put strong duties to sell on directors; *Unocal* sought proportionality; even *Moran* implied that directors would have a duty to "yank the pill," and could not "just say no." *Interco* explicitly said so: target managers could not use the poison pill to "just say no," but only to find another bidder or to defeat a coercive tender offer, such as a two-tiered offer.[144] But if the outsider made its offer for any and all shares, that precluded justifying the pill as fighting a coercive two-tiered bid, said the *Interco* court. And the implication of *Moran*, concluded the court, was that the target had to dismantle its defensive machinery and could not use new defensive maneuvers.[145] Throughout this time the Delaware legislature did not respond to these developments with pro-managerial antitakover statutes.[146] Then, only toward the end of the decade, around 1989, did Delaware courts take a sharp antitakeover fork in the path. Why did they wait so long?

Including the federal dimension in the analysis of Delaware's corporate law development helps explain why Delaware changed its course better than a pure race-to-the-top or race-to-the-bottom theory can. If other states were producing antitakeover laws, then, if Delaware had wanted as much reincorporation business as it could get, state-to-state competition should have induced it to match the other states bidding in a race. But it did not in the early and mid-1980s.[147]

---

[143] Martin Lipton, To Our Client: The Interco Case, Nov. 3, 1988 ("private" mailing available to corporate America). The idea did not stay hidden. See Tim Smart, *For Managers, Delaware Isn't the Haven it Used to Be*, BUS. WK., Dec. 19, 1988, at 33 ("legal advisers to worried managers already are suggesting that companies … consider playing elsewhere …."); Charles Storch, *As company, Time focusing on 1 newsmaker*, CHICAGO TRIBUNE, July 9, 1989, at 8 (Delaware's blocking Interco management from using the pill "so enraged Martin Lipton, the lawyer … credited with inventing the … pill …, that he urged his … clients to consider reincorporating elsewhere."); Stephen Labaton, *The 'Poison Pill' Takes a Beating*, N.Y. TIMES, Nov. 14, 1988, at D2; Roger Parloff, *The Outlook of Poison Pills: After Interco and Pillsbury, What Next*?, MANHATTAN LAWYER, Jan. 24-30, 1989, at 31

[144] The two-tiered offer gives more money to those who rush to tender first, less to those hold back, creating an incentive for shareholders, even those disliking the overall terms, to stampede for fear of being on the low-value "back-end."

[145] City Capital Associates v. Interco, Inc., 551 A.2d 787 (Del. Ch. 1988).

[146] The legislature knew how to respond to managers: when the duty of care was called into question in 1985 via *Van Gorkom*, the legislature promptly facilitated freeing managers from liability. See Del. Gen'l Corp. L. § 102(b)(7), enacted in 1986.

[147] Delaware has other considerations. The 1980s takeover bids came from outside "raiders," like T. Boone Pickens and Carl Icahn, or from large firms seeking to takeover smaller ones. The latter is a Delaware constituency, the former not. But over time, the "raider"-induced takeovers declined, leaving only the large firm initiated takeovers. That would have meant that Delaware would over time have had more pressure to be a moderate on antitakeover laws—targets still resisted as before, but the portion of the offerors that were Delaware's corporate constituency increased. Yet during this

For most of the 1980s Delaware had reason to fear ouster from the federal authorities more than competition from the anti-takeover Rust Belt states. The federal authorities were making pro-takeover law via the SEC and the courts, and threatening to enact preemptive moderate takeover law via Congress. (Even moderate federal law threatened Delaware, because it would move the center-of-corporate gravity closer to Washington.) If Delaware mis-stepped and moved too far out of line with the federal actors, it could tip one or another of those actors, especially Congress, into hard-to-reverse action that would oust Delaware of what would become its most important hold on corporate affairs, the takeover.[148]

(a.) The executive branch: White House politicians; SEC commissioners. Before the insider trading scandals hit in the late 1980s, the Washington atmosphere was pro-takeover. Reagan-era officials promoted a view of takeover entrepreneurs like Carl Icahn as populist heroes attacking corporate bureaucracies that had become elitist sinecures for the rich and ineffective.[149] There was nothing subtle about the Reagan Administration's pro-takeover actions: The White House Council of Economic Advisors opposed the end-of-the-decade Delaware statute when it was proposed. One SEC Commissioner, Joseph Grundfest, bluntly threatened Delaware with preemption if it acted,[150] another said the Delaware legislation was constitutionally impermissible,[151] and the SEC Chair said federal preemption was the proper policy: "Federal law should control [takeovers] by preempting state statutes that unduly interfere with the free transferability of securities."[152] In case Delaware did not get the message, the SEC Chair two months later wrote a leading Delaware corporate lawyer (one deeply involved in drafting the Delaware law), quoting the preemption speech to him. That lawyer would later become Chief Justice of the Delaware Supreme Court.[153] The Delaware legislature acted, but, compared to other states, it acted moderately.

---

period, Delaware became *more* antitakeover. The release-of-Federal-pressure story that I develop in the text fits this aspect of Delaware's movement. The Delaware story here is also consistent with state actors being unsure of what was the right takeover policy.

[148] See Roe, *Takeover Politics*, supra note 21.

[149] Peter T. Kilborn, *Treasury Official Assails "Inefficient" Big Business*, NEW YORK TIMES, November 8, 1986, at A1. The front-page-of-the-Times attack came from Richard Darman, a key Reagan-era player.

[150] See Letter of Joseph Grundfest, Commissioner of the Securities and Exchange Commission, to David Brown, Council of the Corporation Law Section of the Delaware State Bar Association, dated Dec. 10, 1987, reprinted in CRAIG B. SMITH & CLARK W. FURLOW, GUIDE TO THE TAKEOVER LAW OF DELAWARE, app. E, at 161, 165 ("a decision by Delaware to adopt an antitakeover statute … is more likely to provoke a federal response … "). And: "enactment of Section 203 [would] increase[] the probability of federal scrutiny." Id., at 165.

[151] See Letter of Charles Cox, Commissioner of the SEC, to the Council of the Corporation Section of the Delaware Bar Association, date Dec. 10, 1987, reprinted in SMITH & FURLOW, supra note 150, app. D, at 157.

[152] Address by SEC Chairman David S. Ruder, 26th Annual Corporate Counsel Institute, Chicago, Ill. (Oct. 7, 1987), quoted in Letter from SEC Chairman David S. Ruder to E. Norman Veasey, Esq., dated Dec. 8, 1987, reprinted in SMITH & FURLOW, supra note 150, app. C, at 155. Veasey would thereafter become chief justice of the Delaware Supreme Court.

[153] Id. (letter from SEC Chairman Ruder to Norman Veasey). Chairman Ruder's letter is only one blunt page, stating "I believe that Federal law should control [takeovers] by preempting state statutes …. I believe that corporations whose activities and ownership are national in scope should not be given protection against takeovers by the states [even those] where their primary production

(b.) The courts and constitutional preemption. And federal courts through most of the 1980s were knocking down state anti-takeover laws as conflicting with the dormant commerce clause. Said the Supreme Court in 1982:

> The Illinois [Anti-takeover] Act is … unconstitutional … for even when a state statute regulates interstate commerce indirectly, the burden imposed … must not be excessive in relation to the local interests served … The most obvious burden the Illinois Act imposes on interstate commerce arises from the statute's ... nationwide reach … giv[ing] Illinois the power to determine whether a tender offer may proceed anywhere. … Shareholders are deprived of the opportunity to sell their shares…. The reallocation of economic resources to their highest valued use … is hindered. The incentive the tender offer mechanism provides incumbent management to perform well so that stock prices remain high is reduced.[154]

At the same time, the courts were defining the on-the-ground takeover tactics as covered by the William Act's provisions banning manipulative or deceptive practices in tender offers.[155] If the Circuit Court decisions held up (by later in the decade, the doctrine failed), all takeover tactics would be regulated nationally, not by the states.

(c.) And Congress of course. Congress held hearings, considered legislation, and at some points seemed likely to take control of takeovers. Because Congress contemplated middle-of-the-road law, Delaware had reason to fear that a sharp anti-takeover act on their part would provoke Congress to act and preempt Delaware's law.

The principal bill considered in the late 1980s would have explicitly preempted Delaware. Little else could make Delaware sensitive here. Antitakeover activists in management aggressively opposed the preemption provisions of the proposed bills. Bruce Atwater, an articulate spokesman for the managers, so testified. The Business Roundtable and the National Association of Manufactures also opposed federal preemption. Shareholder activists did not.[156]

---

facilities are located." These matters, he said, by the way, were not internal affairs of the corporation, but national affairs. Notice how the line for internal affairs is re-drawn based on what one wants to, or does not want to, regulate. If it's important, it's national.

[154] Edgar v. MITE, 457 U.S. 624, 643 (1982) (plurality opinion).

[155] In Mobil v. Marathon, the Sixth Circuit ruled that Marathon Oil's grant of a crown jewel option to U.S. Steel to ward off another party's takeover offer was a manipulative act, one barred by the Williams Act. Mobil Oil had sought to buy Marathon, whose managers did not want to be employees (or, more likely, ex-employees) of Mobil if Mobil succeeded. Marathon gave U.S. Steel an option to buy 17 percent of Marathon's stock (a "lock-up") and an option to buy part of Marathon's huge, rich Yates oil field (a "crown jewel" option). If Mobil succeeded it would have found key assets leaving (at below market prices) and would have been obligated to sell stock to U.S. Steel at a price favorable to U.S. Steel. Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1981), cert. denied, 455 U.S. 982 (1982).

[156] See *Witnesses at Takeover Bill Hearing Split on Preemption of State Regulation*, 19 SEC. REG. & L. REP. (BNA) 851 (June 12, 1987). Well-known anti-takeover activists from the Business Roundtable, like Bruce Atwater, lobbied *against* federal preemption, presumably fearing that the federal bill would hurt them more than would state action. The leading bill, that of Representatives Dingell and Markey, who chaired the relevant committee and sub-committee, had *anti*-poison pill measures that management detested, measures that are the core of managerial defensive tactics that the states were validating at the time.

The bills' substance was middle-of-the-road. Although they regulated bidders' tactics, deepening the Williams-Act-style notice rules on offerors, the bills would have *also* come down hard on defensive tactics such as the poison pill. The principal bill, introduced by Representatives Dingell and Markey, the big players in the House, in its section entitled "Abusive Defensive Tactics: Poison Pills; Lock-up; Tin Parachutes," would have authorized the SEC to issue rules making it "unlawful for any issuer to establish or implement, during any proxy contest or tender offer … *any defensive tactic in violation of such [SEC] rules*." To ensure that the SEC would not mistake the anti-pill message, the act said that "at a minimum, [its rules *must*] *treat as a defensive tactic requiring shareholder approval" any poison pill measure*.[157]

Congress' precise position on the pro- vs. anti-takeover spectrum matters less here than that Congress considered preempting Delaware. As usual, if the issue is big, Congress might step in, and the states knew it. Consider just the title of an article from one widely-read business periodical: "States vs. Raiders: Will Washington Step In?"[158] Leaders of the merger bar advised Delaware at a critical point *not* to pass an anti-takeover statute because passage would increase the probability of federal preemption.[159]

(d.) The Federal abdication. The courts were the first federal authority to leave the scene, with the Supreme Court cutting back initially on the William Act's preemptive power: manipulative practices were re-interpreted to include only bid-rigging, not defensive maneuvers or strong-arm bidding tactics.[160] But, although the Court limited federal authority under the Act, the plurality view in *Edgar v. MITE*—that the dormant commerce clause preempted states from burdening interstate commerce with antitakeover law—stood until 1987, when the Supreme Court in *CTS* knocked it down, reversing circuit court preemption of state antitakeover action.

The SEC was still visibly pro-takeover in 1987, and it influenced congressional policy-making. But then its once aggressive stance faded away. Personnel changes best explain the result—a drafter of state anti-takeover law went onto the commission in the early 1990s, and the vociferous pro-takeover commissioners left it.[161] Congress too

[157] *Tender Offer Reform Act of 1987*, H.R. Bill 2172, Apr. 27, 1987, 100th Cong., 1st Sess. § 14. John Coffee, an astute observer, described at that time the "caution being shown by the Congress. Even Senator William Proxmire, the Senate's most zealous critic of takeovers, has only been able to secure approval within the Senate Banking Committee for a modest statute that attempts no more than minor reforms … ." John C. Coffee, Jr., *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-ups*, 1988 WISC. L. REV. 435, 436.

[158] Vicky Cahan, *States vs. Raiders: Will Washington Step In?* BUSINESS WK., Aug. 31, 1987, at 56. The bill would also have required one-share, one-vote and a mandatory bid rule.

[159] Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 906 (1990). Alva describes the well-known merger lawyer, Joseph Flom, as lobbying against an anti-takeover law, saying it could provoke federal preemption. He also reports that Martin Lipton, a well-known *anti*takeover lawyer, also lobbied *against* that *anti*-takeover law.

[160] Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985).

[161] Compare pronouncements from Joseph Grundfest, an aggressively pro-takeover Reagan appointee, Grundfest Letter, supra note 150, and Joseph Grundfest, *Subordination of American Capital*, 27 J. FIN. ECON. 89 (2000), with actions by Stephen Waldman, a later appointee who drafted Pennsylvania's tough *anti*-takeover laws.

finally faded from the field by the end of the 1980s, and stayed away in the robust economy of the later 1990s.

(e.) The Federal gravitational pull on Delaware? Delaware's moves roughly tracked federal moves. When Washington was overall pro-takeover or moderate, Delaware was reticent or middle-of-the-road. Its Supreme Court proclaimed proportionality, and zig-zagged from *Moran* (itself with limits) to *Revlon* (tough, anti-manager, pro-takeover). Its legislature resisted passing an anti-takeover statute longer than the other states, and then acted mildly. Then with *Time-Warner* in 1989 Delaware became anti-takeover.

Until *Time Warner*, Delaware's 1980s takeover jurisprudence could be summed up as follows: Once a firm was to be sold via a friendly takeover, the firm had entered, as it was dubbed, "*Revlon*land" and its managers had the fiduciary duty to sell the firm to the highest bidder. If a firm was the target of a hostile bid, it could use a poison pill to ward off *coercive* offers, not to "just say no" to fair offers. But by the end of the decade, the takeover machine hit *Time-Warner*, and "Revlonland" became a very, very small place.

In *Time-Warner*, there was to be what everyone would call a friendly sale of Time, to Warner. Paramount then offered more to Time's shareholders than Warner had, to the dismay of Time's managers. Time refused to sell to Paramount, and Paramount sued, arguing that Time managers had violated *Revlon*. But the Delaware Supreme Court said the board could pursue "a deliberately conceived corporate plan … unless there is clearly no basis to sustain the corporate strategy… ." The board dismissed *Revlon's* relevance (the company was being sold not broken up), and Time's shareholders lost Paramount's $200 per share bid, with Time management forcing Warner's lower $138 per share on them.[162] The Court sharply rejected the earlier pro-takeover *Interco* decision, and let Time's "just say no" defense stand. The consensus view has been that the Delaware court was taking a sharp anti-takeover turn.

Why did the Delaware Supreme Court's jurisprudence differ in 1989 from that in 1985? I submit that its main competitor in making takeover law had given up. It could then act more freely, either implementing its own conception of the proper role of management in takeovers, or buckling under managerial pressure, or concluding that state competition demanded that its own takeover rules should not differ substantially from the antitakeover law of sister states once the Federal pressure had abated.[163]

---

[162] Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989). And:

> Delaware law confers the management of the … enterprise [on] the … board … [, which] select[s] … a time frame for achiev[ing] … corporate goals. That [task] may not be delegated to the stockholders. Directors are not obligated to abandon … corporate plan[s] for a short-term shareholder profit … .

Id. at 1154. This passage is still read in Delaware as rejecting *Interco*'s limits to the board's discretion in resisting a takeover. See In re Pure Resources, Inc., 2002 WL 31300797 n.38 (Del. Ch. Oct. 7, 2002).

[163] Could the famous Lipton memo on *Interco*, and its threat of reincorporation out from Delaware, have been on the Justices' minds? We'll never know for sure, but the Delaware Supreme Court's explicit rejection of *Interco*, a lower court decision not then on appeal suggests that possibility. When the federal authorities loomed large, Delaware didn't accede to managerial wishes. But then the federal authorities disappeared. With the Federal heat off, it could respond to the post-Interco calls from management's lawyers to exit Delaware. See supra note 143 & accompanying text.

One could argue that the federal authorities exerted a gravitational pull up during the 1980s, and, when they released Delaware at the end of the 1980s, Delaware dropped to the bottom. Or, one might argue that the federal government's gravitational pull continued, but shifted. By the early 1990s Washington takeover politics was changing. Scandals in insider-trading and at Drexel Burnham were de-legitimizing takeovers. The stronger economy by the mid-1990s seemed not to need takeovers to help it perform well, so public-spirited policy-makers had less reason to focus on takeovers as an engine of economic renewal. In this second view, Delaware moved in tandem with the federal mover, maybe a little faster and a little farther, but still roughly on a parallel line. (To be sure, these outside economic pressures could affect Delaware directly, not just through the Federal government.)

* * *

So, whether or not one adopts a release theory or a movement-in-tandem theory, the result—the fear of federalization thesis and a federal gravitational pull—helps to explain, and may even be needed to explain, the making of American takeover law. For a time, American takeover law was largely federal law. When strong arms of its main rival were competing (the SEC, the courts) or stirring (the Congress), Delaware toed a line closer to Washington than to the other states. Delaware's takeover moves are better explained with the federal actor in play than by a pure interstate race theory.

6. Dropping pretense: Sarbanes-Oxley. Sarbanes-Oxley, enacted in 2002, does not even pretend to stay on the disclosure/trading side of the Federal-state division of power, not even offering rhetorical respect for state rules governing the corporation's internal affairs. It digs deep into corporate governance, regulating the nitty-gritty. In reaction to the Enron-class scandals, Congress mandated structures and responsibilities. States were perhaps perceived as having been lax on controlling the internal structures—consider Delaware's General Corporations Law § 102(b)(7), which along with its 40-odd state followers facilitated the wholesale dropping of board liability for duty of care violations—so Congress would mandate what firms must, and must not, do.[164]

Some Sarbanes-Oxley rules may not be well-considered. Its ban on company loans to officers,[165] if literally interpreted, means that firms cannot lend funds to relocating new CEOs, cannot lend officers money to buy the company's stock, etc. Delaware's express rule was (and is) to the contrary—"[a]ny corporation may lend money to … any officer of the corporation … including any officer … who is a director … whenever, in the judgment of the directors, such loan … may reasonably be expected to benefit the corporation."[166] Delaware's rule may be better. But the federal behemoth took over, squelching the states with substantive federal law, effectively wiping out Delaware's statute.[167]

---

[164] Delaware's § 102(b)(7) effectively reversed *Van Gorkom*, the toughest of several Delaware decisions prodding boards to be better. Had it survived, one wonders whether boards like Enron and WorldCom would have been better.

[165] Sarbanes-Oxley § 402(a).

[166] Delaware Gen'l Bus. Corp. L. § 143.

[167] Section 402 of Sarbanes-Oxley is a flat bar, precisely opposite from Delaware's rule:

Sarbanes-Oxley mandates SEC rules for audit committee independence.[168] It controls compensation by requiring that a class of bonuses be forfeited if the company goes bankrupt.[169] It mandates that the audit committee control hiring and firing of accountants, and the ancillary business that accountants do with the corporation.[170] It mandates rotating audit partners, and pushes toward rotating the accounting firm.[171] It orders the SEC to grab control of off-balance sheet transactions and special purpose vehicles.[172] It sets up the possibility of federal control of who may and may not sit on a corporate board.[173] Once these matters were for state law. No more.[174]

* * *

And so we see a history of repeated federal intervention—actual or threatened—in corporate law-making. Whether it was the early mixed issues of antitrust and corporate reorganization, or the 1930s issues of shareholder voting and insider trading, or the SEC's 1950s proxy rules that impeded proxy fights the states had allowed, or the 1960s Williams Act that softened the tough takeover bidder tactics that the states had been permitting, or the 1960s issues of going private, or the 1970s issues of fiduciary duties, or the 1980s issues of power in takeovers, or the early 21st century issues of scandals and effective internal governance, the federal government has been a player in the key corporate issues of the day.

In each case one could argue that ouster (or its threat) was "special," so important to the national economy that the "normal science" of state corporate law-making did not apply. But that is exactly the point: when the issue is important, federal ouster occurs, or is threatened. Delaware cannot look just to the other states when it confronts a big issue, but to Washington, where its most important competitor sits.

> Prohibition on Personal Loans to Executives—It shall be unlawful for any [public company] to extend … credit, to arrange for the extension of credit … in the form of a personal loan to or for any director or executive officer … of that issuer.

Whether this ban will last is questionable: repeal or interpretive demise seems plausible. The term "personal" loan may give regulators and lawyers an opening. The point is that Congress was, and is, ready to act, even on details of corporate internal governance.

168 Sarbanes-Oxley, § 301.

169 Sarbanes-Oxley, § 304.

170 Sarbanes-Oxley, § 204.

171 Sarbanes-Oxley, §§ 203, 207

172 Sarbanes-Oxley, § 401.

173 Sarbanes-Oxley, § 305, barring "unfit" directors.

174 The New York Stock Exchange displaced parallel state rules elsewhere, requiring that a majority of the directors of NYSE-listed companies be independent. And federal players seek to further displace state authority. Deborah Solomon, *SEC Nominee Urges Curbing States' Power*, WALL ST. J., Feb. 6, 2003, at A6 ("if states don't cooperate, Mr. Donaldson [the nominee to be chair of the SEC] said, he would ask Congress to redefine the regulatory structure … .").

IV. THEORY: WHY THE UNITED STATES HAS NOT HAD, AND CANNOT HAVE, A TRUE RACE

A. An Inconclusive Academic Debate?

Fine minds have argued that states race to the top. And fine minds have argued that states race to the bottom. Data has been brought forward to prove states race to the top[175] and to show they race to the bottom.[176] The debate is stalemated, and the idea here of a looming omnipresent federal trump helps to explain why the debate has been *and must be* inconclusive. Because key choices were removed from the states, or faced the threat of removal, or went Federal even before states acted, we cannot tell whether the big issues that remained with the states and are efficient were shaped by the federal government's good influence (because it's the custodian of the American economy) or whether the big ones that remained and are inefficient were shaped by the federal government's pernicious influence (because it's susceptible to error and interest group influence and, due to its a over-arching position, can impose inefficient corporate rules).

The state race analysis must be inconclusive because we live in a federal system. Absent a constitutional amendment barring federal involvement in corporate affairs, the federal government can determine, will determine, and has determined many critical elements of corporate governance. The current state of affairs—a tradition of deference to state regulation of corporate affairs, a tradition that is breached when it seems important to federal actors to do so—is the most deference that the federal government can realistically give. And with that level of deference, Delaware corporate law theoretically must be, as it has been, subject to being displaced by, and often influenced by, federal authorities, thereby rendering any true race to the top impossible, however attractive it might be in theory. Even if Delaware is only dimly aware of Federal action, what persists in Delaware is that which the Federal authorities do not find offensive.

B. The Impossibility of Race-to-the-Top Theory

Let's say we have conclusive evidence that the dominant state's corporate law is efficient. That evidence though would not, and could not, be conclusive on whether state competition in corporate chartering is efficient. We would not know whether the federal threat made it efficient and the dominant state if left alone would have raced to the bottom. Did the federal authorities reverse the most egregious state rules, leaving in place the harmless ones and the good ones?

We have some organizational theory parallels on which a new theory of the production of corporate law might be built. An organization's decisions are said to

---

[175] See Daines, supra note 1; Romano, supra note 8.

[176] Compare Lucian Bebchuk, Alma Cohen & Allen Ferrell, supra note 2; Bebchuk & Hamdani, supra note 4; and Lucian Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, __ J.L & ECON. __ (2003), with Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987); and ROMANO, supra note 8.

improve if the process of proposal is separated from ratification, if we have two separated decisions, by different decision-makers, e.g., managers propose, the board ratifies.[177] And we have the corporate theory that efficiency was enhanced by having decentralized managers run the firm day-to-day, subject to review, veto, and overall strategic planning from the centralized and separated headquarters.[178] Similarly, one might begin a new theory with the view that the federal authorities do little as long as nothing seems badly askew in corporate results, in Delaware law, or in the American economy. But if one of these deteriorates badly, the federal authority intervenes: state autonomy for the most part, but not complete insulation. States, in this vision, might not be afraid of immediate ouster, but know that a crisis will attract federal attention, and their corporate law authority might be sapped if it does. They must make rules that do not induce, or are not perceived as contributing to, economic and social crises.

So it could still turn out that we have a "genius" of American corporate law,[179] but not one as conventionally understood. But even if so, that would not necessarily mean we would want more intervention, in a way that would shut down more state law-making and deny the system the benefit of experimentation. Discovering that we have an optimal level of federal intervention might induce players to go for more, to test the limits, and that might *demean* the quality of law overall. But if Delaware does in fact produce law that is overall good for shareholders, we cannot tell whether it did so due to federal pressure or due to state competition.

C. The Indeterminacy of Race-to-the-Bottom Theory

1. If Delaware law is inefficient. Suppose the contrary, that Delaware corporate law is demonstrably inefficient. Would we then know that Delaware raced to the bottom? We would not, because we would not know whether Federal politics would have produced bad law, due to, say, populist outrage or interest group maneuvering or congressional sloppiness. Delaware might have concluded it had to do the "wrong" thing, because otherwise the federal authorities would take the issue away from it.

Proponents of Delaware's advantages point to Delaware's fine judges. Yet, analysts also point out the fuzziness of many decisions that do not yield a firm rule ("facts and circumstances"), that fulminate against breaches of fiduciary duty (but do not hold liability). Federal competition helps to explain the fuzziness. If Delaware players are uncertain what the Washington politics will be (or indeed what it is), better to be fuzzy and immunize oneself from harsh criticism they would get if they took a sharp, visible stand. A strong anti-managerial stand in takeovers might motivate managers to petition congress. A clear anti-shareholder stand might motivate the SEC

---

[177] Cf. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control,* 26 J.L. & ECON. 301, 303-04, 308 (1983).

[178] This was called the M-form corporation and had its theoretical heyday during the age of the conglomerates, until the conglomerates fell from favor. See OLIVER WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTIRUST IMPLICATIONS (1975).

[179] This is Roberta Romano's well-known description of the interstate chartering race, in her well-respected book of the same title: ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993).

(in the 1980s) to promulgate new rules or to go to Congress. So better to be fuzzy, to be reasonable, and to lay low. And when one actually decides, be vague and zig-zag from decision to decision, so as not to offend any of the federal players that might react and attack. And only come to rest with a strong position when it is clear that the federal authorities have lost interest, or clear that they are all pointing in the same direction as you are.

2. If Delaware law is complementary. The problem is even harder. Imagine that there's a "right" balance between rules that give managers discretion and rules that limit it. Assume ten rules that matter, and they all should be somewhere in the middle, or five should confine managers and five should give them much discretion. Assume further that the dominant state *always* gives managers discretion. Since we know that the "right" balance is somewhere in between, we might falsely conclude that the states raced to the bottom when giving managers discretion.

But we could not properly reach that conclusion. If the other five federally-set rules all *confined* managerial authority, then, since the right result is a 50-50 mix, the pro-managerial state would, on a system-wide basis, be efficient, despite that locally they overly favored managers and *appeared* to race to the bottom.

To decide that states raced, and would race, to the bottom, we would have to know what they would do if they controlled the *entire* mix. But this is something that we cannot know in a federal system, with an active central law-maker.

3. If Delaware law is efficient. What if proponents of a race-to-the-bottom could demonstrate a) that Delaware corporate law differs from that of the other states and b) that Delaware is overall more efficient. The bottom-racers could concede that Delaware was affected by the Federal gravitational pull, that the federal government pulled Delaware up, and, hence, the race is naturally one to the bottom.

This analysis would be faulty. First, we *still* would not know whether Delaware (and the other states) would have raced to the bottom or the top if they had within their control *all* of corporate law, including all of the mechanisms that would affect the costs of capital and firm value. Perhaps if they did, they'd do even better.

Second, and more importantly, the bottom-racers would be conceding that the key race *in fact isn't being run* on state-to-state racetracks but is being made, at least in important part, by the Federal authorities, or in the shadow of the Federal authorities. Corporations, they'd yield, are primarily run by Federal and Federal-influenced Delaware law, and the bottom-racer theorists would then be giving up the contention that most firms are governed by law made via a race to the bottom. They'd have conceded the core of their theory of what drives state corporate law-making.

4. If Delaware has a monopoly. Were the federal players not central to making corporate law at times, and on the periphery otherwise, more would be at stake in making state corporate law. With more at stake, states could charge more, and that opportunity might invigorate what now seems to analysts to be a weak race.[180]

---

[180] For the near-monopoly view, see Kahan & Kamar, supra note 4, and Bebchuk & Hamdani, supra note 4. By taking away New Jersey's "authority" to confer anti-competitive profits in the early 20th century, Federal authorities presumably lowered the value of New Jersey's corporate law, as I note in Part III.C.1. When New Jersey could no longer effectively "sell" anti-competitive

D. Revising the Race with a Federal-State Model

American corporate law has been made in an environment much more complex than a pure state race. Understanding that there cannot be a pure race, that the federal behemoth looms large in much state decision-making, does not mean that there is not state variation. States may compete, but the stakes are lower than is usually thought. In effect, the states can race, to the bottom or the top, only on those issues where the federal authorities leave the field, and convincingly display no interest in coming back, or where the states know that there is a "band" in which they can maneuver without provoking any federal reaction.

1. Delaware's position. To see how complex the model must be, let's take a Delaware perspective here; and let's take the state-by-state race seriously. Delaware then can find itself in a bind: It can end up fighting a two-front war, and from time to time has. First, in the traditional model, it competes with other chartering states to sell corporations their charters. But, second, it also competes with the Federal authorities in making corporate law. And its two main competitors have differing motivations, which do not always lead to the same substantive result. (The fact that it can react to federal threats with law that doesn't match other states suggests that Delaware has some packet of "market" power with which to maneuver.)

Even when one competitor, the federal one, is not in the game, Delaware law-makers must know that if there's a crisis that can be traced to Delaware's results, they will be blamed and perhaps ousted from the game. (And in fact, Delaware might at times fight a three-front war: bigger states with local interest groups have differing goals than both Delaware and the Federal authorities. So, during the 1980s Rust Belt states protected local managers and local labor from takeover-induced disruption, irrespective of the effect on local corporate chartering revenue; they were less sensitive to the Federal magnetic pull, because chartering revenue was unimportant to them.)[181] Sometimes one front threatens Delaware more than another; sometimes all encroach on its autonomy; and at times, rare to be sure, Delaware can breathe freely without feeling any of the three main pressures.

2. Public choice. A public choice structure might lay atop this. Delaware might be seen as the locus of "private" corporate law-making. Managers and shareholders, through their lawyers and other representatives, make their contracts, often via the Delaware legislature, and the Delaware courts arbitrate their disputes. When results get out-of-hand—local scandals or economic deterioration that is seen as implicating corporate law issues—then the local cover is breached and federal actors make, or

---

corporate structures (because Federal antitrust law controlled their use), perhaps it couldn't charge as much and no longer found it that worthwhile to retain.

[181] That states sometimes, as today, do not compete directly on chartering—the thesis in Kahan & Kamar, supra note 4—does not fully eliminate the state "front" in the war, especially if some states make corporate law for local purposes without seeking chartering revenue. They can please and keep local charters if they give those firms what they want. Contestable market theory also tells us that even if Delaware could have room to maneuver as a quasi-monopolist, it could lose the business if it badly mis-steps.

threaten to make, corporate law. Saliency attracts both the media and federal attention,[182] which the Delaware actors seek to avoid. Delaware's muscle might arise from agenda-setting: it usually moves first and in Delaware managers and shareholders have more clout than non-core corporate players (like employees, public interest groups, etc.). By setting the agenda it has a first-mover advantage, and the Delaware deals can stick, unless saliency or offense to federally-influential players moves the game to Washington.

E. Taking the Long View

If we step back from any specific state action to take the big picture view, we see Delaware as engaged in something more important than a state-to-state race. Begin our big picture view about four decades ago in the 1960s. Delaware is perceived then as badly protecting shareholders in the prevailing transactions of those times. By the late 1970s Federal players consider displacing Delaware on several fronts. Cary lambastes the pygmy; the SEC attacks Delaware's going private rules; the Second Circuit expands 10b-5 into a federal set of fiduciary duties; and elements of Congress consider federal incorporation.

Delaware then adjusts, and by the early 1980s, it is seen as *unattractive* to controllers for reincorporation, due to its moralizing tone and the substance of its court decisions,[183] culminating with Delaware's 1985 *Van Gorkom* attack on American management. State competition as shaping Delaware seems subdued at that time; the federal threat seemed to influence Delaware more. Only after *Van Gorkom* does the possibility of reincorporation out of Delaware become substantial, and Delaware becomes more solicitous of management, via § 102(b)(7). In the few years before then, Delaware seemed to have been pulled into the federal fiduciary duties' orbit. But by 1985, the Federal pull had shifted away from fiduciary duties and over to takeovers, freeing Delaware to act as it pleased on general fiduciary matters.

But at that time, Delaware could not move to be fully pro-managerial in takeovers because the federal government was either pro-takeover (the SEC and the executive branch generally, and the judiciary until *Schreiber* and *CTS*) or moderate (Congress via the Dingell-Markey middle-of-the-road bill that would have barred key defensive measures like the poison pill). So Delaware hedges and zig-zags. *Unocal* validates only "proportionate" defensive measures. *Moran* allows the pill to ward off coercive bids and says a close look on "yanking the pill" will be had, and *Revlon* then promulgates tough auction rules. Then in the late 1980s the federal players leave the scene. First the courts with *CTS*, then Congress, and eventually the SEC. By the 1990s, drafters of state anti-takeover legislation were appointed to the SEC, and the toughest pro-takeover commissioners had left. *Time-Warner*, close to the "just say no" decision managers and their lawyers wanted, came down in 1989, and still stands, partly because the Federal pressure to push it back is gone.

---

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

[183] See Coffee, supra note 108 & accompanying text.

And then in the 1990s Delaware can breathe free from federal pressure, which by then was weak relative to its weight in the rest of the 20th century. Congress, after it abandoned a takeover law project by late 1990, was quiet. The SEC had few new initiatives after the 1992 proxy reforms. Conservative courts were deferring to the states, not using securities law to expand federal governance authority. Delaware could garner more of the reincorporation business as federal incorporation (the 1970s issue) and federal pressure on takeovers (the 1980s issue) were both off of the table. The data show an accelerating trend in Delaware garnering the reincorporation business.[184]

But that era came to an end with Enron. With the Sarbanes-Oxley Act, the federal authorities are back in motion, and Delaware has every reason to once again be conscious of the possibility, and already in several dimensions the reality, of ouster and federalization. One would expect Delaware corporate institutions to start to get "tough" with insiders, controllers, and incumbents just as they did in the late 1970s and early 1980s. And maybe we can already see Delaware moving, with every fiduciary duty decision in Delaware's Supreme Court going against managers since Sarbanes-Oxley passed.[185]

V. EUROPE

Two important initiatives have moved the race theory from the American to the international stage. In Europe, the *Centros* decision, the most famous corporate decision to come out of the European Union, sets Europe up for an inter-jurisdictional corporate race, one between the EU member nations. The European analysis focuses on the parallels to the American race debate,[186] with some looking, or hoping, for a race to the top, and others fearing a race to the bottom.

At the same time, an academic debate has erupted in the United States on whether securities law should be governed by a race—i.e., whether to allow an American issuer to opt to be bound by French securities law, without moving to the jurisdiction or issuing securities there.[187]

---

[184] Bebchuk & Cohen, supra note 176.

[185] See *Director Liability Warnings*, BUSINESS & SECURITIES LITIGATOR, Feb. 2003, at 12. See also [Disney decision.], Cf. Lawrence Lederman, Robert S. Reder & Gene Boxer, *A Blow for States*, THE DAILY DEAL, Oct. 25, 2002: "Perhaps [In re] Pure Resources [2002 WL 31300797 (Del. Ch. Oct. 7, 2002) is the Delaware court's] effort to regain some momentum for the state in corporate governance … by incorporating … federal tender offer regulation … into the requirements for a transaction [that the] state statute does not specifically address." The difficulty here is to sort out whether the Federal gravitational pull explains Delaware's sharp movement, or whether it's solely due to Delaware's perception of the underlying corporate problems.

[186] See the discussion in Eddy Wymeersch, *Centros: A Landmark Decision in Company Law*, *in* CORPORATIONS, CAPITAL MARKETS AND BUSINESS IN THE LAW 629-54 (Theodor Baums, Klaus J. Hopt & Norbert Horn eds., 2000). Cf. Barbara Trefil, *European Company Law: Comments and Meta-comments on* Centros, 2 GERMAN L.J., at ¶7 (Dec. 2001).

[187] Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998); Stephen J. Choi, *Regulating Investors not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (2000); Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998). For skepticism, see Howell E. Jackson, *Centralization, Competition, and Privatization in Financial Regulation*, 2 THEORETICAL INQUIRIES IN LAW 649 (2001); Merritt B. Fox, *Retaining Mandatory*

The European discussions take the American race debate at face value. But the United States does not have, and cannot have, a pure interstate race. So those who look to international competition in securities regulation cannot point to the American race as a parallel, because the transnational securities regulation competition would not have a centralized vetoing institution. And those who analyze the EU's *Centros* debate need to understand that the full parallel brings Brussels—the EU centralized decision-maker—into the picture.[188] If Brussels is effective, defective or ineffectual, then that affects the race. For the Europe and American parallels to be kept, Brussels must be as good or bad as Washington, and be as likely or unlikely to make EU-wide corporate law. Europe has reason to focus as much on having an effective but not heavy-weight Brussels as it should on the fineries of inter-jurisdictional competition. But it is the latter that seems to have thus far occupied analytic attention. The EU structure of a centralized corporate authority that can in principle trump "local" national authorities is in fact the structure—notwithstanding the American rhetoric of state-to-state racing—that the United States has had all along.

CONCLUSION

The reality of American corporate law-making is that if the issue is important, federal authorities either act on it immediately, take it away from Delaware, or threaten to do so. Delaware players have reason to fear that if they mis-step, the federal authorities (congress, the courts, the SEC) will enter the picture. If Delaware players appear to damage the economy, public-spirited law-makers in Washington react. If they offend a powerful interest group too much, and that group lacks clout in Delaware, the group turns to Washington. As such, the United States has not had a pure interstate race.

Even if Delaware *never* reacted to federal action, this federal story would hold, since federal players can, and sometimes do, reverse state corporate law results and sometimes don't bother to wait for state action but regulate directly. A great deal of what is legally important to the corporation is federal not state law. What remains with the states is the corporate law that the federal players tolerate, and what gets reversed is that which they cannot. The structure of corporate law has to be a mixed-federal-state structure, even if Delaware never reacted (though it has). Delaware may say the words, but they only get to do so when the federal authorities do not take away the microphone.

If American state-made corporate law is good, one cannot necessarily conclude that the good result is due to state competition, because side-by-side with any horizontal state competition is the vertical power of the federal government. And if the state-made corporate law is bad, we cannot tell whether the states are mirroring defective decision-makers in Washington.

Securities Disclosure: Why Issuer Choice is Not Investor Empowerment, 85 VA. L. REV. 1335 (1999); Frederick Tung, *From Monopolists to Markets?: A Political Economy of Issuer Choice in International Securities Regulation*, 2002 WISC. L. REV. 1363 (2002).

[188] Cf. Elsa Conesa & Arnaud Leparmentier, *La Commission européenne persiste à vouloir faciliter les OPA*, LE MONDE, Sept. 26, 2002, at 21 (Europe's central authorities more pro-takeover than national authorities).

The instances of federal ouster are just too many to be ignored. Hardly a decade went by in the 20th century without a major shift of corporate law-making, or the threat of one. Federal incorporation dominated the debate in the early 1900-1910 era, and then again in the early 1930s. It came back in the 1970s, mostly in the form of Cary's famous proposal for minimal federal standards. The securities laws in the 1930s took voting away from the states, took insider trading away from the states, and mandated information delivery to shareholders because the states had done nothing about it. In the 1950s, the SEC federalized the proxy contests, making them harder for insurgents, acting even before states acted definitively. In the 1960s, the first hostile takeovers succeeded and Congress sought to impede them with the Williams Act. And specific corporate matters were reversed by federal authorities: the going private rules—the central corporate transaction of its era—were partially federalized and the SEC's actions and rhetoric provoked Delaware to reverse itself; state law allowed selective stock buy-backs and the SEC reversed it; the states allowed voting discrepancies among shareholders but the stock exchanges under SEC pressure reversed them. For a time the circuit courts were turning fiduciary law into federal law, and while that diminished, some still remains. New securities rules in the 1990s obliterated state parallel law by expressly preempting the state. And Sarbanes-Oxley, reflecting Congressional urgency in 2002 to react to the Enron scandals, mandates a host of corporate governance matters, from the power of the audit committee, to management construction of internal control systems, to the micro-details of loans to managers. All these were once provinces of state law.

If states produce good corporate law, we need new theory to explain why. Perhaps that explanation will come from parallels to organizational theory, which recommends separating authority to propose from authority to ratify. Perhaps it will come from a Montesquieu-type separation of powers, checks and balances argument. Perhaps it will come from parallels to organization theory that posits efficiencies from having centralized strategic planners who do not run operations day-to-day, but who give operating executives a budget limit and who stand ready to take over a lack-luster division's management. It will not come from reconstructing the race-to-the-top theory, which just does not describe what is possible in a functioning federal system. If American corporate law is good in the end, its quality may well derive from this vertical organizational advantage as much as, or maybe more than, it derives from horizontal competition among the states for the charter business.

But this theoretical angle on the quality of corporate law is only a possibility, not a necessity. More plausibly what we have just done is undermined the last century of corporate law thinking on the interstate race. There cannot be a pure race such as has been posited if there's a federal system, where the federal player can take the issue away from the states. We live in such a federal system. And the possibility is not theoretical, as every corporate crisis—the stuff that tests the quality of corporate law—raises the threat or the actuality of the issue moving from the states to Washington. The idea of a pure race, comforting as it might have been, is over. We never have had one in the United States. It's just not possible.